



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

CONTRACTUAL SAVINGS IN THE LIFE INSURANCE INDUSTRY

REGULATORY REFORMS: COMMISSION SCALES & MINIMUM EARLY TERMINATION VALUES

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1. INTRODUCTION

This document builds on the foundation of the March 2006 National Treasury discussion document, *Contractual Savings in the Life Insurance Industry* (“the Discussion Paper”), which outlined a range of proposals designed (i) to give effect to the December 2005 Statement of Intent (“SOI”) signed between the Minister of Finance and the life insurance industry, and (ii) to introduce further regulatory reforms with respect to contractual savings products. The SOI committed the life insurance industry, the National Treasury and the Financial Services Board (“FSB”) collectively to finding solutions to the challenges of improving cost effectiveness and consumer protection provided by the contractual savings products of the life insurance industry.

The first phase of the SOI commitments encompasses retrospective measures to improve policyholder value for policies written in the past and existing policies. This was given effect through regulations implemented on 1 December 2006, which provided that insurers would enhance poor policy values resulting from the early termination of retirement annuity and endowment policies that occurred after 1 January 2001.

The regulatory reforms outlined in this document form the next phase designed to further improve the cost effectiveness and consumer protection provided by contractual savings products written in the future. These reforms deal specifically with changes to the structure of commission payable on contractual savings products, as well as enhanced minimum early termination values. Taking due cognisance of the possible change in system requirements, a date of implementation of 1 August 2008 is proposed.

The reforms proposed here also provide a platform for the more far-reaching changes envisaged in the medium-term social security and retirement reform programme, as outlined in the February 2007 National Treasury discussion document, *Social Security and Retirement Reform*. These proposed medium-term changes include improved portability of individual retirement savings, as well as governance and product standards aimed at enhancing competition among retirement savings product providers.

2. PROCESS

Soon after the release of the Discussion Paper, a timetable for responses was released, dividing the project into three phases, or work streams.

The most immediate issues to resolve were those directly impacting on the fair value being offered to investors in contractual savings products, namely commission scales and early termination values. These were referred to as Work Stream 1 issues. Comments on Work Stream 1 issues were required by 31 May 2006. Since then, there has been an extensive process of stakeholder consultation and regulatory drafting. The regulatory reforms outlined in this document are the outcome of this process.

The SOI also included a commitment by the life insurance industry to improved transparency and cost containment going forward. Many of these issues are also urgent, but require further research, and as such form a second layer of reform. Work Stream 2 issues include improved disclosure, clarity in terms of intermediary relationships, enhanced consumer education, product simplification, and broader commission issues, such as consistency across financial services industries and the

question of commission for risk business. While there has been notable progress in many of these areas since the release of the Discussion Paper in 2006 – such as the recently revised LOA Code on Benefit Expectation Management and LOA Code on Linked Annuities, as well as the development of simpler and more flexible contractual savings products by certain long-term insurers – further research and analysis by the National Treasury and FSB on these issues is envisaged during the course of 2008.

Work Stream 3 issues are those that were raised in the Discussion Paper but are to be covered under separate work programmes. These concern the governance of retirement annuities, which falls under the retirement reform programme, and a proposed broader assessment of competition issues, which may be considered at a future date.

The remainder of this document outlines the regulatory reforms that are the outcome of Work Stream 1.

3. CONTEXT

The reforms outlined in this document must be placed in the context of the longer-term objectives for retirement and other long-term saving. Two long-term objectives are relevant, as highlighted in the National Treasury Discussion Papers dealing with retirement reform published in December 2004 and February 2007:

- retirement saving vehicles should provide full portability of benefits; and
- there is a general policy preference for this sector to be driven by market forces rather than regulatory intervention, provided the market is characterised by effective competition.

There are a number of implications of these principles.

- Disclosure will need to be significantly improved, as will consumer understanding of financial needs and the products available to meet them. This will help consumers choose products on the basis of need and enable them to select providers on more objective measures of value to the customer.
- The intention is that the conditions for de-capping commission will be more favourable by the time the retirement reform is fully implemented, allowing providers to determine, in a competitive market environment, an appropriate level and incidence of incentives for agents and intermediaries, within the constraints established by the retirement reform.
- Commission payments need to be better aligned to customer interests. Portability can only be supported by a shift to a more as-and-when commission model or through the provider and intermediary accepting the risk of early termination.

These principles will require a transition period. Current standards of disclosure do not sufficiently support consumer understanding of products, nor do they permit customers to formulate decisions on the basis of price. Legislation governing advice is in place in the form of the Financial Advisory and Intermediary Services (FAIS) Act, but needs time to take full effect. Finally, both insurers and intermediaries need the opportunity to prepare for an environment of portable retirement saving products.

The set of proposals discussed in this paper concerns the transition period. The broad thrust of these proposals is that:

- Commission scales on savings products are to be retained but adjusted to bring intermediary and customer interests more closely into line. A blend of up-front commission and ongoing commission is motivated.
- The minimum early termination values agreed as part of the SOI are to be enhanced further as part of the shift to full portability envisaged in the retirement reform process.

Ideally, the transition period would introduce step-wise improvements to regulatory requirements towards the envisaged future, but this would add significant complexity to insurer and intermediary administration processes and may leave consumers unclear as to their position at a given point in time. The preferred approach is to introduce only one set of transitional regulations in preparation for the retirement reform to be implemented in the medium-term.

The move to full portability of retirement savings will have significant implications both for the business models of long-term insurers and the income streams of financial intermediaries. The following specific transition mechanisms are proposed in this regard:

- A phased-in approach to implementation. Due to an extensive consultation period, it is now almost two years since the reform proposals outlined in the March 2006 Discussion Paper were first highlighted. This has allowed many product providers and intermediaries to adapt their business models accordingly, with some providers already having introduced new forms of contractual savings products that meet, and in many cases exceed, the minimum standards outlined in this document. An implementation date of 1 August 2008 is proposed, to allow insurers and intermediaries to put in place the necessary system and business changes.
- A mix of upfront and ongoing commission may be paid during the transition to full portability. This will allow for a phased adjustment to intermediary business models and income streams.
- This is further supported, in the case of intermediaries largely operating in the low-income, low-premium market, by special provisions that allow the maximum proportion of upfront commission to be increased, subject to a maximum Rand amount determined by regulation. This is to help support the ongoing business sustainability of both product providers and intermediaries operating in the low-income market, enabling flexibility in the payment for services rendered, while also ensuring that an appropriate minimum level of consumer protection is in place.

4. REGULATORY REFORMS

With these considerations in mind, the main regulatory reforms introduced by the National Treasury and FSB through proposed amendments to Parts 3 and 5 of the regulations in terms of the Long-term Insurance Act, 1998, are as set out below.

4.1 Part 3: Commission structures

Existing intermediary remuneration for contractual savings products is strongly biased in favour of up-front commission, with three-quarters payable in the first year and the balance in the second. This impacts greatly on the value that policyholders receive from their product, especially in the event of an early termination of the policy. The Discussion Paper pointed out that retirement annuity fund members receive on average only about 40% of their investment value on termination in the

first year of the policy term and 60% on termination in the third year. More than 30% of policies are terminated within the first three years.

At the heart of the issue of up-front commission is the poor alignment of interests of policyholder, intermediary and product provider. The inherent conflict of interest may motivate an intermediary to replace an investment policy with another similar policy simply to obtain a new source of commission, even though this could well be to the detriment of the client. There is also no financial incentive for the intermediary to provide ongoing service and advice to the client, promoting ongoing savings. Lastly, a system of up-front commission raises the barriers to entry for potential new providers of contractual savings products in the life industry because it increases upfront capital costs.

With this in mind, the main reforms introduced by the proposed amendments to Part 3 of the regulations include:

*Modifying **maximum scales of commission** for all insurer-provided savings contracts written after the implementation date of 1 August 2008, to meet the following set of rules:*

- a maximum rate of commission of 5% of premium;
- no more than half of the commission may be paid up-front (i.e. no more than a nominal 2,5% of premium), subject to a minimum discount rate and a maximum discount term; and
- a special provision to cater for small and emerging intermediaries selling low-premium business, that the maximum proportion of up-front commission may be increased to more than half, subject to a maximum amount of R400.

*Modifying the **terms of commission payment** for all insurer-provided savings contracts written after the implementation date of 1 August 2008, to meet the following set of rules:*

- an increase from 2 years to 5 years in the period from the commencement of the policy contract during which commission payments will be reversed, on a sliding scale, should a policy be stopped or made paid-up, to act as a disincentive against intermediary mis-selling;
- a provision that policyholders may redirect the payment of commission to another suitably accredited intermediary or insurer representative of their choice, should they be dissatisfied for any reason with the level of financial advice and administration they are receiving; and
- a prohibition on the payment of up-front commission if an existing contractual savings product is replaced by another such product, to protect against the risk of unnecessary, commission-driven churning of policies.

This set of regulatory reforms is aimed at balancing the following objectives:

- generating an appropriate set of incentives: (i) the introduction of commission that is spread over the term of the policy better aligns the incentives of intermediary and policyholder, encouraging ongoing service and advice; and (ii) the new scales considerably reduce the amount of commission paid up-front, assisting insurers to pay better early termination values, on what is hoped to be a lower rate of lapsed policies;
- enabling a transition period during which insurers and intermediaries can adjust business models to prepare for full portability and as-and-when commission structures;

- removing incentives to sell a new policy when a premium increase would be more appropriate;
- allowing flexibility, through providing for regulatory ceilings, within which bounds insurers are expected to compete; and
- allowing for ongoing flexibility by encouraging a voluntary shift by insurer or intermediary from up-front to ongoing commission.

The proposed commission scales have been assessed across a wide variety of product types, with the assistance of technical analysis by an independent actuary, and are regarded as the most appropriate balance of the interests of insurers, intermediaries and policyholders, bearing in mind the envisaged changes associated with retirement reform.

4.2 Part 5: Minimum early termination values

Minimum early termination values for contractual savings products were established as part of the December 2005 SOI so as to provide a safety-net against extremely poor policy values in the event of early termination.

The SOI covered: (i) negotiated minimum early termination values for policies terminated from 1 January 2001 to 1 December 2006, and (ii) further enhanced minimum early termination values for policies terminated after 1 December 2006.

At the time of the SOI, the National Treasury also signalled that it would be proposing further enhancements to minimum early termination values as part of the contractual savings review outlined in the Discussion Paper, which would apply to policies designed and sold from some future date. Such enhanced minimum early termination values are the subject of these regulatory reforms.

For retirement saving policies, this set of enhanced minimum early termination values is seen as a transitional measure in moving towards full portability requirements as outlined in the retirement reform proposals.

Most respondents to the Discussion Paper supported the implementation of minimum early termination values as a prospective policy tool on the basis that minimum values are a form of consumer protection and, in the case of retirement savings policies, form a bridge between the legacy system that offered no protection on early termination and the anticipated future system guaranteeing portability of products.

The main reforms introduced through the proposed amendments to Part 5 of the regulations include:

*Improving the **protection provided to policyholders modifying or terminating insurance policies** through the following limitations:*

- the maximum deductible charge on an early termination or partial early termination of any investment policy written after the implementation date is 15% of the investment value (or 15% of the investment value multiplied by the proportion by which the premium has been reduced in the event of a partial early termination);
- the maximum deductible charge will be reduced over the term of the policy, on a straight-line basis, from 15% in year 1 to 0% by half-way through the policy term (but with a maximum of 10 years and a minimum of 5 years);

- the expenses permitted in the calculation of the investment value must be constant over the term of the policy (i.e. not front-end loaded);
- the insurer may, in addition, deduct an administration charge of no more than R300, to cover the expenses of the termination, but this administration charge must if necessary be reduced to ensure that the policyholder receives at least 70% of the investment value; and
- the insurer must ensure that the extent of possible early termination charges are always clearly disclosed to the prospective policyholder or member when applying for an investment policy, as well as in the policyholder summary and in annual statements to existing policyholders or members.

This set of standards meets the objectives of providing a minimum early termination value that:

- offers a high and reasonably transparent level of protection to policyholders;
- provides a transition for retirement annuity policies to the reformed retirement environment in which full portability of policies will be an important principle;
- gives insurers reasonable opportunity to recoup expenses in a manner that is simple and clear to policyholders; and,
- supports the ongoing business sustainability of insurers offering investment products in the low-income market, while ensuring a minimum level of protection to such customers.

The proposed regulated maxima are the outcome of careful consideration and consultation, including technical analysis by an independent actuary of the potential impact on insurers, intermediaries and policyholders.