Distributing long-term saving policies in a low-saving environment

Lessons from South Africa

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Abstract

South Africa is a middle-income country with the unfortunate status of world leader in income inequality. This brings a number of policy challenges because it requires initiatives to meet a wide range of needs. At present, the country provides a means-tested pension grant, but no supporting mandatory pension system. Large parts of the high-income sector provide adequately for retirement through occupational pensions but the coverage gap for workers at lower income levels is deeply concerning. Individual supplementary efforts to save for retirement are weak.

Long-term insurers have traditionally provided individual-account long-term saving products but have done so at poor value for money, particularly in the event of early termination of the contract. This has not been helped by the high levels of commission payable, under a set of regulatory maximums, to the sales intermediaries of these insurers. Though these commission scales have significantly worsened financial outcomes for policyholders, alternative channels have found it difficult to penetrate the market, in the context of a weak savings culture and low demand-side sensitivity to charges, without similar incentive models.

A number of promising developments have taken place over the last few years. Customer awareness of the damaging impacts of high fees has been supported by published research, consistent publicity of the issue by the press and a number of high-profile rulings by ombudsmen. In the absence of a complete dismantling of the commission scales, a strategy not without its risk, however, the problem largely persisted.

What followed may be described as a dance or chess match between the regulatory authority and the largest insurers, with the representative industry body, under which commission scales were incrementally reduced and regulated maximum fees on early exit forced downwards. The prospects of a positive outcome to the benefit of (nearly) all parties are good.

South Africa's circumstances are perhaps unusual. The lessons learned from this experience may nevertheless prove instructive to regulators and industry players facing a similarly intractable set of challenges, particularly in developing countries.

This paper is about long-term saving, specifically about the challenges of distributing long-term saving products into a market with a poor record of saving. Expensive, inflexible insurance policies came under enormous pressure in the first decade of the 2000s when it became clear that insurers were levying substantial penalties on policyholders who wished to alter the terms of these policies. Charges had to come down. Flexibility for policyholders had to be improved. The need for regulatory intervention was triggered by a rapid deterioration in consumer confidence in these products.

But this paper is also about the response of the regulator. This was a time in which treating customers fairly was a relatively new concept and the supervisory authority was not sufficiently prepared (or mandated) to manage market conduct risk. It was not sufficient merely to tell insurers to change; this telling needed to be supported by a process of adjustment in other parts of the market, at least partly driven by the regulator. A combination of direction, coercion and moral suasion was called for. The process is ongoing but has indeed borne fruit, in the interests of customers and the industry as a whole.

Driving change in any regulated space calls for a range of skills, which depend on the culture and political economy of the environment concerned. Still, a purely directive style, even in the midst of a crisis of public confidence, seldom produces the levels of competitive cooperation required for sustainable long-term outcomes that are in the best interests of customers. It is hoped that this paper, built around a story of regulatory development, might prove useful to others with responsibility for driving industry-wide change in financial services.

1. Context

This section provides context for the discussion that follows on long-term saving products. It describes the broader economic and social environment and the nature of the financial services industry within which these products are provided.

1.1 Demography and economy

South Africa is a young democracy. Nelson Mandela was released and the ban on the African National Congress (ANC) lifted in 1990. Multi-racial elections were held for the first time in 1994. Promises by the ANC government to redress the injustices of the past have proved difficult to deliver on, particularly within the constraints of international financial markets.

South Africa remains one of the most unequal countries in the world. The United Nations Development Programme Human Development Reports put South Africa at close to the worst, citing Income Gini coefficients from the World Bank World Development Indicators for 2013. In this respect, it finds itself in company with much less populous counterparts of Namibia, the Comoros and Seychelles. South Africa's inequality rating is now significantly worse than erstwhile companion on the rankings, Brazil.

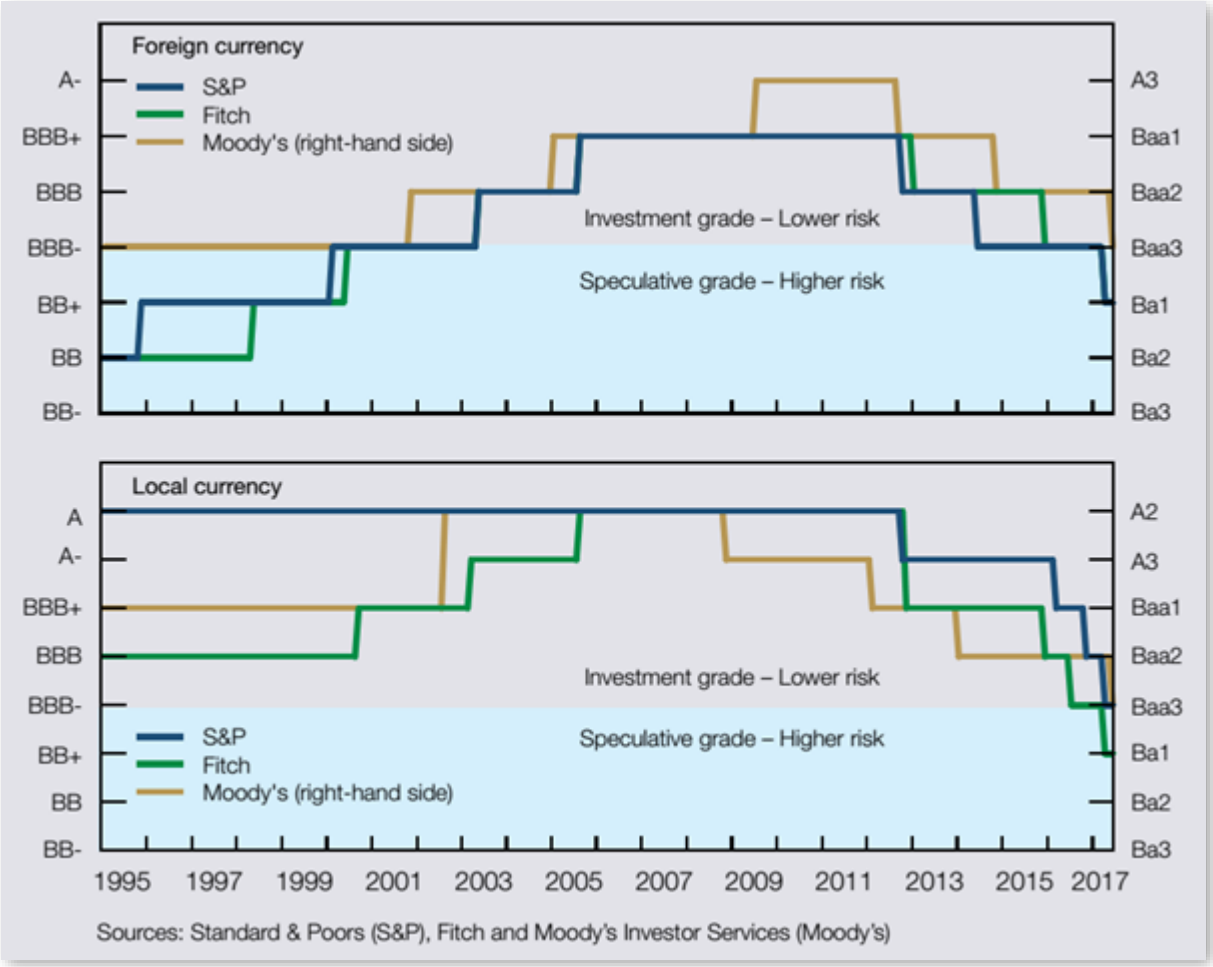
Despite policies of redress that include an extensive system of social grants, a broadly successful roll out of basic free or subsidised housing and utilities, and policies to improve equity in the workplace, South Africa's inequality still includes a considerable racial overtone that frequently

finds voice in political discourse. The country's very poor initial response to the AIDS epidemic, for example, disproportionally affected Black African residents. Among those aged between 15 and 24, the country still has the world's fourth highest incidence of HIV and AIDS, exceeded only by neighbours Botswana, Lesotho and Swaziland (Population Reference Bureau, 2015).

South Africa is an outlier on inequality tables, but in other respects, it tends to lie in the middle of rankings. Its population numbers 55 million, which makes it a medium-sized country by global standards. Falling fertility and mortality rates put South Africa somewhere between developed and developing counterparts in broad demographic terms. The share of the population aged 65 or more is 6 percent, higher than African counterparts but considerably lower than many other parts of the world. GNI per capita (2014) of USD12 700 also marks South Africa as middle-income, though this hides the income inequality and high rates of poverty (Population Reference Bureau, 2015).

Diligent efforts in the early years of the democratic era to convince financial markets to support the South African project appeared to bear fruit. This was not always translated into strong economic growth as policymakers spent, necessarily, on poverty alleviation and infrastructure

Figure 1.
South Africa's Sovereign Credit Rating over time



Source: South African Reserve Bank (2017)

development. The diligence characterising the first ten or fifteen years since 1994 has more recently been somewhat undone by the ambiguous economic policies and questionable political decisions characterising the era of the Zuma administration, from 2009 onwards. Figure 1 shows both phases of South Africa's economic position, through the eyes of the rating agencies.

Overall, while a number of social indicators show strong progress, economic performance has been disappointing (Figure 2). South Africa failed to take advantage of the resource boom preceding the global downturn of 2008 and 2009. Though the country weathered that storm reasonably well, economic performance since then has been anaemic.

High levels of government expenditure on social services may have been one of the contributors to poor economic growth, but it has not materially addressed the income-inequality problem. Unemployment, moreover, a stubbornly persistent South African problem, was recently reported at 27.7 percent, a 13-year high (Statistics South Africa, 2017).

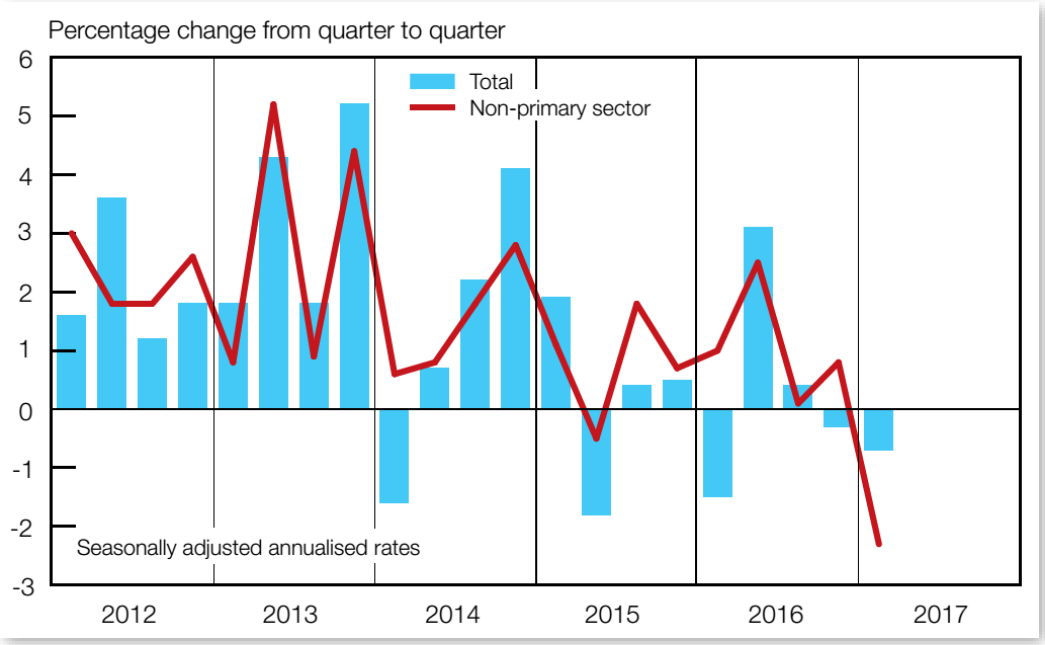
National statistics do not tell the whole picture in this country of (at least) two parts. Notwithstanding the commitment to social services and to labour protection, a broadly liberal economic policy has sustained a strong, innovative services sector.

In one significant respect, however, the sector has failed to attract customers. South Africans are notoriously poor at saving. Gross household saving has hovered at between one and two percent of Gross Domestic Product (GDP) for the last few years, currently 1.3 percent (South African Reserve Bank, 2017), well below the corresponding rates of South Africa's trading partners, particularly in developing countries (Figure 3).

Anecdotal evidence of employees resigning their jobs to access the accumulation in their retirement funds is too widespread to ignore, notwithstanding the personal tax implications of

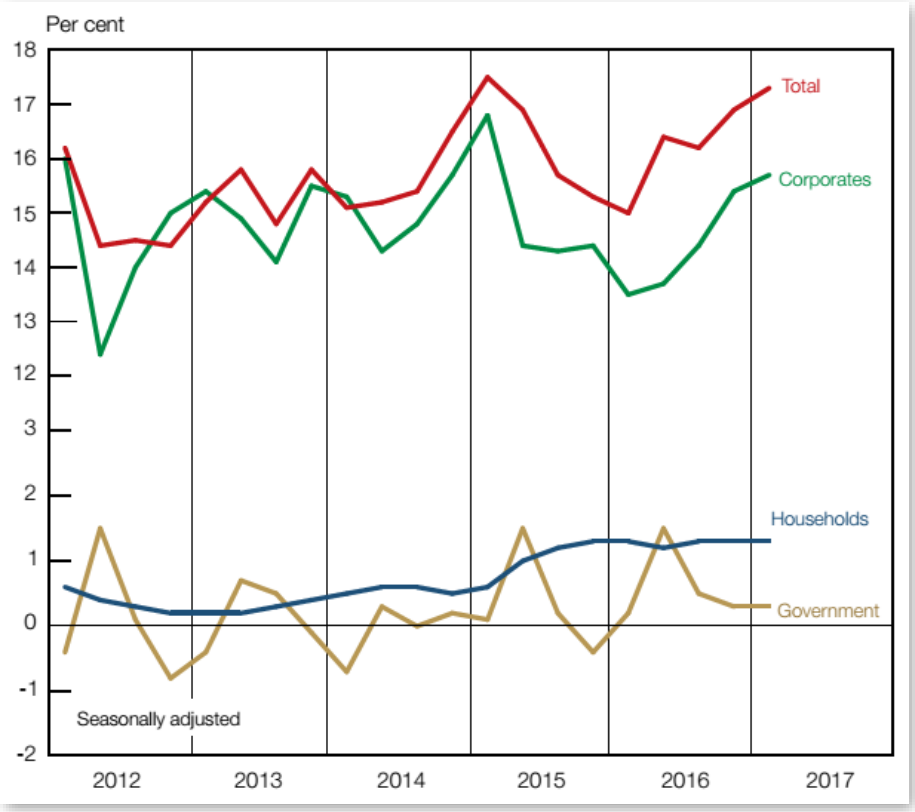
Figure 2.

South Africa's real gross domestic product



Source: South African Reserve Bank (2017)

Figure 3.
Gross saving as a percentage of gross domestic product



Source: South African Reserve Bank (2017)

such actions. Whether or not people are resigning to access their savings, it is clear that the rates at which employees leaving employment cash in their accumulated savings is high (National Treasury, 2012c).

1.2 Pension system

The pension systems of South Africa and its neighbours are somewhat unusual compared with the corresponding systems of its counterparts in other parts of the world. Against the World Bank five-pillar model for describing the elements of the framework for pension provision, the South African model displays notable holes.

Pillar Zero, non-contributory pensions

South Africa's old age grants, which form part of a wider framework of social security funded from general government revenue, is means-tested but in practice nearly universal. The level of the pension, ZAR1 600 (USD125), is generous compared with countries in the region, and costs some 1.72 percent of Gross Domestic Product (GDP) to provide, also much higher than its neighbours, with the exception of Lesotho (Guven & Leite, 2015).

Research consistently shows the effectiveness of grants, in the hands of the elderly, at alleviating the effects of poverty on younger generations, particularly grandchildren (Case & Deaton, 1998,

Duflo, 2003, and Neves *et al*, 2009). The costs of providing this and other grants, as a proportion of GDP, is nevertheless rising.

Pillar One, mandatory, national, contributory system

The World Bank allocates mandatory, contributory pension systems, run on a national basis and frequently with an element of redistribution, to what it calls Pillar One arrangements. Along with neighbours Namibia, Botswana and Lesotho (but no longer Swaziland), South Africa does not require workers to contribute to a national pension system.

Considerable discussion has led to a succession of policy proposals characterised by high levels of agreement regarding the imperative to provide such coverage and the broad principles along which it should be designed.[1] Little progress has been made, however, on agreeing the design of the system, let alone on plans for implementation.

Pillar Two, mandatory, decentralised contributory system

A number of countries require workers to contribute to schemes established on a decentralised basis, administered by private-sector entities, often with limited or no redistribution. A number of South Africa's workers contribute to retirement fund arrangements, but this is not on the basis of a government mandate. Some of the alternative designs under consideration by policymakers combine elements of Pillar One and Pillar Two-type contributions.

Pillar Three, voluntary retirement saving

In countries with a combination of Pillar One and Pillar Two arrangements, Pillar Three is usually considered a form of supplementary saving. In those cases, such saving is usually at the behest of an individual rather than a group. In South Africa, Pillar Three saving is central to preparation for retirement by middle- and upper-income workers, and many of their lower-income counterparts.

Contributions to retirement funds in South Africa attract tax rebates. To do this, the funds must be registered as official retirement funds and meet a number of conditions. Retirement funds are legal entities independent from the employer paying contributions into them, managed by what are known as boards of trustees, though in fact they are not subject to trust law. The trustees have a fiduciary responsibility to the fund and to the members of the fund (Mort, 2014).

In South Africa, occupational arrangements number in the thousands. These vary from the Government Employees Pension Fund, with over 1.6 million active or pensioner members, to the many smaller funds and a growing set of arrangements structured for multiple employers, referred to in local parlance as *umbrella funds*. In the absence of comprehensive reform of the old age system, let alone of the wider system of social security, the National Treasury has been driving a series of incremental reforms to the pension fund environment,[2] with limited success.

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[1] *See Commission of Inquiry (2002), Department of Social Development (2006 and 2007), National Planning Commission (2012) and National Treasury (2004 and 2007), for example.*

[2] *Refer to National Treasury (2012a, 2012b, 2012c, 2012d, 2013a and 2013b) for more information on the thrust of these intended reforms.*

Possibly the most important of these reforms is a prohibition on members accessing accumulated retirement saving prior to retirement. They may currently do this on termination of employment. Trade Unions have resisted such a change on the basis that their members frequently experience financial hardship and should not be prevented from accessing assets that they regard as belonging to them under these circumstances.

Another element of the Pillar Three framework must be identified. Individuals may deposit contributions into an arrangement known as a Retirement Annuity Funds (RAFs), the subject of this paper. These entities are described more fully in Section 2.1.

Pillar Four, informal, household and other non-cash transfers

Informal transfers play a significant part in sustaining South Africa's elderly. The relative generosity of the grant in the context of high poverty means that financial flows within families often go the other way.

Research nevertheless suggests that one of the reasons that low-income South Africans do not save for the long-term is that they prefer to put spare income into tangible assets like building material, in time developed into a source of income and later a home. Individuals surveyed as part of the research also suggested that the financial products available to them were not widely taken up because they were not regarded as suitable to their needs (Genesis, 2008).

The ILO perspective

The discussion thus far describes the system of providing for South Africa's elderly in terms of the World Bank model. The International Labour Organisation (ILO) has embedded in its minimum standards for social security provision a set of contingencies that citizens are expected to be protected against. One of these is old age.

The International Social Security Association (ISSA, 2015) maps African countries to a framework of mandatory old-age income security programmes, by type. The large majority of these countries are described as providing mandatory earnings-related retirement income. This is misleading. In practice, the proportion of the working-age population covered by such arrangements is very low, in the large majority of cases below 10 percent (Dorfman, 2015).

South Africa stands out as one of few that does not provide an earnings-related income benefit. Its benefit is instead described as means-tested. The word "mandatory" in this context is also slightly misleading because participants do not contribute to the arrangement.

South Africa's social security programme is otherwise good, though not comprehensive. The ILO (2011) expresses the view that the country still lacks a comprehensive social security system, pointing to holes in health-care coverage and the inadequacy of protection for the many unemployed, notwithstanding the existence of the Unemployment Insurance Fund.

Concluding comments

South Africa's combination of Pillar-Zero and Pillar-Three provision exacerbates the sense of a binary economy addressing the needs of the poor and the wealthy reasonably well, but not those many working-age individuals caught somewhere in the middle. The absence of Pillars One and

Two increases the importance of ensuring that the market for voluntary provision works effectively. For those who do not have access to an occupational retirement fund and for whom the old age grant will be insufficient to sustain an acceptable lifestyle in retirement, these RAF products are all that they have to prepare for retirement.

The discussion turns next to a description of the supply side of the market.

1.3 Insurers and investment managers

South Africa has an advanced financial sector, not just by developing-country measures but by any standards. The sector includes banks, insurers, retirement funds of various types, asset managers, a stock exchange and a wide variety of equity- and debt-based investment classes and derivative products.

The country's banks are soundly regulated by the South African Reserve Bank (SARB), which lists ten locally-controlled banks alongside a number of foreign-controlled competitors. Four banks are dominant, one of them a subsidiary of Barclays PLC, and the others locally controlled. A fifth is rapidly gaining ground among emerging middle-income customers. A sixth looks after a very large number of small accounts, as the bank responsible for hosting the accounts into which social security grants are deposited.

The supervisory authority of non-bank institutions, the Financial Services Board (FSB), lists over 170 long- and short-term insurers and reinsurers. The market is dominated, however, by five or six long-term insurers, roughly the same number of personal-lines short-term insurers, a scattering of specialist short-term insurers offering corporate lines business and four or five reinsurers, all of which are subsidiaries of international parent companies.

Insurance in South Africa goes back to 1845, when Old Mutual was founded. Others followed over the course of the 20th century, but consolidation has limited the number of substantial insurers to the five or six referred to earlier. All of them offer a full range of products and all have an ownership relationship with a bank. Many of them also offer short-term insurance products. Most would now describe themselves as broad-based financial services companies.

While life- and health insurance products are broadly profitable and are sold both to individuals and to employed groups, most of the large insurers are focused on the acquisition of assets. Some growth in index-linked product types is emerging, but investment management remains a highly profitable business for those entities that are able to gather sufficient assets to achieve good scale. Customers are not particularly sensitive to price. This helps to explain the importance of RFA products to these insurers. As scale is an important part of the business model for asset management, many of the smaller insurers do not offer products involving saving but stick to pure insurance arrangements. This reduces the number of insurers competing for long-term saving business.

Competition for assets comes mainly from specialist investment houses. These entities have historically sought to acquire assets through individual collective investment offerings or by providing specialist services to pension funds. Some of them have registered insurance licences

and are indirectly competing with the insurers, but only in the investment space, not by offering life- and health insurance as well.

Notwithstanding the fiercely competitive landscape, new entrants have shown that there is space for innovation. Some of these have gained a decent foothold in the market, the majority by providing pure insurance at first and moving later into investment products.

1.4 Regulatory framework

South Africa has separate supervisory authorities covering banks and non-banks, respectively the SARB and the FSB. This is subject to imminent change. Under the new structure, referred to in South Africa as a *Twin Peaks* regime, all prudential regulation will fall under the SARB and market conduct under a reformulated (and renamed) FSB.

The FSB, as it currently exists, is the autonomous supervisory authority responsible for overseeing all financial entities except banks. It operates through a Registrar and a set of Deputy Registrars, each of which has not only legal responsibility for exercising supervisory jurisdiction over a part of the market, but also administrative duties over the corresponding part of the supervisory authority.

The main parts of the market covered by these Deputies are:

- long- and short-term insurers,
- retirement funds,
- capital market institutions, and
- intermediaries.

Each part of the FSB raises funding through levies on the entities that it supervises, retaining financial independence from government. Accountability to Parliament is effected through the Ministry of Finance, the National Treasury.

A number of support services are provided by the FSB, among them enforcement and consumer education. The FSB has the capacity to receive complaints from consumers but it does so mainly to gain insights into the entities that it is responsible for supervising.

The primary channel for redress to consumers is not the FSB but a series of Ombudsman offices, among them the Ombudsman for Long-term Insurance and the Pension Funds Adjudicator (PFA). These offices also raise funds through levies, typically calculating these levies to reflect in some way the mix of complaints received in respect of the products or services of each entity falling under the purview of that office.

2. Time lines

Having outlined the nature of the South African market, the discussion that follows describes the sequence of events undermining consumer confidence in long-term saving products, leading to government intervention. Section 2.1 starts by describing the retirement annuity fund (RAF) product that is central to the case study.

2.1 Product types

An RAF is established as a registered retirement fund, with the same governance infrastructure as an occupational fund. Its only assets, however, are

- the insurance policies that it purchases from an insurer on behalf of a member, or
- the ring-fenced assets of an investment manager, also purchased on behalf of the member of the RAF.

Insurer-managed RAFs have been in existence for some time. Typically, the insurer establishes the RAF framework, appoints the trustees of the fund and designs the products that the fund invests in, on behalf of its members. To the customer, the arrangement looks like its counterpart outside of the pension framework, the long-term endowment policy. He or she may choose to add life or disability insurance to the plan and frequently has a great deal of scope to vary the investment strategy of the policy. These arrangements lie on the bridge between pension funds and insurance, and are subject to both sets of regulatory requirements. The narrative that follows suggests that the significance of this dual regulatory framework was largely missed by the insurers.

An RAF may also be offered by an investment manager. In this case, the fund purchases assets, on behalf of the individual member, managed by the investment manager. Again, typically the investment manager establishes the retirement fund for the purpose of adding to its customer base and assets under management. As for insurers offering RAF products, conflicts of interest exist between the role of the asset manager as provider of product and the corresponding role as a trustee of a retirement fund providing impartial management on behalf of the member. As described in the sections that follow, the extent of this conflict is generally lower than for the corresponding conflict for the sponsor of an insurer-established arrangement.

Three further points must be made about the context within which RAF products are sold. The first of these is that these policies were sold as long-term saving arrangements but marketed as savings arrangement. They were typically also sold with projected maturity values that resembled telephone numbers. This established the sense in the policyholder of a personal account.

The second point is that what distinguishes these products from equivalent alternatives outside of the RAF is that contributions to the RAF attract tax incentives. As these incentives take the form of an offset from income tax, they are very attractive to higher-rate taxpayers, particularly those who do not make contributions to an occupational retirement fund. (Tax incentives on retirement fund contributions have recently been subject to an annual cap, slightly reducing this impact.) One of the consequences of the tax incentives is that savings cannot be accessed prior to a specified age. Customers were nevertheless led to believe that alternatives could be made to their insurance policies without undue consequence.

The third point is that, as in many countries, insurers are permitted to pay commission to intermediaries under whose advice customers purchase their products. Unlike most other countries, however, commission is subject to maximum limits. Typically, at least until the last 10 years or so, insurers paid commission to intermediaries, employees of the insurer or independent, at

the level of the maximum. In line with these regulated scales, commission was payable largely up front, three-quarters at policy inception and the balance on the first anniversary. Policies with longer terms to maturity, more profitable to the insurer, attracted higher commission under these scales. Commission could be clawed back from the intermediary only if the policy were lapsed in the first two years from commencement.

Commission was also payable on the RAF arrangements issued by investment managers, but this was paid, at lower levels, largely on an ongoing basis, with a very small additional amount – an administrative fee really – payable up front. Simply put, intermediaries had a substantial incentive to recommend the insurer-offered RAF over the alternative offered by the investment manager. For many years, in fact, it was little known that investment managers offered RAF products at all.

2.2 Research on charges

Rusconi (2004) describes an analysis of fees and charges across a range of South African retirement funding vehicles. The research divided these vehicles into the three types broadly available, occupational retirement funds, RAF products offered by insurers and RAF products offered by investment managers in vehicles then known as unit trusts.

Charges were assessed by modelling the lifetime impact of these fees, assuming a disciplined saving pattern throughout a typical working life, on the retirement benefits that would have been received were there no fees at all. The models used also determined the equivalent annual charge, expressed as a percentage of assets under management, that would have had the same impact. A number of international pension systems were described. The calculated results for the three parts of the South African system were assessed against the figures available under their international counterparts.

The results of the analysis were expressed as ranges to allow for the uncertainty of outcomes that an individual might experience in any of these three vehicles, even assuming a diligent pattern of saving. This uncertainty was largely attributable to differences in the asset management fees that would result from alternative choices of assets. Even so, it was clear from the research that, while not all occupational retirement funds or collective investment vehicles were cheap, charges levied by the insurers managing RFA products were unambiguously high, by any standard.

The paper attracted an unusual (and unexpected) level of publicity. One particular journalist, with a career focus on personal finance, picked up on the results and used them as the basis for key articles for a number of weeks after release of the paper. This in turn attracted the attention of policymakers. The paper was presented and discussed, late in 2004, at a sitting of the Parliamentary Portfolio Committee on Finance. This is the body of lawmakers responsible for monitoring developments in the financial services industry and setting direction for policymakers at the National Treasury to implement. The sitting attracted further adverse publicity to these products, the insurers selling them and the intermediaries advising customers to purchase them.

2.3 Legal rulings

The real blow to public confidence came with first one and then a string of rulings by the PFA. These were issued over the course of 2005. The PFA did not rule that the fees under the products

were unduly high. (He was unlikely to have had the legal authority to do so.) He ruled that, on early termination of the policy, the penalties levied by the insurers against the nominal value of the policy were unreasonable and had been inadequately disclosed.

These penalties make sense to an actuarial mind, considering the conditions under which the policies were written. A long-term saving policy is issued for a fixed term with fixed terms and conditions, often with pre-determined increases to contribution levels. Significant cost is incurred both at time of sale and in administering the products thereafter, but mostly at time of sale, and mostly because commission is payable up-front with no opportunity to claw it back from the intermediary except where the policy is lapsed within two years of sale.

The policy was sold to make a certain profit, or at least to break even. Insurers reasoned that, should the policyholder unilaterally break the agreement, they had the right to recoup their expenses (and in many cases, profit as well) at the time of the change. This was in fact the established practice at the time. Policy documents most likely expressed the rights of the insurer to take such an action. It is safe to say, nevertheless, that disclosure of the pertinent charges, and the impact of termination of the policy or any changes by the policyholder that had the effect of reducing the expected profit to the insurer, was broadly inadequate.

This was indeed the view taken by the PFA. He ruled that, notwithstanding any legally protective disclosure in the policy document, the policyholder had not been adequately informed of the consequences of any changes to the policy. A large cut to the nominal value of a long-term saving policy resulting from a small reduction to the term to maturity, or to the premium, even just a removal of the automatic inflation-related increase to the premium, was regarded as unreasonable. Insurers were instructed, in each of these cases, to compensate policyholders for perceived damages.

Some of the insurers challenged the jurisdiction of the PFA over these cases, claiming that the issue at hand was the terms and conditions of a contract offered by an insurer to a customer and had nothing to do with retirement funds. This was quickly dealt with. That the insurers were caught unawares both by the paper and subsequent rulings by the PFA was an indictment on their awareness that they were offering pension fund products, financially supported by the tax incentives provided by government.

The personal finance press ran story after story as cases came to light. Terms used by journalists like “confiscatory penalties” added fuel to the fire.

2.4 Policy intervention

With each fresh decision by the PFA, the pitch of negative publicity against the insurers grew. The need for rapid intervention by policymakers became increasingly evident. Such intervention had in any case been under consideration, as part of initiatives to reform the system of retirement provision (National Treasury, 2004). These events increased the urgency with which such intervention might be called for.

Insurers argued that they were justified in implementing the penalties implicit in the design of their products. They suggested that the commission scales were a part of the problem, claiming

that it would not be possible to sell the product at a lower rate of commission and that these costs were justifiably recouped when the policyholder altered the contract.

They nevertheless understood the precariousness of their position and the wrath of policyholders, as expressed in one of the opening paragraphs of the agreement soon reached:

> *"… Whereas the members of the long-term insurance industry… recognise the problems highlighted by the Pension Funds Adjudicator (PFA) with respect to the lack of transparency of costs and charge structures, with the result that the expectations of consumers in respect of the net returns from retirement annuity fund member policies and other savings policies have not been met, particularly in the context of early premium cessation…" (Statement of Intent, 2005, paragraph 1, preamble)*

While the accumulated savings under an RFA product could not be withdrawn by policyholders, and insurers had firm prohibitions on transferring these to another retirement fund, unhappy policyholders were experiencing the same problems under equivalent products outside of the tax incentive system, the endowment products, and these certainly could be surrendered. In the meantime, insurers were battling with the deluge of complaints from their policyholders.

The office of the PFA was also having to manage high volumes of grievances. These threatened to drown out the corresponding legitimate concerns at the Office of the PFA by members of other types of retirement funds, occupational arrangements, for example.

Government, of course, also had an interest in addressing the concerns raised by these penalties and restoring confidence in insurers in particular and in the financial services industry in general. Discussions were held with insurance leaders and a pragmatic decision was reached. This was disclosed in the so-called *Statement of Intent*, late in 2005, under which insurers agreed to limit the charges levied against policies that were altered or terminated, to stipulated percentages of the nominal value of the policy at the time. At 35 or 40 percent of this value (depending on the type of policy), these limits still appear high, but they were designed to put a stop to the potential panic and give to the PFA objective boundaries within which to work.

Parties to the agreement also addressed the sticky issue of retrospective changes to policy terms. This is frequently the most vexing question in the context of compensation to customers: how far back must investigations go? Insurers were required to investigate all similar changes to policies going back to 1 January 2001. Painful as this must have been, at least a starting date for such investigation had been agreed. All participants agreed – and policymakers emphasised – that these limits did not represent the end of the process of change.

The spirit of the agreement was later expressed in a Directive issued in 2013 by the FSB, with the benefit of hindsight:

> *"The Statement of Intent signed between the Minister of Finance and the long-term insurance industry in December 2005 recognised that in the past the lack of transparency of charge structures resulted in the reasonable expectations of policyholders in respect of net returns from contractual savings products (particularly in the context of early premium reduction and cessation) not being met. As a result, the industry, in the Statement of Intent,*

> *committed itself to not deducting charges in excess of agreed measures for contractual savings products on the occurrence of certain contractual events prior to the completion of the policy term." (FSB, Directive 153.A.i, 11 October 2013, paragraph 2.1)*

Rough calculations by the insurance industry at the time put the value of these limits at approximately R3 billion (of the order of USD300 million), an impressive number but not detrimental to any of the market participants.

3. Regulatory development

A crisis of public confidence had been averted and a stopgap put in place. This imperfect measure had next to be used in the pursuit of long-term policy objectives. The discussion that follows aims to describe the sequence of regulatory changes and the ultimate outcome that they sought to achieve.

3.1 Political agreement

It is tempting to describe the events of the next few years as a choreographed masterpiece of policy development. This would be simplistic and unfair, not least because the response of the participants of a market to any regulatory change, no matter how small, is not known in advance.

What was clear was that a complex set of changes was required. It was clear as well that attention to customer needs had been lacking up to that time.

Policyholders

Customer confidence needed to be restored. It is in the long-term interest of most market participants to foster the confidence of customers and potential customers. A great deal would be required to achieve this.

- Products needed to be designed with the interests of customers at heart.
- Fees needed to be reduced and product flexibility improved.
- Product disclosure needed to be enhanced so that potential policyholders understood what they were signing up for.

Their focus was supported by the early stirring of a revolution in attitudes to customers. The Treating Customers Fairly (TCF) framework, at the time under implementation in the United Kingdom following a number of mis-selling scandals in that country, emerged as a promising possibility for addressing market conduct concerns in South Africa. The FSB took the opportunity to signal the coming of the TCF revolution to the market.

Intermediaries

Frequently caught in the middle of a blame game with insurers, intermediaries recognised that they probably had the most to lose. They were already feeling the pressure of the rapidly intensifying requirements associated with the Financial Advisers and Intermediary Services (FAIS) Act, which sought to professionalise the sector. The FAIS Act imposed on intermediaries a set of

entrance examinations and considerably increased requirements of documentary evidence covering all advice provided.

Notwithstanding the pressures that intermediaries were already under, the real threat at the time was of a significant cut to commission scales.

Insurers

Insurers were calling for such cuts, arguing that to impose the limits put on them through the Statement of Intent without cutting commission scales was unreasonable. They were of course free to reduce the commission payable on these products without any action from the policy-maker. They were hoping that a change in rules would save them the difficult possibility of stepping out of line from their peers in the remuneration payable to their distribution channel.

3.2 Regulation

The policymaker had announced at the time of the Statement of Intent that further action would follow. This duly happened, though not as quickly as might have been hoped.

Stage One: confirm the agreement

The first step was to convert a political agreement into Regulation. This was more difficult than expected. As often happens, an agreement arrived at under pressure proves flawed with the passage of time. The insurance policies to which the agreement was subject were defined as part of the Statement of Intent, for example, but this definition was imperfect. This left outside of the terms of the agreement a number of cases that should perhaps have been included. As a second example, voluntary increases on policies were inadvertently excluded from the terms of the Statement of Intent. This produced an unanticipated continuation of high charges on so-called *causal events*.

Regulations were promulgated late in 2006, tidying up a number of the rough edges and confirming required practice in areas of continued uncertainty, particularly the terms of the mandate to compensate policyholders in respect of past causal events. The opportunity was not missed to act on the signal sent at the time of the Statement of Intent that further cuts to change limits would follow. The terms of compensation for all policy changes from 1 January 2001 to the (near future) date defined by the Regulations were as set out in the Statement of Intent. For all causal events taking place after that date, 1 December 2006, however, a lower set of limits applied.

A clear message was being sent to insurers: further pressure was to be put on these charges. It was clear that these regulations were just part of a longer process. A coordinated set of changes was likely to address the concerns of all participants.

Stage Two: facilitate market change

In 2009, the regulations were further updated. In this case the changes were considerable. The limits on causal event charges were substantially lower. The limits allowed under the Statement of Intent and 2006 regulations were between 30 and 40 percent of the value of the policy, depending on the type of policy concerned. The new limits were 15 percent of the value of the policy at the time of the change, plus a limited administration charge.

However, the new limits applied only to policies issued from 1 January 2009 onwards. A much lower set of maximums on the commission payable for investment products issued from that date onward was designed to dovetail with the limits on causal event charges. The assistance requested by the insurers had been given.

This ushered in a new era for RFA and other investment products. Commission scales brought insurer-provided products more closely in line with their counterparts offered by investment companies. Disclosure was improved. Flexibility of design was also improved. Customers understood their products better and confidence in the industry was largely restored. A good deal of work remains to improve standards of disclosure and the quality of advice provided to customers.

3.3 Complications

Those who, having adjusted to the new market dynamics introduced by the 2009 regulations, thought that change was at an end, were rudely awakened by the emergence of another complication.

The string of rulings of the PFA had never quite been brought to a halt by the Statement of Intent in 2005. Some of these concerned apparent errors in calculation by insurers, or in their interpretation of the sequence of events affecting the value of a policy.

But others were much more complex, as later explained by the FSB:

> *"A number of rulings issued by the Pension Funds Adjudicator have highlighted the unfair and unreasonable practice by certain insurers, where multiple causal events occur in respect of the same policy, to deduct the **maximum** regulatory causal event charge **for each** causal event. This practice is inconsistent with the spirit, intent and purpose of the Statement of Intent and the Regulations, as well as fair outcomes for customers in terms of Treating Customers Fairly (TCF) principles…" (FSB, Directive 153.A.i, 11 October 2013, paragraphs 2.4 and 2.5, formatting altered, emphases in original)*

It soon became apparent that, where customers made two or more changes to their policies, each of which satisfied the regulatory definition of causal event, some insurers were applying the regulatory limits separately for each event rather than considering their impact in aggregate. This meant that, in a number of cases, the limits specified in the Statement of Intent were being breached by the application of the rules in the second and later instance.

It also meant that the sequence of actions by the policyholder had a material impact on the outcome:

> *"… it results in… policyholders who initially reduce and then cease premiums to policies (or where combinations of causal events occur) being in a poorer position than those policyholders who immediately cease contributions, in effect penalising those policyholders who make an effort to keep their policies in force." (FSB, Directive 153.A.i, 11 October 2013, paragraph 2.5, formatting altered)*

The passages quoted are from a directive, an instruction with the force of regulation, issued by the FSB in 2013. The date of publication falls a long time after the corresponding update to the

regulations, 2009. It reflects a period of debate. That there might be a problem with multiple causal event cases was brought to the attention of the supervisory authority soon after the release of the regulations. That insurers couldn't agree on how to resolve it took a little longer.

The FSB had hoped that, with a little persuasion, insurers could be convinced to interpret the regulations, in the event of multiple causal events, in the spirit of the Statement of Intent. Not all insurers saw things this way and the directive eventually had to be issued. The primary purpose of the directive was to clarify the principle that, on second or later causal events, insurers had to make sure that the aggregate impact of charges across such events could not exceed the maximum charge specified in the regulations for a single event.

Would that things were this simple. The directive also emphasises that:

- regulatory limits specify a maximum not a standard charge,
- where charges stipulated under the actuarial basis produce a better result for the customer than the regulatory maximum, these charges had to be used, and that
- where changes to the actuarial basis would have had the effect of worsening the outcome for a customer, the FSB was to be notified of these changes and the reasons for such changes.

Product approval is not part of the supervisory framework of the FSB, so the provision requiring notification of a change to the actuarial basis is unusual. Finally, the directive specified the actions that insurers needed to take where they had been applying the regulations in a manner inconsistent with the directive.

This was not quite the end of the process. Challenges were raised on one or two of the technical details in the directive and a second version needed to be issued a month after the first by way of clarification. In 2016, the FSB undertook a formal review of levels of compliance by a number of the largest insurers with the terms of all pertinent regulations and directives.

3.4 Intent

The expressed intention of the FSB, with the policymaker for financial services the National Treasury, was to drive the fees levied on the so-called causal events lower.

An industry in trouble

Whether life insurance companies were justified in the first place in recovering unrecouped expenses (to express it kindly) or levying confiscatory penalties (as some put it) on these policies, was not really the point any more. The basis on which they were designed was no longer acceptable to the market. The message that went with it, "trust me, I'm an actuary" had lost its currency. Customers rightly expected greater flexibility, better value and improved transparency.

In truth, any such defence was weak. That products had been designed in a different era made no difference. Disclosure of pertinent details regarding fees and the consequences of contractual modifications was poor. It is unlikely that customers even regarded the arrangement as an inflexible contract of very long duration. Products sold in a high-inflation era with significant

increases to premiums could not be sustained when economic or personal circumstances changed. Consequences, however, flowed in one way only, against the customer.

Insurers point to the commission scales as if they constituted a defence. These scales certainly contributed to the problem, commission on long-term arrangements amounting to not much less than the first year of premiums. Insurers claimed that to offer anything less than maximum commission would be detrimental to sales performance.

This defence also cannot really stand muster, for it illustrates two industry wrongs:

- the interests of intermediaries were being put above those of the customers, and
- competition on the basis of price had all but disappeared.

The most startling revelation concerning the research carried out into the overall level of charges (Rusconi, 2004) was that it was a surprise, even to the insurers, that insurer-based RFA products were so much more expensive than South African and international alternatives. Competition on the basis of price was non-existent. Neither customers nor intermediaries understood the fees that they were paying.

Insurers may indeed have been correct to point out that paying less than full commission (and passing the benefit over to customers) would have been disastrous for their sales performance. That this was so, however, represented an enormous indictment of established industry practice.

Driving down the charges

And so, while the stated intention of policymakers and supervisors was to force a reduction of charges on early termination, it was widely understood that this constituted an imperfect treatment of a symptom to deal with a cause. Some insurers were quite clear on this, pointing out that unduly forcing down early termination charges would unfairly penalise customers who held their policies until the date of maturity.

What resulted, then, was a delicate dance of sequenced changes,

- of threats and encouragement,
- of rules and principles, and
- of fee limits and initiatives to improve price competition.

Changes were signalled but opportunity had to be given for insurers to respond to these changes. The rule-maker had to understand the impacts of potential changes prior to their implementation, (for which insights from industry were required) but could not be seen to be cooperating with industry, lest risks of regulatory capture became reality.

Help was available in the growing understanding that customers needed to be at the centre of industry activity: TCF was coming.

3.5 Supporting developments

An unspoken contributory factor to the early termination charges debacle was that the supervisory authority did not have a clear mandate to look after the interests of customers. Its

historically prudential-orientated authority had led it to focus on the financial strength of insurers, pension funds and other financial services entities, but not – except in moments of crisis – on the appropriateness of the products that these entities were providing.

Treating Customers Fairly

The development of the TCF regime was formally launched by the FSB in 2011 in the form of a discussion document (Financial Services Board, 2011). Largely following the lessons learned in the United Kingdom and the corresponding framework under development in that country, the FSB announced the imperative of ensuring that products and services were built and delivered around the needs of customers.

> *"The TCF regime is built around the goal of meeting a number of fairness outcomes. Financial Services entities across a broad range of categories are required under TCF to demonstrate that these outcomes have been met in respect of their customers and to give an account of their proposed approach to any shortfall in meeting these outcomes." (Rusconi & Truyens, 2014)*

These outcomes are the same as those targeted in the corresponding initiative in the UK:

- **Outcome 1: Customers are confident** that they are dealing with firms where the fair treatment of customers is central to the firm culture.
- **Outcome 2: Products and services** marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly.
- **Outcome 3:** Customers are given **clear information** and are kept appropriately informed before, during and after the time of contracting.
- **Outcome 4:** Where customers receive advice, the **advice is suitable** and takes account of their circumstances.
- **Outcome 5:** Customers are provided with **products that perform** as firms have led them to expect, and the associated service is both of an acceptable standard and what they have been led to expect.
- **Outcome 6:** Customers **do not face unreasonable post-sale barriers** to change products, switch providers, submit a claim or make a complaint.

Importantly, they apply to all financial services entities, including intermediaries and banks. This helps to explain the need to rearrange the regulatory framework, on the one hand putting all prudential regulation under one entity and, on the other, ensuring that the market conduct standards of all financial service providers are supervised by a single entity.

Critically, however, market conduct is to be assessed against a set of outcomes. This approach is much more difficult for regulated entities to follow because it implies that the burden of proof of compliance falls to the entities. No longer is it sufficient to demonstrate that a set of actions has been undertaken. Now they must demonstrate that these actions have led to the outcomes sought. This has implications for all aspects of governance, product development, distribution, operations, marketing and customer communication.

Retail Distribution Review

Policymakers had long held the view that, in an ideal world, commission would not be subject to a scale of regulated limits, as indeed was the case in the majority of comparable markets.

> *"South Africa is moving to an environment of mandated portability of retirement products under which commission not paid on an as-and-when basis involves risk to the product provider and intermediary. For all saving products of the life insurance industry the intention is to move to a more favourable environment for the removal of commission caps with the implementation of retirement reform, and to strengthen considerably the extent to which consumers exercise their choices based on all relevant information." (National Treasury, 2006)*

They were also convinced that the market was not ready for de-regulated commission and that the ground had to be laid in a number of other areas. The quality of disclosure and consumer education needed to be improved, for example, and uncertainty around reform of the retirement environment needed to be resolved.

Incremental progress had been made in a number of areas, but a significant step forward arrived with publication of the retail distribution review (RDR), which sought to resolve concerns across the market for intermediary services.

> *"The review was undertaken in response to the fact that, despite the significant progress achieved through the Financial Advisory and Intermediary Services (FAIS) Act in raising intermediary professionalism, improving disclosure to clients and mitigating certain conflicts of interest, significant concerns about poor customer outcomes and mis-selling of financial products remain." (Financial Services Board, 2014)*

The RDR represents a comprehensive assessment of the dynamics of the market for retail products and their distribution. It states a set of outcomes for distribution models that speak of:

- the delivery of suitable products,
- fair access to suitable advice,
- comparability of the nature, value and cost of advice and other intermediary services, and
- enhanced standards of professionalism of financial advice and intermediary services.

Ultimately, the review sought a market characterised by *"… fair competition for quality advice and intermediary services, at a price more closely aligned with the nature and quality of the service"* and *"… sustainable business models for financial advice that enable adviser businesses to viably deliver fair customer outcomes over the long term."* (Financial Services Board, 2014: 1)

Among the 55 proposals is the sought-after goal of the regulatory process in respect of the products covered by this discussion:

> *"Product suppliers will be prohibited from paying any form of remuneration to intermediaries in respect of investment products, and from including any costs associated with intermediary remuneration in product charging structures, whether in the form of ongoing charges or early termination charges. Intermediaries will correspondingly be prohibited from earning any*

> *form of remuneration in respect of investment products other than advice fees agreed with the customer, in accordance with the applicable requirements for such fees.... Where existing investment products are priced to include the cost of commission in product charging structures, product suppliers will be required to demonstrate how they have reduced product charges on products sold after the applicable effective date, in light of the prohibition on commissions." (Financial Services Board, 2014: 52)*

As thorough as the assessment was and as compelling its argument for change, implementation has proved more difficult than anticipated. The proposal to remove commission on long-term savings arrangement and other investment products stands still, but has been scheduled for later enactment, following the corresponding implementation of a number of preparatory actions (Financial Services Board, 2016).

3.6 Way forward

The process of driving regulatory change in financial markets is inherently complex. It is delicate as well because such change does not occur in a vacuum. It is subject not only to the uncertainty of developing, agreeing and passing legislation, and the corresponding advancement of policy in related areas, in South Africa's case the much-needed pension reform.

It is also subject to market developments that are apparently random but part of a pattern or set of signals, a court ruling, a special focus by the press, or an academic paper. Some of these can be dangerous because they might lead to considerable uncertainty, even customer panic. Policymakers, under such circumstances, should be looking not only to stabilise the uncertainty, but to take advantage of these opportunities to drive appropriate change.

4. Lessons learned

A number of lessons may be drawn from the events described in Sections 2 and 3. This is based on the limited lens of a set of events covering a rather narrow segment of the market, so should not be considered a comprehensive description of policymaking or regulatory concerns. It is nevertheless hoped that the insights gained might be helpful to counterparts in other jurisdictions facing problems with similar attributes, particularly where concerns emerge rapidly, undermining customer confidence in a marketplace.

The thoughts that follow are grouped under three clusters. These cover

- the process of policy and regulatory development,
- the nature of relationships between supervisors and the entities under their responsibility, and
- the importance of working with sound information concerning the needs and understanding of customers.

Some overlap between these categories is unavoidable.

4.1 Policy development

In the trauma of a serious market disruption, it is most important for policymakers and supervisors to **have the end goal in mind**. That way, they are in the best position to respond to the unfolding events not only with the steady calm that markets need, but they have the best chance of steering the discourse in the direction most conducive to achieving this end goal. Of course, achieving this requires that work of sufficient quality and diligence has already gone into the process of shaping this end goal, within the context of a broader policy framework.

Developing a sound end goal requires **cooperation with policymaking counterparts in related entities**. The same is true in the midst of a crisis. Supervisors and policymakers must strive, in the midst of difficulties, to use relationships with these counterparts as constructively as possible. This enhances the possibility that all perspectives are taken into account and improves the probability of an eventual outcome in line with longer-term objectives.

Notwithstanding the pressure to act quickly, decision-makers should work hard to **understand the impacts**, in the short- and long-term, of alternative responses to the problem. This applies to all policy- and supervisory development, of course, but is particularly important, in the midst of a problem, when the stakes are high but often overstated. This points also to relationships with supervised entities. These relationships might be very helpful in improving the understanding of the manner in which product suppliers and distribution channels might respond to change. It is also helped by a soundly-informed understanding of customer need.

Finally, policymakers and supervisors should consider carefully **the balance between rules and principles**. It is tempting, in time of pressure, to implement rules. As the experience laid out in this narrative shows, rules developed under duress frequently prove inadequate to cater for the wide range of circumstances experienced in practice. If principles exist, then authorities should consider reminding supervised entities to make decisions within the framework of these principles; if they do not, consideration should be given to the principles that should guide the policy response to the problem identified.

4.2 Relationships with supervised entities

Relationships between those responsible for supervising a marketplace and those who manage the supervised suppliers can, of course, be dangerous, potentially producing conflicts of interest and contributing to the risk of regulatory capture.

The following lessons for policymakers and supervisors might be learned from the South African experience in this regard:

- **engage actively** with key members of regulated entities, building a wide base of opinion, but
- ensure **excellent records** of all discussions to ensure that messages are clearly understood and the possibility of inappropriate influence minimised,
- **engage with industry bodies**, by all means but, wary of the dangers of lobby, **meet with individual entities or other interested parties** as well, to ensure that minority views are understood,

- **send strong signals** to the market as early as possible, consistent with the intended end game, even where details are not at that stage available,
- work hard to ensure a sound **focus on market conduct**, so that customer interests are consistently upheld, and
- foster available opportunities to encourage **competitive behaviour on the basis of customer-centricity**.

The goals that policymakers have for the financial markets under their care are met primarily by the appropriate decisions and actions by the leaders and staff of supervised entities.

4.3 Customer need

Possibly the most common error of policymakers, though frequently also of product suppliers, is failing to **understand the wants and needs of customers** in sufficient detail. Policymakers are encouraged either to invest in or to encourage deep resourcing into understanding the perspectives of customers on the problems at hand. A crisis is seldom the best time to do this, so it would be better if investment in understanding market desires and perceptions were an established part of the operation of this market in the first place. Policymakers may need to facilitate such research rather than carrying it out directly.

Policymakers should take care to **get into the market** as much as possible. Keen curiosity regarding industry dynamics is an essential attribute of a policymaking or supervisory body. While research in this regard could be encouraged and fostered, active engagement, as a way of the working life, should form part of the working responsibility of a number of key people in these policymaking environments.

Finally, capacity and legislative authority to supervise **market conduct** is critical. Profitable products sold irresponsibly, or without sufficient regard for customer need or affordability, can do more harm than good to any market for financial products and services.

All of this suggests that both policymaking and supervisory entities need to take care to resource and skill their staff complements appropriately. Leadership capabilities and technical acumen are key requirements of an effective policymaking or supervisory body.

5. Concluding comments

Risk-based supervision requires constant assessment of the best use of resources to the concerns and potential concerns across the marketplace under the responsibility of the supervisor.

From time to time, issues arise that are outside of the control of the supervisor and policymaker. Responding to these requires thoughtful consideration of the real issues at hand. Having a clear view of the intended end gives supervisors a better chance to manage uncertainty in a way that nudges a market towards this objective.

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