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REPUBLIC OF SOUTH AFRICA

CONTRACTUAL SAVINGS IN THE LIFE INSURANCE INDUSTRY

DISCUSSION PAPER

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1. Introduction and Summary

This discussion paper considers issues that impact on the ability of the South African life insurance industry to offer contractual savings products that are appropriate, cost-efficient and equitable.

Over the last year or two a great deal of attention has been focused on the cost and fairness of retirement annuity funds and other savings products offered by the insurance sector, such as endowment policies. This culminated in the signing of the Statement of Intent between the Minister of Finance and the long-term insurance industry in December 2005. Though the Statement of Intent primarily addresses issues of poor benefits in the event of early termination of contributions, the agreement also includes a commitment to examine other issues impacting on costs, including commission structures, disclosure standards and consumer education.

It has become increasingly evident that several aspects of the traditional business model followed by insurance companies in providing savings products are inappropriate in a changed environment – a situation that leads to sub-optimal outcomes for consumers in terms of competition, cost and consumer protection.

Although there is currently a broader process of retirement reform underway, certain issues that are particular to the retirement savings products offered by the insurance sector require urgent attention. Much of the blame for high costs and poor fund values has been focused on commission payments to intermediaries.[1] In this paper we try to show that the question of costs is a complex one, influenced by a number of factors.

The paper deals specifically with savings contracts that are provided by insurers. Similar arguments also apply to aspects of risk products sold by insurers and to the savings products sold by other industries. These, however, are not the focus of this paper.

This is a discussion paper. It focuses on principles and high-level proposals, with a view to eliciting comments that will assist in crafting detailed proposals and revised regulations. The process going forward will entail further consultation with all stakeholders.

Structure of this paper

Section 2 of this discussion paper outlines changes to the savings environment that have led to an increased focus on issues of costs of contractual savings and risks borne by investors.

These changes include lower investment returns, changes in employment patterns and the structure of the industry, and a revised focus of regulation.

Section 3 details how the inability of existing business models and regulations to meet these changing needs has manifested itself in the South African context. It outlines evidence of high costs, poor product transparency and inequitable early termination values.

In **Section 4**, we attempt to outline a number of factors that have contributed to this state of affairs, before dealing with each aspect in more detail in the sections that follow. These factors can be broadly categorised around the main themes of costs and competition.

Issues affecting effective competition include the number of competitors and transferability between products; levels of disclosure, consumer education and product complexity;

[1] For the purpose of this discussion paper, the term "intermediaries" is used generically to refer to: (i) the tied agents of insurers; (ii) independent brokers; and (iii) financial advisors.

governance arrangements; and regulation of commission and other charges. Factors influencing the particular burden of costs include the incentive structure guiding the actions of intermediaries; the level and structure of commissions; and the extent of safety nets in the form of minimum early termination values.

Key recommendations

In the light of these challenges, the main recommendations of the National Treasury task team include:

Efforts to lower costs and improve effective competition, such as:

- the introduction of new competitors into the retirement savings environment as part of the broader retirement fund reform process and the reduction of barriers to effective competition, informed by a joint National Treasury, Financial Services Board and Competition Commission investigation of the insurance sector and other service providers in the long term contractual savings market;
- a revised set of disclosure standards that focus on enhancing the timing, frequency, clarity and comparability of information provided to investors, combined with further research on the usefulness of financial projections in aiding investors' decision-making;
- encouraging the long-term insurance industry to expand standards of accreditation for contractual savings products that are affordable, accessible and appropriate; and
- a heightened focus on significantly improving financial literacy, through a partnership between the industry, the regulator and other stakeholders.

Regulatory changes to reduce the possibility of product opaqueness and conflicts of interest in the governance of retirement annuity funds, such as:

- aligning disclosure requirements under the Pension Funds Act and the Long-Term Insurance Act;
- issuing a Code of Governance for Trustees to clarify the fiduciary duties of the trustees of retirement annuity funds; and
- issuing regulations and model rules on matters that must be included and addressed in all retirement annuity fund rules.

Measures to better align the incentive structure of intermediaries with the interests of the client, such as:

- requiring that intermediaries must declare themselves to a prospective policyholder as either an insurer agent (i.e. a tied agent or an independent broker), or an independent financial advisor – the distinction being that insurer agents are remunerated by the insurer only and independent financial advisors are remunerated by the customer only;
- requiring that only independent financial advisors may describe themselves as "advisors" or "providing advice"; and
- improving the quality of investment advice through higher standards of intermediary education and implementing a system of accreditation.

Continued regulation of commissions until there is evidence that other measures, such as disclosure, consumer education and competition are effectively protecting policyholders, with the regulated level and structure of the sales commission subject to certain conditions, namely:

- the regulated maximum level of commission should reflect the fact that commission absorbs a higher proportion of fund value in the current low inflation, low return environment;

- a limited proportion of the commission should be paid upfront, with the balance payable over the term of the policy, to provide an incentive to the sales agent to ensure that the policy is appropriate to the needs of the customer and to service the policyholder throughout the term of the policy;

- the payment of ongoing commission should be conditional on the provision of ongoing support to the policyholder;

- the policyholder should maintain the right to re-direct ongoing commission to an alternative agent or discontinue it completely;

- commission on contractual contribution increases should be paid as and when the increases occur and are conditional on ongoing support to the policyholder;

- the structure and level of commission scales should be determined through further discussion with the objective of balancing the interests of all parties, bearing in mind that this is essentially a matter between the insurer and its agent, and that the policyholder will be provided with a degree of protection through other measures;

- consideration should be given to transitional arrangements in commission regulation to take into account the needs of small and emerging intermediaries (such as financing arrangements or other forms of income support between the insurer and intermediary), so as to continue to support access to savings products by low-income investors; and

- changes to the regime impacting on advice fees and sales commission should be applied in a consistent manner to both risk products and savings products and a consistent approach determined for single premium products.

Measures to ensure an improved "safety net" for investors in cases where the investor reduces or discontinues contributions to a contractual savings product, including:

- regulations to give effect to the agreement contained in the Statement of Intent on minimum early termination values applicable to existing policies and policies terminated after 1 January 2001.

- regulations covering enhanced minimum early termination values, to be applied to new policies from a date of implementation to be specified in such regulations, that provide for:

    - a graduated set of minimum values;

    - early termination values that are high enough to provide an adequate level of portability and protection to the policyholder, but are sufficiently low to provide some discouragement of early termination;

    - a sharing of the risk of early termination between the parties to the contract, namely the policyholder, insurer and intermediary, aligning as far as possible the interests of all parties

- The basis for the calculation of minimum early termination values should take into account differences in product types. Suggestions on the most appropriate approach are invited, but could include:

    - an appropriate proportion of the gross-of-fee investment account; or

- a proportion of the investment account net of maximum ongoing fees, with the added requirement that, for other charging methods, the termination values should be equivalent to those of an insurer with these ongoing fees.

2. Environmental Changes

2.1. A number of changes to the savings environment, as discussed below, have led to a greater emphasis on cost and a growing awareness that the existing business model is becoming increasingly outdated.

Lower investment returns

2.2. In this country, and all around the world, inflation levels are currently low and are expected to stay that way for the foreseeable future. The implications of an environment of lower average investment returns for consumers and providers include the following:[2]

2.2.1. Charges have the potential to erode a greater proportion of investment returns. No longer will it be possible to ignore the impact of charges on the basis that these are not significant in the context of the overall return.

2.2.2. Consumer expectations regarding the return from savings may need to be reframed.[3]

2.2.3. Disclosure standards must be improved so that consumers are able to make intelligent choices between products, while properly taking into account the impact of charges.

Changes in employment patterns

2.3. Consumer lifestyles have changed considerably. Job tenure is generally shorter, which has led to a need for greater flexibility of financial products. While consumers may recognise the imperative to save over a long period for their old age, they prefer to do so in a way that caters for their changing circumstances. These developments combine with strengthening consumer demands, increasing the pressure on providers of financial products to adapt to these shifting needs. Implications emerging from this change include the following:

2.3.1. There is a need for products that provide greater flexibility. The business model can no longer assume lifetime contributions. Meeting consumer expectations will require portability, without eroding the value of savings.

2.3.2. Consumers are required to exercise more control and choice over their financial affairs. This calls for increased consumer education.

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[2] The inflation targeting regime, strengthening foreign currency reserves and continued fiscal discipline have contained inflation within its target range and brought stability, if not strength, to the exchange rate of the Rand. Yields on index-linked government bonds have dropped to levels comparable to those experienced in developed economies. This suggests that there has been a significant reduction in perceptions of risk in the South African economy. Effectively the "risk premium" associated with investment in South Africa is substantially less than was previously the case. If this feeds through into the equity market, real returns earned on investments are likely to be lower in future than those experienced historically.

[3] The December 2004 National Treasury Discussion Paper on Retirement Fund Reform indicates that, at a real return of 4% and contribution to retirement savings of 10% of salary, 30 years of saving would provide for a pension of around 40% of pre-retirement salary. If the real return were only 2%, the saving period would need to extend to 37 years or the contribution rate to over 13% to achieve the same goal.

Ultimately, better-educated and financially literate consumers are also in the long-term interest of product and service providers.[4]

Industry changes

2.4. At the same time as these consumer changes have been taking place, the life insurance industry has also been undergoing some fundamental changes. Demutualisation has altered the balance of interests in the contractual savings environment considerably. For example, under a mutual organisation model a conservative approach to policyholder decisions, charges or bonus policy was generally not to the long-term detriment of policyholders, because policyholders were also part owners of the insurer. Demutualisation has altered this dynamic. Shareholders now seek to maximise their profit and minimise their business risk. Whereas previously the interests of insurers and policyholders could be said to be broadly aligned because of the ownership structure, this is no bnger the case.

Focus of regulation

2.5. In combination, these environmental changes increase the risks to which consumers of contractual savings products are exposed. The costs of contractual savings products have the potential to take up an ever greater proportion of savings at a time when consumers are increasingly susceptible to bearing these costs. In addition, the profit motive of insurers will tend to drive up these costs in the absence of effective competition. This provides a strong rationale for regulatory change. Whilst regulation has traditionally focussed on the prudential soundness of insurers, there is an increasing need for regulation that focuses more directly on issues of consumer protection, including the conduct of providers and intermediaries as well as the features of the products they sell.

3. Insurer Costs and Equity Concerns: Background

3.1. As outlined below, current business models seem ill equipped to respond effectively to these environmental changes.

Evidence on costs of retirement savings vehicles

3.2. Insurer-provided retirement annuities appear to be expensive, according to research carried out in 2004 on the efficiency of the South African retirement industry.[5] This is of particular concern given the heavy dependence of South Africans on private sector vehicles for their retirement savings. The research examines the aggregate working life administration charges for an individual saving for retirement in one of three tax-deductible vehicles and compares these costs with a wide variety of international benchmarks. The research suggests the following:

3.2.1. Collective investment retirement products provide reasonable value, while occupational retirement funds appear slightly expensive overall. The real concern uncovered by the research was that insurer-provided retirement annuity products appear to be very expensive when assessed both against local alternatives and international

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[4] An environment in which consumers are more aware of, and can better express, their financial needs allows for easier alignment between these needs and product design – which in turn contributes to a more sustainable business model and improved competitiveness.

[5] Rusconi, R (2004) *Costs of Saving for Retirement: Options for South Africa*, presented at the Convention of the Actuarial Society of South Africa, October 2004

benchmarks. Annual equivalent reductions in yield[6] were estimated to be between 1.8% and 2.9% over a 40-year saving period for these products. This compares poorly with reductions in yield of 1.2% to 1.4% calculated for the equivalent product in the United Kingdom, namely the personal pension, a product that is regarded in that country as being unnecessarily expensive.

3.2.2. These figures may in fact understate the true cost, in that they assume a disciplined saving pattern of 40-years' worth of uninterrupted contributions, increasing every year by 7%. In reality, such savings patterns are rarely observed, implying even higher aggregate costs.[7]

3.2.3. There is further cause for concern. The estimated cost of commission as a proportion of total charges is significantly lower than the empirical figure provided in submissions received from the Life Offices' Association (LOA).[8,9] This is a further result of the fact that the research assumed a disciplined saving pattern and no early termination. The much higher LOA statistics suggest shorter average policy terms and a significant weighting of terminations towards the early part of the policy. This suggests that policyholders are bearing a significantly higher level of costs than those calculated by Rusconi.

3.3. Commission is an important element of these charges. While commission is generally not a particularly large component of total cost in the case of long-term policies, it rapidly increases in significance as the policy term reduces. As demonstrated later in this paper, the potential impact of commission will also become more significant in an environment characterised by lower overall investment returns.

3.4. A few reasons have been proposed for the charge difference between the retirement savings vehicles offered by long-term insurers and those of collective investment schemes, most notably that houses providing the latter are often subsidised by the distribution networks of the former. The facts remain that: (a) the consumer appears to be paying a considerable amount for their contractual savings through the insurance sector, even where there is no interruption in their contributions to such policy; and (b) commission is a significant though not sole driver of this cost.

Impact of commission scales

3.5. An important factor that influences perceptions of poor policyholder value and rising costs of insurer contractual savings products is the particular structure and level of commission. Since commission forms an important part of the

[6] The reduction in yield is the equivalent annual dampening impact on investment returns caused by the aggregate impact of all charges. For example, a 1% reduction in yield applied to a gross investment return of 10% results in an overall return on assets net of all charges of 9%.

[7] Rusconi has expressed concern that he may have underestimated the impact of commission by allowing for premium increases in his calculations but not allowing for the corresponding commission payable on these premium increases. Correctly allowing for the additional commission would increase all of Rusconi's calculated insurer cost ratios.

[8] Life Offices' Association (2005a) LOA Discussion Paper on Costs and Commission Structures for Long-term Insurance Savings Policies, submitted by the LOA to the FSB and National Treasury, June 2005. The LOA calculates that commission accounts on average for 35% of all costs across endowment policies and retirement annuities.

[9] It is noted that the LOA figures cover endowments as well as retirement annuities, but this does not invalidate the concerns.

discussion, some of the details of the existing environment are set out in the points that follow:

3.5.1. Commission on contractual savings and risk products in the insurance sector is based on a fixed scale that is related to the size of the premium payments. The scale provides for payment of the bulk of the total commission in the first year and the balance in the second year of the policy, irrespective of the policy term.

3.5.2. The rationale for the commission scale is two-fold. The upfront payment facilitates the cash flows of the intermediary, allowing the establishment of a business that might otherwise depend on income to be received over an extended future period. The original reasoning behind a regulated ceiling on commission was that it protects small insurers from the potential bargaining power of large intermediary organisations, who might otherwise require unaffordable levels of commission from these insurers as a condition for placing business with them.[10]

3.5.3. Commission absorbs a significant proportion of the premiums paid early on during the term of a policy. In the first year the commission on a retirement annuity policy, for example, constitutes 3% of the annual premium for each year of the contractual policy term.[11] This means that commission payments on a 20-year policy in the first year amount to 60% of the premium paid in that year. A further 20% of the premium is paid in commission in the second year.

3.5.4. Commission on endowment policies is paid on a similar basis but on a slightly higher scale, i.e. 3.25% of the annual premium for each year of the contractual policy term. Most risk products, like term insurance contracts that provide life cover for a period of time, pay commission on the same scale as for endowment policies.

3.5.5. In terms of commission regulations, so called “claw back” provisions permit insurers to recover commission from the intermediary, should the policyholder choose to terminate the policy during the first two years of the policy.

3.5.6. The value paid out to a policyholder[12] on early termination contains an allowance for reclaiming unrecovered commission, in simplistic terms deducting the amount of this commission from the value of the policy. If termination occurs in the first two years of the policy, the paid-up value is meant to be adjusted for the amount of commission to be clawed back from the intermediary, although in reality this practice differs across insurers.

3.5.7. In addition to the above, early termination values include a deduction for the initial administration expenses of the insurer. Therefore, it is not difficult to see why these values could be extremely poor when surrender occurs within the first few years of commencing the policy.

[10] It is less clear whether this rationale is as important today. Some suggest that the scales themselves have stimulated the development of alternative distribution models, for example the Linked Product Service Provider (LISP), that have added incentive layers that bypass the legislation and consumer protection that the commission scales are designed to provide.

[11] This is subject to a minimum and maximum term.

[12] To avoid doubt, the term policyholder also refers to a member of a retirement annuity fund.

It is clear that both the structure and the level of commission have a significant impact on these values.

3.5.8. The commission burden that the policyholder/member bears is significant. The LOA calculates that commission accounts for 35% of all costs across endowment policies and retirement annuities; or 38% if profit margins are not considered a cost to the policyholder. This does not include the cost of the infrastructure that supports the sales effort, which adds another 13%, suggesting that commission and the structures necessary to support it comprise on average roughly half of the total cost of providing a policy.

3.5.9. The erosion of policyholder return by commission is more significant in an environment typified by low returns. The table below shows that the reduction in yield as a proportion of the investment return is significantly higher in instances where the investment return is low. This highlights the increased importance of the discussion around commission in the current environment.

Impact of commission on investment return: alternative scenarios

	Term of retirement annuity policy		
	5 yr	**10 yr**	**20 yr**
(1) Low return scenario			
Commission reduction in yield (RIY)	1.64%	0.80%	0.39%
RIY as proportion of gross return	27.3%	13.3%	6.5%
RIY as proportion of real return	54.7%	26.7%	13.0%
(2) Mid return scenario			
Commission RIY	1.69%	0.82%	0.39%
RIY as proportion of gross return	16.9%	8.2%	3.9%
RIY as proportion of real return	33.8%	16.4%	7.8%
(3) High return scenario			
Commission RIY	1.74%	0.84%	0.40%
RIY as proportion of gross return	12.4%	6.0%	2.9%
RIY as proportion of real return	24.9%	12.0%	5.7%

Source: Rusconi (2004) and further calculations.

The reduction in yield is the equivalent annual fall in investment return attributable to charges, in this case commission alone. Standard retirement annuity commission scales have been used for the purposes of this calculation.

The annual assumptions for each scenario are: (1) investment return 6%, inflation 3%, premium increase 4%; (2) investment return 10%, inflation 5%, premium increase 7%, as in Rusconi (2004); (3) investment return 14%, inflation 7%, premium increase 10%

Determinations of the Pension Funds Adjudicator

3.6. Certain Pension Funds Adjudicator rulings have raised concerns of a lack of transparency of retirement annuity products. Some of the practices questioned by the Adjudicator include:

3.6.1. A significant reduction of the policy value on premature cessation or reduction of premiums. This situation results from a business model

that recovers unrecouped expenses on early termination, but lacks appropriate up-front disclosure of, and agreement to, such practice in policy documents provided to the member of the retirement annuity fund.

3.6.2. A significant reduction of the policy value on notification of the member's intention to retire earlier than original specified, with the added complication that commission scales provide an incentive to the intermediary that sells such a policy to motivate a late retirement date.

3.6.3. Annual premium increases that result in automatic, undisclosed commission payments to the intermediary, even in cases where the intermediary provides no ongoing support or is no longer in contact with the insurer. In the latter case, these automatic commission payments are often credited to the insurer.

3.6.4. Appointment of trustees of the retirement annuity fund by the administering insurer, leading to a conflict of interest and the consequent possibility that such trustees fail to properly carry out their fiduciary responsibilities.

3.6.5. Despite provisions in the Income Tax Act for inter-fund transfers, prohibition in the rules of many retirement annuity funds on transfers to another fund before age 55 - a practice that the Pension Funds Adjudicator regards as anti-competitive.

3.7. These rulings concern only the retirement annuity marketplace, and not any other types of contractual savings or insurance products. The Adjudicator's concerns are in some ways unique to these products, which involve a complex set of relationships between policyholder, retirement fund and insurer. They are however indicative of a general environment of opaque product design and poor disclosure.

Poor early termination values

3.8. Concerns have been raised about a lack of risk sharing implicit in the calculation of fund values provided on early termination of life insurance savings policies.[13] This relates to the early termination values of the two basic types of recurring premium savings policies, namely: (a) endowment policies; and (b) retirement annuity policies.

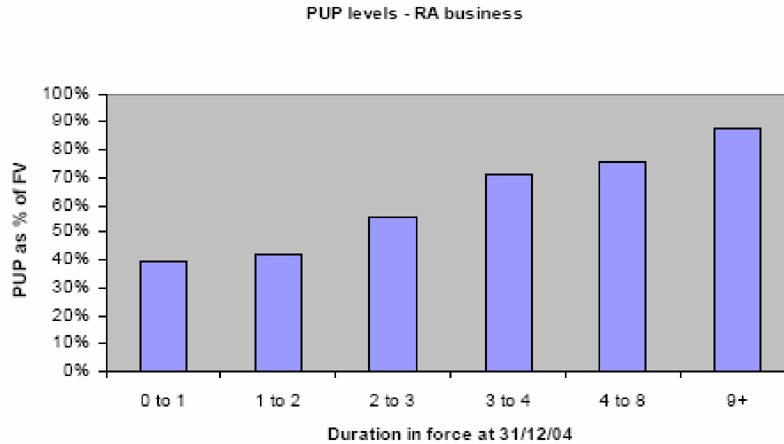
3.9. The main reason for poor early termination values under the current business model is the high up-front costs involved in the distribution of life insurance products. These costs consist of two basic elements, namely: (a) commission; and (b) other acquisition costs of the insurer (including distribution, marketing and issuing costs).

3.10. When calculating an early termination value, insurers usually aim to recoup all of the expenses incurred in writing the policy (i.e. that part of the up-front costs that has not yet been recovered via regular charges is deducted from the fund value of the policy). These expenses would include the vested commission and the

[13] The term "early termination" refers to any reduction in premiums, cessation of premiums (paid-up), surrender of a policy, transfer of a policy, lapsing of a policy and reduction in retirement age. This is consistent with the definition used in the 2005 Statement of Intent.

acquisition cost allocated to the policy.[14] This reduces early termination values considerably, particularly in the early years of a policy's term.

3.11. The chart below[15] shows the extent of the impact of this approach on the fund values received by retirement annuity fund members on cessation of premium payments. The difference between full fund value and the paid-up value received by the member is the proportion of investment value eroded by the practice of recouping upfront expenses. It illustrates that, on average, members receive only 40% of their fund value should they terminate their policies in the first year. In fact, for the first three years of a policy's life, early termination will result in the member receiving on average less than 60% of the fund value.



3.12. The extent of the costs borne by retirement annuity members in the event of early termination is not only excessive, but also widespread. The table below shows attrition rates for each successive year of duration of a typical retirement annuity policy. More than 30% of policies are terminated within the first three years. In combination, this implies that more than three out of ten retirement annuity fund members end up losing more than 40% of the value of their investment.

Retirement annuity attrition rates

Policy duration	Conversions to paid up
Year 1	18.8%
Year 2	9.4%
Year 3	6.3%
Year 4	5.9%
Year 5	5.5%
Year 6 – 10	5.1%

Calculations by Independent Actuarial Consultants

[14] Currently all commission is fully vested after two years. In the case of terminations before two years, some commission may be clawed back, which the insurer is meant to pass on to the policyholder to improve termination values.

[15] Calculations undertaken by Independent Actuarial Consultants.

3.13. It should be borne in mind, however, that these early termination values are to some extent the outcome of the regulatory environment in which retirement annuity funds operate. A Financial Services Board (FSB) study has shown that the values provided on early termination, both in terms of policy surrenders and conversion to paid-up, are in line with the prudential requirements of governing statutes. The study shows that surrender and paid-up values:

3.13.1. reflect the obligation on insurers to comply with section 52(3) of the Long-term Insurance Act 52 of 1998, which requires that the actions of an insurer do not risk detrimental impact on the financial position of the firm;

3.13.2. are being calculated in a variety of technical ways, none of them inconsistent with the actuarial principles under which the contracts have been established; and

3.13.3. generally do not involve a deduction for lost future profit.

3.14. Underwriters of retirement annuity funds appear in the main to be complying with the Long-term Insurance Act in calculating early termination values, but are exercising such discretion as they have in favour of the shareholder.[16] The legislative framework governing insurers has historically focussed on financial soundness concerns, rather than provision for more explicit consumer protection measures in the form of market conduct or product regulation.[17]

3.15. The FSB study shows that insurers are making an effort to discourage early termination and to improve paid-up values on early termination. However, as outlined later in this paper, this intervention is a necessary but not sufficient condition to address the issue of poor early termination values.

4. Insurer Costs and Equity Concerns: Potential Causes

4.1. The elements giving rise to the abovementioned concerns can be broadly categorised around the main themes of costs and competition. In general, concerns with respect to excessive costs point to a market in which competition is less effective than it could be. Competition is deemed effective if there is a significant number of product providers or there is a credible threat of new entrants; consumers are empowered to make rational choices and can exercise these choices at low cost. Issues affecting effective competition include:

4.1.1. *Competition and transferability between products*: This is determined not only by the number of market players and their respective market shares, but also the degree of contestability in terms of barriers to entry and exit and the credible threat of new entrants. Product providers will also be incentivised to provide better products if they can not only attract new clients into the market, but also lure current clients away from competitors through improved product offerings. To benefit clients, the cost of this transfer should be low and must not exceed the reasonable cost involved in effecting such transfer.

[16] By contrast, the ability of trustees of retirement annuity funds to reduce retirement benefits in the event of early termination is not sufficiently disclosed or provided for in the rules of the fund, as required in terms of the Pension Funds Act. This lack of disclosure, rather than the method used to calculate such early termination values, has been at the heart of the Pension Funds Adjudicator's determinations that such deductions are unlawful.

[17] Although it should be noted that regulation aimed at financial soundness is also part of broader consumer protection, in that a volatile insurance industry is not in the best interest of the investing public.

4.1.2. *Levels of disclosure, consumer education and product complexity:* As long as investors do not understand how the products offered to them work and cannot effectively compare them to other products in the market, information asymmetries will imply that product and service providers can remain profitable without having to be competitive.

4.1.3. *Governance arrangements and levels of vertical integration*: In cases where an institution is providing a product or service that it in turn obtains from a connected party (such as, fund sponsors and trustees who are connected to the administering insurer), there will always be concerns about conflicts of interest and fair pricing.

4.1.4. *Regulation of commission and other prices*: In some cases, certain prices (such as commission) may be capped in order to protect investors. It may be the case, however, that such regulated prices become the norm rather than a ceiling below which product providers compete.

4.2. *The impact of intermediary relationships, commission structures and early termination values*: It is not only costs in general that are a concern, but also the fact that the costs are particularly inequitable in certain circumstances – notably where the savings contract is terminated early. Issues affecting both the frequency and seriousness of these charges include:

4.2.1. the incentive structure guiding the advisory relationship between the client and the intermediary;

4.2.2. the incentive structure guiding the sales relationship between the intermediary and the insurer, notably the structure of commission payments;

4.2.3. the quality of advice provided by intermediaries and the extent of responsible selling of contractual savings products, with due regard to need and affordability; and

4.2.4. the extent of financial safety nets in place to protect the consumer from the worst extremes of the risk of early termination, such as minimum early termination values.

4.3. Lastly, issues of costs and equity in the contractual savings of insurers are also affected by the particular focus of regulation and whether it is appropriate to changing circumstances.

4.4. Each of these issues effecting insurer costs and investor perceptions of a fair deal are dealt with in more detail below.

5. Competition

5.1. A market is contestable if barriers to entry and exit are low and monopoly power is reduced by the credible threat of new entrants. Competition is effective if consumers are empowered to make rational choices and exercise these choices at low cost.

5.2. Evidence of concerns regarding the disputed extent of effective competition derive from a variety of sources:

5.2.1. Concentration ratios are high. The 2004 report of the Registrar of Insurance shows that the five largest South African insurers, excluding reinsurers, look after more than 76% of industry assets. The five dominant firms in the retirement annuity market administer

93.8% of all industry liabilities. This suggests an industry characterised by oligopolistic competition rather than perfect competition, with a corresponding focus on product and marketing innovation, rather than on price competition.

5.2.2. The fact that independent research shows that overall fees in the retirement annuity market are high by international standards, suggests that one possible reason for the perceived lack of effective competition is that disclosure and transferability itself are not as effective as they could be in promoting competitiveness.

5.2.3. The same research also demonstrates a good deal of variability in charging structures between insurers, suggesting that insurers have considerable leeway in terms of price determination.

5.3. Besides the measures discussed in the sections that follow that are aimed at improving disclosure, comparability and product understanding, the National Treasury has also proposed other direct interventions that will contribute to higher levels of competition in the sector – specifically with reference to the market for retirement savings. The 2004 Discussion Paper on Retirement Fund Reform recommends the following:

5.3.1. A National Savings Fund ("NSF") should be introduced, specifically to provide a suitable retirement funding vehicle for low-income workers and individuals in the informal sector. It is envisioned that the NSF would ensure affordable administration costs through economies of scale. In many ways, this could form a benchmark against which the value provided by private pension funds could be measured.

5.3.2. The market for retirement savings should be opened up to industries other than insurance companies (such as banks or collective investment scheme management companies), provided that all providers are subject to the same regulatory standards.

5.3.3. "Individual retirement funds"[18] should be established that will allow for greater flexibility, transparency and transferability, including:

5.3.3.1. accepting regular or irregular contributions (subject to limits established by tax law); the amount of the benefit payable to the member would be determined on a defined contribution basis;

5.3.3.2. offering a choice of benefits and contribution rates within limits established by the management board of the fund, the sponsor and the regulator;

5.3.3.3. allowing transfer of retirement savings between funds at the request of the member, provided the fund to which the savings are transferred meets the conditions applicable to the first fund;

5.3.3.4. disclosing all fees charged to prospective and existing members and to the fund by its service providers; in order to encourage competition amongst such service providers, the

[18] The definition of such funds is that they would not require an employer/employee relationship. The relationship will be between the member and the fund. As such, retirement annuity funds would naturally migrate to this framework.

regulator could publish the comparative fees of the funds on offer; and

5.3.3.5. providing fund members with a detailed annual statement disclosing inter alia all costs and fees charged, current withdrawal benefit, net amount invested, average return per annum and other such information as the regulator may prescribe.

National Treasury recommendations

5.4. It is anticipated that the structural changes envisaged by the broader retirement fund reform process will tend to increase competition and drive down costs of retirement saving. In the interim, the factors leading to high concentration levels in the long-term insurance sector and the exact nature of perceived concerns regarding high and variable charges require further investigation. Accordingly, the National Treasury recommends that:

5.4.1. a study of competition between insurers in the contractual savings market be commissioned as a joint investigation between the National Treasury, FSB and Competition Commission; [19] and

5.4.2. as long as it would not add substantially to the ability of the study to deliver useful results within a reasonable timescale, the scope be extended to include:

5.4.2.1. all providers in the contractual savings industry;

5.4.2.2. fund administrators and investment managers; and

5.4.2.3. all aspects of both the long-term and short-term insurance market.

6. Disclosure Standards

6.1. While disclosure standards in the South African contractual savings environment have improved in recent years, they still fall short of international standards.

6.2. Self-regulation of disclosure standards was introduced in 1982 in the form of the first Benefit Illustration Agreement, established by the LOA in order to enhance and standardise disclosure requirements. Changes were made over time to improve this agreement. In 2005, the LOA replaced the Benefit Illustration Agreements with the Code on Policy Quotations (CPQ), adding further conditions for disclosure on charges. While this is a marked improvement, commentators have raised a number of problems with regard to the Code, for example:

6.2.1. The reduction-in-yield figure is not simply and transparently stated but has to be inferred as the difference between the net and gross investment returns.

6.2.2. Projected values are based on the net investment return, preventing a simple comparison of the impact of costs on returns for similar products offered by different providers.

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[19] A similar study on Competition in South African Banking was jointly carried out by the National Treasury, Financial Services Board and the Competition Commission in 2004.

6.2.3. Other summary statistics of aggregate charges should be included in instances where these figures are likely to express information in a way that is better understood by the consumer.

6.2.4. The usefulness of the current system of providing projections of investment returns needs to be tested to determine its general usefulness in improving consumers' understanding of the products being proposed to them. The Pension Funds Adjudicator has highlighted the problems caused by not adjusting projected future fund values to the realities of today's low inflation, low return environment, and not communicating these changes to the member so as to effectively reframe the member's expectations. Used incorrectly, benefit projections can become marketing gimmicks, rather than a tool for the purposes of responsible financial planning.

6.3. Regulated disclosure standards were introduced in 2001 in the form of Policyholder Protection Rules. The Financial Advisory and Intermediary Services (FAIS) Act, 2002, which came into full operation on 30 September 2004, added still further conditions to existing disclosure requirements. FAIS, for example:

6.3.1. puts in place requirements for the authorisation of financial services providers and the duties of such providers;

6.3.2. empowers the Registrar to draft a code of conduct covering financial advisors and sets out the principles under which the code must be drafted;

6.3.3. establishes the office of the FAIS Ombud to handle issues of dispute resolution; and

6.3.4. sets out a wide range of enforcement measures.

6.4. The code of conduct drafted since promulgation of the Act:

6.4.1. sets out rules covering representations made to a client by a financial services provider;

6.4.2. mandates the provision of clear information to clients concerning (a) product suppliers and (b) any interest of the financial services provider in the suppliers;

6.4.3. requires the provider to supply the client with detailed, specified information concerning the contracts entered into with product suppliers; and

6.4.4. requires the provider to (a) conduct a thorough needs analysis, (b) ensure that any advice provided is appropriate to the needs and risk profile of the client, and (c) back up any advice with specific disclosures.

Lessons from international experience

6.5. Significant lessons may be gleaned from the disclosure standards established by regulators in other jurisdictions. These increasingly reflect the attitude of

regulators that a light touch on product restriction, combined with strict standards of disclosure, work best for the consumer.[20]

6.5.1. The United Kingdom has, since 1995, required disclosure of commission payments to independent intermediaries and tied agents. The regulatory authorities are giving serious attention to the possibility of tightening these rules: for example, requiring annual statements that remind the policyholder that commission is still being paid to intermediaries and that ongoing service and advice should be provided in return.

6.5.2. Australia has a high-level framework for disclosure designed to answer the three most important questions facing a new policyholder:

6.5.2.1. What service am I receiving? Disclosure at the required standard in response to this question is found in the Financial Services Guide.

6.5.2.2. What advice am I gaining? Disclosure at the required standard in response to this question is found in the Statement of Advice.

6.5.2.3. What product am I buying? Disclosure at the required standard in response to this question is found in the Product Disclosure Statement.

6.5.3. The Australian system requires unambiguous dollar disclosure of charges and commission, and not percentages or other alternatives that might be misinterpreted. This approach is set out in statute. Setting the disclosure obligations at this level leads to consideration along the lines of, "Under what circumstances might relief be granted from disclosure requirements?" rather than "What should be disclosed and how should it be set out?".

6.5.4. The Australian regulator has also set out a number of "Good Disclosure Principles", recognising that it is very difficult to set detailed disclosure requirements for every distinct financial product. According to these principles, disclosure should

6.5.4.1. be timely;

6.5.4.2. be relevant and complete;

6.5.4.3. promote product understanding;

6.5.4.4. promote comparison;

6.5.4.5. highlight important information; and

6.5.4.6. have regard to consumers' needs.

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[20] This needs to be qualified by acknowledging that a regulatory "light touch" is dependent on a suitable set of qualifying conditions, for example, reasonable levels of financial literacy, which may not yet exist in South Africa, and that this regulatory philosophy is mainly evident in countries wealthier and more financially sophisticated than South Africa. Also note that the philosophy does not rule out product standards, such as CAT standards (see section 7.3), as an additional regulatory mechanism. The development of product standards is intended not so much to regulate products but to permit an area of increased consumer satisfaction that **may** permit a relaxation of advice regulation.

6.5.5. Disclosure requirements in the Netherlands are specified in regulations and conveyed to consumers in the form of the Financial Information Leaflet. The regulatory specification is detailed but not completely prescriptive as regards content. Nevertheless, the rules include directives regarding the format and presentation of the leaflet and the quality of information contained therein. They also limit provider specification of exclusions or limitations of its liability. An exclusion or limitation of liability with respect to the content of the financial information leaflet may relate only to incompleteness in the information provided and the fact that it is based on up to date information as known at the date of the most recent revision of the leaflet.

6.5.6. The Dutch system is particularly strong in terms of requiring disclosure of information in a way that is straightforward, specifying the information to be communicated under a number of basic headings, such as:

6.5.6.1. "About the financial information leaflet".

6.5.6.2. "What are the financial risks of '[name of the product]'?"

6.5.6.3. "What happens in the case of death?"

6.5.6.4. "What to do if you have a complaint?"

6.5.7. The Dutch authorities also tightly regulate the provision of projected policy values. They specify standardised assumptions to be used in three sets of investment return calculations:

6.5.7.1. a gross investment return of 4% with a deduction for the anticipated charges under the contract;

6.5.7.2. recent actual after-charge returns under the contract; and

6.5.7.3. a pessimistic return, set by the regulator, which allows for the mix of assets and expected volatility of the returns obtainable from each asset class.[21]

National Treasury recommendations

6.6. The National Treasury team recommends the following:

6.6.1. A revised set of disclosure standards be established that meets the following principles:

6.6.1.1. *Timing of disclosure*: Relevant information concerning potential policies and the advice backing these policies must be provided in a timely manner.

6.6.1.2. *Frequency of disclosure*: Relevant information should be provided on a regular basis, at least annually.

[21] The table of return assumptions set by the regulator varies from time to time with changes in investment circumstances. The pessimistic return is, for each asset class, the 10th percentile of the statistical distribution of expected returns. It varies according to the investment horizon of the product.

6.6.1.3. *Independence of disclosure standards*: Self-regulation of transparency standards, whilst useful, can never be truly independent. The standards of disclosure must become part of the regulatory framework, as is the case in most countries.[22]

6.6.1.4. *Clarity of presentation*: Language must be clear and simple,[23] numerical descriptions straightforward and unambiguous and disclosure documents must not be cluttered with unhelpful information.

6.6.1.5. *Consumer testing*: Disclosure only works to the extent that it is understood. All disclosure proposals should be rigorously tested for their potential to improve consumer understanding.

6.6.1.6. *Comparability*: Disclosure standardisation must permit clear and easy comparison of equivalent products.[24]

6.6.2. The usefulness of financial projections must be researched. They should be discontinued if they do not benefit consumers in their decision-making. If they are continued, they should be modified to demonstrate more clearly the uncertainty of future outcomes.

6.6.3. An exclusion or limitation of liability in the content covered by the disclosure standard may relate only to incompleteness in the information provided and the fact that it is based on up to date information as known at the specified date of the most recent revision of the document in question.

7. Simplified Products

7.1. Unnecessary product complexity and opaqueness can not only add to costs, but also reduce effective competition through limiting comparability. While the long-term insurance industry has tended in recent years towards introducing greater investment choice and flexibility in contractual savings products, this is not always in the best interest of those consumers who want a low-cost option.

Lessons from international experience

7.2. It is possible to address issues of complexity and cost by establishing a completely new class of products and labelling it as "meeting the required standard". This was one of the recommendations of a review of the contractual savings industry in the United Kingdom (Sandler review, 2002). The review recommended that a set of straightforward products, complementing the Stakeholder[25] pension product concept, ought to be introduced in order to reduce the need to regulate the advice process.

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[22] This could also include the publishing of standardised industry statistics by the FSB to enable trustees and investors to measure fund expenses against appropriate benchmarks.

[23] Language policy should be in line with the terms of the Financial Services Charter. Contracts must be available in the legal languages of the country, i.e. English and Afrikaans. All other documentation must be made available in the major languages of a province.

[24] Projections should use the same gross return, for example, allowing consumers to compare the impact of charges on policy values.

[25] Stakeholder was established by the UK government as a new type of retirement fund with a view to addressing issues of cost and to make retirement provision more attractive to low-income earners. Insurers and administrators can market Stakeholder funds only if they comply with certain strict requirements. The most important requirement

7.3. As an alternative or possible addition to establishing a new product line, a set of product standards could be developed. Products that meet these requirements would be awarded accreditation. The United Kingdom has implemented this system in the form of the so-called "CAT standards". These standards are set by the regulator and mandate minimum requirements in relation to:

7.3.1. **Charges**: a maximum permissible charge and limitation on the types of allowable charges;

7.3.2. **Access**: standards for minimum acceptable lump sums and regular contributions, sometimes concurrent with minimum portability and flexibility requirements; and

7.3.3. **Terms**: additional regulatory requirements of an accredited product to protect against inappropriate features and ensure minimum standards of administration and governance.[26]

7.4. In the UK, products either meet the CAT standards set for them or they do not. Consumers should have higher confidence in certain products based on their accreditation. The intention is to stimulate the development of simple, cheap products that meet the policy objective of encouraging saving at reasonable cost.

7.5. The danger with standards such as these is that they can create market distortions. Providers are given a natural incentive to meet only the minimum standards but no more, even where competitive forces in a free market might have given a better result to consumers. Standards such as the CAT system are also accused of misleading customers, suggesting a guarantee that they do not actually provide.[27]

7.6. It is also possible to leave the development of product standards to the industry. This may run some of the same risks of distortion as a centrally imposed set of standards, but the process of developing such standards can assist in building a partnership with the regulator in striving towards serving the best interests of the consumer.

7.7. The Association of British Insurers (ABI) launched a quality mark scheme in 2000 called Raising Standards, which constitutes an accreditation of product providers:[28]

7.7.1. The scheme has eight standards based on three customer promises that cover the aspects that usually concern people when buying financial products. Brands are awarded the quality mark only if they meet the requirements of the eight standards and only if all of the products falling under that brand within the scheme meet the requirements. These products include individual life insurance and pension products, collective investment schemes and group products in instances where a brand is in direct contact with the individual.

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was that the total cost of administering the fund (including commissions, distribution and marketing costs) was initially not allowed to exceed 1% of the assets under management per annum. This cost ceiling was subsequently increased to 1,5% to allow for, amongst other things, a greater level of commission to intermediaries. It was found that the 1% margin did not allow for the payment of reasonable commissions and fees, and it was claimed that these distribution challenges led to a slower than expected growth of these funds.

[26] In the United Kingdom, for instance, units in collective investment products must be single-priced at mid market price and investment risks must be highlighted.

[27] For example, the CAT standards in the United Kingdom do not guarantee investment return.

[28] See www.raisingstandards.net for more information.

7.7.2. The eight standards cover: (1) the provision of clear and comparable information, (2) presentation of charges, (3) the provision of yearly statements, (4) an extended cooling-off period for product cancellation, (5) an aggregate cost ratio for first-year surrenders meeting prescribed standards,[29] (6) customer satisfaction, (7) query handling processes and (8) complaint management. The web site provides members with a copy of the manual setting out the rationale for and details of the standards, and adds useful tools and information, covering issues like communication methods and an online plain English assessment tool.

7.7.3. Among the actions required for accreditation is the elimination of opaque charging structures from new business. The ABI reports that significant progress is being made in this regard and risks are being taken by insurers in the consumer interest: charges are being spread more evenly over the term of the contract, improving early termination values, but at the same time increasing the financial risk of early termination to the insurers.[30]

7.7.4. Standards are enforced by an independent body, the Pension Protection Investments Accreditation Board.

The South African experience

7.8. South Africa has taken up the challenge of product simplification through the mechanism of the Financial Sector Charter, which aims to improve access to financial products by low-income individuals and groups. As part of the industry agreement, a set of "access" standards has been drafted, which sets out criteria of appropriateness, affordability and accessibility. With regard to the products offered by life insurers, the access standards specified in terms of the Charter include the following elements:[31]

7.8.1. products appropriate to identified needs, specifically the priorities of death, serious illness and provision for old age;

7.8.2. affordability, value for money and fair terms, along the lines of the UK CAT standards;

7.8.3. straightforward documentation, including a simple summary of key policy terms, that is available in multiple languages, to enable broad product understanding;

7.8.4. access to transactions that meet specified standards covering product purchase, premium payment, policy amendment, claiming and receipt of claim;

7.8.5. improved understanding of product purpose and terms; and

7.8.6. improved physical accessibility.

7.9. The draft standards cover a number of product types but do not include retirement savings products at this stage, as the industry is awaiting further

[29] The cost ratio is broadly expressed as the multiple of the policy value lost through early termination and the proportion of policies terminated. The standard is 4%, a good deal lower than the average for the South African industry average for retirement annuities of over 11% (60% reduction × 18.8% termination rate).

[30] Association of British Insurers, 2004c:29

[31] Life Offices' Association, 2005e:1

direction on the retirement reform process, particularly as regards the envisaged form that the National Savings Fund is to take.

National Treasury recommendations

7.10. National Treasury recommends that:

7.10.1. The development of straightforward and affordable long-term contractual savings products for low-income individuals be taken forward as a key element of the retirement fund reform process.

7.10.2. The long-term insurance industry be encouraged to expand product standards and accreditation initiatives beyond the Financial Sector Charter access standards to encompass all segments of the long-term insurance market. Such standards should be developed in consultation with the regulatory authorities and policy makers, in the interests of improving consumer confidence and better meeting consumer needs.

8. Consumer Education

8.1. South Africa is not alone in its challenges posed by poor levels of financial literacy. Regulators in other jurisdictions have been given explicit mandates and budgets to tackle the issue of consumer education.

Lessons from international experience

8.2. The Securities and Exchange Commission (SEC) in the United States established the Office of Investor Education and Assistance in 1994, which runs a variety of initiatives like hosting town meetings, printing publications and setting up school education programmes,[32] backed up by a significant volume of consumer information on the SEC website. Note that a distinction should be made here between investor education, which is largely what the SEC aims to provide, and consumer education, which is far broader in its objectives and wider in its reach.

8.3. The Financial Services Authority (FSA) in the United Kingdom has put into action its mandate to educate consumers in a variety of ways, including a website that includes comparative product information and a decision-tree system designed to assist consumers to determine which product is best suited to their needs. Following the recommendations of the 2002 Sandler review, there has been an increased focus on consumer education at the FSA, with this function also having received a ring-fenced budget.

8.4. The Irish and Australian authorities also provide information to consumers through their web sites and printed brochures.

8.5. Internationally, research and education activities are not only the responsibility of the regulators. In the United Kingdom, the ABI actively encourages and undertakes research that makes a meaningful contribution to understanding the issues affecting both its members and the consumers of the industry's products.

The South African experience

[32] This effort is supported by a study in the United States some years ago found that mandatory financial education at high school level raises the rates at which individuals save during their adult lives.

8.6. The LOA already has a definite commitment to financial education in terms of the Financial Sector Charter. Every insurer has a target to allocate 0.2% of post-tax operating profit specifically to increasing the understanding of low-income consumers to the products covered by the access standards (which are therefore deemed appropriate to these individuals). In addition to this, the LOA could however also play a useful role in respect of research on consumer needs.

8.7. The FSB has been provided with a statutory mandate to "promote programmes and initiatives by financial institutions and bodies representing the financial services industry to inform and educate users and potential users of financial products and services". This essentially requires the FSB to play a facilitation role. A formal FSB consumer education strategy has been in place since October 2001.

8.8. In the majority of the international cases, the regulator has an explicit mandate and a significant budget to address the needs of consumer education and acts essentially as an agent of government in pursuit of this goal. The FSB, by contrast, depends entirely on industry levies for its financial resources. A similar commitment to consumer education by the FSB would require a significant revision of the FSB mandate and funding.

8.9. The Department of Trade and Industry is in the process of drafting broad consumer protection legislation that has, as part of its objectives, the improvement of South African consumer education. The future regulatory model for consumer education in the financial sector will have to take account of this wider context.

National Treasury recommendations

8.10. The National Treasury team recommends that:

8.10.1. heightened attention be given to an effective partnership between the industry, the regulator and other stakeholders to significantly improve the financial literacy of all South Africans.

9. Governance Arrangements for Retirement Annuity Funds

9.1. In the case of retirement annuity funds underwritten by long-term insurers, concerns regarding costs and competition are further exacerbated by the complex structure and governance arrangements of such funds.[33]

9.2. A retirement annuity fund is a pension fund that is in most cases sponsored, administered, underwritten, invested and, in many respects, governed by a long-term insurer.[34] In terms of a contractual arrangement, the fund pays contributions to the insurer on behalf of each of its members in return for an annuity income for the member that starts on his or her retirement date. The retirement annuity fund acts solely as a conduit between the member and the insurer and holds no assets of its own, other than a policy with the insurer.[35]

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[33] Retirement annuity funds were originally set up by long-term insurers as a tax-incentivised vehicle for retirement savings by the self-employed – the equivalent of the occupational pension funds enjoyed by those in formal employment. Over time, retirement annuity funds have also become the primary vehicle used by persons in formal employment to supplement occupational retirement fund benefits. Retirement annuity funds are pension funds and are regulated by the Pension Funds Act, 1956.

[34] Not all retirement annuity funds are insured. The comments in this document apply to those that are, although all other retirement annuity funds must in any case fulfill their obligations under the Pension Funds Act.

[35] In most cases where a retirement annuity is to be provided by a fund, on the retirement of a member of the fund, it is funded by a long-term policy issued to the fund when the member joins the fund. The fund, which serves as the

9.3. The long-term insurer generally appoints the board of trustees that manages the retirement annuity fund. This board of trustees often includes employees or former employees of the insurer.

9.4. The fact that sponsorship and governance of the fund by and large lie with the administering insurer can be perceived as a form of vertical integration that introduces clear conflicts of interest for trustees and consultants. [36] In particular, in cases where trustees are appointed by the insurer administering the retirement annuity fund, concerns arise about the ability of such trustees to act in a manner that is fully consistent with their fiduciary duties towards the members of the fund.

9.5. A further problem is that the rules of the retirement annuity fund, which govern the relationship between the members and the fund, often do not explicitly state the basis on which member benefits are calculated under different circumstances – in particular, there is no clear disclosure of the benefit payable upon early retirement or early cessation/reduction of contributions. Usually the rules of the retirement annuity fund incorporate the long-term insurance policy that underwrites the retirement benefit[37] by reference only, without clearly disclosing to the member the terms and conditions attached to these policies.

9.6. These governance issues were highlighted in the 2005 Statement of Intent as requiring urgent regulatory change. Such measures would include, where necessary, changes to practice notes, regulations or legislation to clarify the uncertainties in the existing regulatory framework. At the same time, it was recognised by all parties that retirement annuity funds are, from a legal perspective, pension funds governed by the requirements of the Pension Funds Act, and that they cannot avoid their responsibilities to members by reference to arguments concerning the complex relationship with the administrator and the fact that the only assets owned by the retirement annuity funds are insurance policies.

National Treasury recommendations

9.7. The National Treasury team recommends that consideration be given as part of the longer term process of retirement fund reform to the possible introduction of measures that:

9.7.1. disallow fund rules that require funds to obtain products and services from specified providers; and

9.7.2. require the trustees of funds to separately appoint these providers, even if, in the end, they may all be within one stable.[38]

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legal vehicle through which the policy is taken out, must take out the policy that the client requests – subject only to any restriction that there may be in the rules of the fund on the type of policy which is available to be taken out through the fund (LOA 2005c;5,6).

[36] For example, a person who joins a retirement annuity fund may find that, in terms of its rules, the fund must be administered by the fund's sponsor, his or her retirement savings must be invested in an investment product provided by the funds sponsor, only an actuary employed by the sponsor may act as valuator to the fund and that, on retirement, only an annuity product provided by the sponsor may be purchased with the member's retirement savings, such as they are at the time.

[37] The long-term insurance policy constitutes the contractual relationship between the insurer and the fund.

[38] Such provisions appear in both –

- the UK Pensions Act, 1995, which requires that trustees of a fund specifically appoint the following advisors to the fund: the fund's auditor; actuary; (in most cases) fund administrator; asset custodian and (in most cases) legal advisor; and

9.8. In the interim, the National Treasury team recommends that:

9.8.1. Legislative and regulatory measures be implemented to align disclosure requirements under the Pension Funds Act and the Long-Term Insurance Act.[39]

9.8.2. A Code of Governance for Trustees be issued to clarify the fiduciary duties of the trustees of retirement annuity funds.

9.8.3. Regulations and model rules be issued on matters that must be included and addressed in all retirement annuity fund rules, including:

9.8.3.1. requiring that the retirement benefits to be provided to a member of such a fund shall be equal to the value of the policy benefits provided under the long-term insurance policy issued to the fund in respect of that member, which policy benefits shall be determined in terms of the provisions of these policies and in accordance with the requirements of the Long-term Insurance Act and the regulations issued, or to be issued under that Act, including those covering the proposed minimum early termination values outlined in section 12; and

9.8.3.2. ensuring that there is adequate disclosure to members of the retirement benefits payable by the fund under various circumstances, including early retirement or premium cessation/reduction.

9.8.4. To address issues of barriers to effective competition raised in section 5, such model rules should also allow for portability of accumulated assets from one retirement annuity fund to another, subject to an administrative charge that is not unreasonable relative to the cost of disinvestment.

10. Intermediary Relationships

10.1. The often conflicted relationship between the intermediary and the policyholder is a key contributing factor to the failure of the existing system to work in the best interests of the consumer. The triangular association – whereby the intermediary provides advice to the policyholder but is incentivised by the insurer, who then recoups such costs from the policyholder – is fundamentally flawed. A commission-receiving intermediary cannot, by definition, be thought to be truly independent.

Lessons from international experience

10.2. The Sandler review (2002) into contractual savings in the United Kingdom recommended that adviser rewards be established separately from the product provider and that only those who accept remuneration exclusively from the consumer should be permitted to refer to themselves as advisors.

- the Australian Superannuation Industry (Supervision) Act, 1994, which requires that the governing rules of a fund may not permit its trustees to be subject, in the exercise of any of the trustees' powers under those rules, to direction by any other person.

[39] The retirement annuity fund member should be placed in such a position that he or she is provided with information at a standard considerably higher than current minimum standards, including a requirement that retirement annuity funds provide members with the rules of the retirement annuity fund, clear disclosure of charges and commission (at least as strong as disclosure standards required of insurers generally) an explanation on the relationship between the fund, fund member and the insurer.

10.3. The Sandler review also recommended a strengthening of the advisor qualification regime, suggesting that it should be modified to improve the focus on investment fundamentals like asset allocation and diversification.

National Treasury recommendations

10.4. The National Treasury team recommends that:

10.4.1. every intermediary be required to declare themselves to a prospective policyholder as either (a) a sales agent of a product or service provider, i.e. an "insurer agent", or (b) an independent financial advisor;

10.4.2. insurer agents be remunerated by the insurer only;

10.4.3. independent financial advisors be remunerated by the customer only, by direct payment or authorised deduction from the policy;

10.4.4. insurer agents may be linked to one provider only, referred to here as "tied agents", or have relationships with a number of providers, known as "independent brokers", in which case they should be able to demonstrate to their clients sufficient knowledge of the products of all these providers to warrant describing themselves as independent;[40]

10.4.5. only independent financial advisors be allowed to describe themselves as "advisors" or "providing advice" because only these intermediaries are free of product or provider bias and may not receive compensation in any form from providers;

10.4.6. the declaration of capacity (hence source of remuneration) cover all clients, meaning that an intermediary may not service some clients in the capacity of an insurer agent and others in the capacity of an independent financial advisor; and

10.4.7. the declaration of capacity apply not only to an individual but to the organisation that they represent, removing the potential for conflict of interest from firms as well as individuals.

10.5. This recommendation is not about separating the sales process from the advice process, it is about addressing the principal-agent conflict. It forces the intermediary to declare in advance the capacity in which he or she operates – and if that is one of acting as an agent of the client, this must be backed up by a refusal to accept any remuneration from any other party.

10.6. Though many tied agents and independent brokers undertake a financial needs analysis as part of the sales process, this cannot be regarded as independent advice in the true sense of the word, in that this service is paid for by the product provider in the form of commission.

10.7. Given the increasing financial risks borne by the investor in a changing savings environment, as highlighted in Section 2, the quality of the investment advice provided is of crucial importance. FAIS has already contributed to improvements

[40] Note that although meeting these criteria qualifies brokers to describe themselves as "independent", brokers cannot represent themselves as "advisors". As outlined in section 10.4.5, the qualifying criteria for the term "advisor" is that the intermediary may not receive any form of compensation from the insurer.

in this area.[41] It has always been the widely communicated intention to improve the qualification standards under FAIS over the course of time. The National Treasury recommends that:

10.7.1. consideration be given to the establishment of higher standards of intermediary education through inter alia a separate privately-managed accreditation system established by intermediary bodies in co-operation with the FSB and FAIS Ombud to set standards that appropriately recognise the expertise required for different product areas; and

10.7.2. accreditation by independent financial advisors under such a qualification system be mandatory.

10.8. This document focuses on insurer-provided contractual savings products, but the principles of a clear definition of the capacity in which an intermediary acts in providing advice or product sales and improved intermediary education, cut across all areas of the financial services industry. The intention is that the same model used to address the principal-agent issue in the long-term insurance sector be applied across the financial services industry.

11. Regulation of Commission and Advisory Fees

11.1. Much of the discussion that has taken place over the last year between policymakers and industry players has focused on the subject of commission. This paper seeks to demonstrate that commission is not the only source of the problems that have arisen, but that current commission scales are not in the best interests of policyholders and are a significant contributor to the inequitable burden of costs.

11.2. Commission regulation can be assessed with reference to six criteria:[42]

11.2.1. whether commission or elements of commission are capped or prescribed in any way;

11.2.2. the structure of commission, whether it is paid up front or on an ongoing basis and, if in combination, how this combination is balanced;

11.2.3. the level of commission in its various elements;

11.2.4. other elements of commission structure, like claw back rules and treatment of contribution increases;

11.2.5. whether the regulations make any allowance for special groups, for instance, low-income policyholders; and

11.2.6. the manner in which the principal-agency conflict is addressed (this point is dealt with in section 10.4).

[41] The FAIS framework determines the qualification requirements for various levels of intermediaries, depending on the financial products that the intermediary sells and/or advises on. The FSB relies on the framework operated by the South African Qualification Authorities (SAQA) or the Committee of Heads of Universities for the development, recognition and determination of the levels of such qualifications.

[42] Similar elements can be used to assess the regulation of advisory fees.

Lessons from international experience

11.3. The modern global trend concerning commission is one of deregulation combined with increased disclosure. Australia, Austria, Canada, Denmark, Japan, Singapore, Uganda and the United Kingdom, for example, do not limit commission (or insurer charges) in any way. The issue continues to receive attention, however, and conclusions of recent research in the deregulated United Kingdom environment[43] provide useful food for thought to South African policymakers, suggesting that:

11.3.1. commission structures be considerably simplified and that all products serving the same broad purpose have the same structure;

11.3.2. the structure should motivate the provision of appropriate advice, separating initial and ongoing advice, and spreading the remuneration for initial advice over time;

11.3.3. annual statements of costs, including advice fees, should be provided to consumers, reminding them that they are paying for advice;[44]

11.3.4. consumer strength should be enhanced by giving them the right to request that payments for advice be switched from one advisor to another, or stopped altogether; and that,

11.3.5. more research on a "mystery shopper" basis would help to establish the quality of advice being provided.[45]

11.4. The Dutch authorities have decided to impose a restriction on the currently unregulated commission environment, arguing that the emphasis on up-front commission provides inappropriate incentives to the intermediary. Regulatory proposals provide for the balance between up-front and ongoing commission to be set at fifty-fifty by 2009 at the latest.

Regulation of levels of commission and/or advisory fees

11.5. As highlighted above, the international norm is to have deregulated commission levels, essentially allowing commission rates and advisory fees to be determined by the market. In South Africa, commission levels for contractual savings products in the insurance sector are capped while advisory fees are negotiated and not subject to regulated maxima. In considering the potential for deregulated commission levels, the alternatives are dismantling the commission arrangements immediately or establishing a set of criteria that must be met as a pre-condition to the removal of commission scales, as discussed below:

11.5.1. Arguments for deregulation include the fact that regulated commissions in the insurance sector: (a) are inconsistent with deregulated commissions in other industries in the financial sector (such as collective investment schemes); (b) can be potentially anti-competitive; and (c) can in some cases be circumvented or result in regulatory arbitrage (relative to, for instance, other forms of product

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[43] Association of British Insurers (2005a) *Financial Advice: How Should we Pay for it?*, published by the ABI, February 2005.

[44] Commission disclosure goes hand in hand with other improvements to disclosure, consistent with the principles set out in the recommendations of section 6.6.

[45] Researchers conducting analysis on a mystery shopper basis test the quality of advice and supporting service, and the appropriateness of the product recommendation, by posing as customers.

distribution, such as direct marketing, where incentives are extremely difficult to regulate through commission scales).

11.5.2. While there is a strong case for deregulation, consideration must also be given to the conditions under which a market-determined approach to commissions would be appropriate. A market-driven approach should result in investor gains, provided that the market is characterised by effective competition. Preconditions would include: (a) an effective system of disclosure; (b) appropriate consumer and intermediary education; and (c) a financial safety net for investors (such as minimum early termination values).

11.5.3. The risk is that, without well-informed consumers, effective disclosure and some type of safety net, commission deregulation would not improve competition. In fact, in the absence of these preconditions, competition for new business would tend to put upward pressure on commission rates. This suggests that some form of commission regulation would need to be retained, albeit temporarily, and this in turn requires that the structure and level of these scales be determined.

11.6. Advice fees, by contrast, are fully disclosed and negotiable between the independent financial advisor and the client. There is no need to regulate advisory offerings in detail because (a) advice is by definition needs driven, (b) it is difficult to police the provision of advice, and (c) the customer has the right to terminate the advisor contract at any time.

Regulation of commission structures

11.7. As outlined in section 2, current commission scales allow for the payment of upfront commission, in the proportion of 75% in the first year, and 25% in the second year of the policy.

11.8. The LOA has submitted a proposal on commission scales for savings products that recommends a partial move away from the upfront commission system and a separation of remuneration for the sales process and for what is termed advice respectively. In terms of the proposal, for regular-premium savings products:

11.8.1. The intermediary responsible for selling the policy receives commission at a recommended rate of 3% of premium in a structure that is a hybrid of upfront and ongoing commission. The commission payments can be received in advance, discounted to reflect the time value of money, at the beginning of each five-year period, for as long as the policy continues. Termination in the first two years triggers claw back. In the first five-year period, none of the initial commission can be clawed back after two years have passed. Termination during any subsequent five-year period triggers claw back in respect of the outstanding term of that five-year period, but not in respect of earlier five-year periods. The proposal is designed to motivate the selling intermediary to make sure that the policy remains in force.

11.8.2. The same intermediary, or any other intermediary chosen by the policyholder, receives commission for providing advice, also at the recommended rate of 3% of premium.[46] This is paid annually for as

[46] Note that in terms of the proposed distinction between independent financial advisors and insurance agents contained in section 10, this could not be termed advice in the true sense of being independent, as it is remunerated for by the insurer. It can, however, be thought of as payment by the insurer for ongoing policyholder support.

long as the policy remains in force. It is designed to motivate the advising intermediary to provide ongoing advice to the policyholder. This is backed up by the right of the policyholder to switch the payment of the advice component of the commission from one advisor to another.

11.8.3. A modification of this approach is suggested for intermediaries servicing the low-income part of the market, on the basis that the proposed commission structure would in many cases not provide a level of income sufficient to sustain a viable business for such intermediary. A substantial drop-off in the number of intermediaries servicing this market could reduce access by low-income individuals to contractual savings products. The suggestion involves a minimum fixed commission and a more generous advancing of sales commission, using a ten-year period, for example, rather than five.

11.8.4. In combination, the two components of the commission payment are designed to:

11.8.4.1. naturally increase early termination values (the LOA proposal predates the December 2005 Statement of Intent covering minimum early termination values); and

11.8.4.2. motivate both the sales person and advisor (a) to provide more appropriate advice initially and (b) to continue to service the policyholder over the term of the policy.

11.8.5. Suggestions were also put forward for single premium arrangements and paid-up policies, designed for consistency of approach. The LOA suggested that products that provide predominantly risk cover should not be affected by the changes.

11.9. A number of responses to the LOA proposal were received, mostly from organisations representing intermediaries. Comments raised included the following:

11.9.1. The postponement of commission revenue would exact a heavy toll on the intermediary industry, which would experience substantial loss of personnel, particularly among those seeking to service low-income individuals. Policy sales would fall, perhaps leading to significant damage to already low levels of household saving.

11.9.2. The LOA proposal seeks to address the burden of high initial costs from commission but fails to deal with the high costs incurred at policy inception by the insurer. In fact, the proposal in no way calls upon the insurer to share the burden of these costs.[47]

11.9.3. Not enough time has elapsed since the introduction of new disclosure requirements under FAIS to assess the impact on costs. It is argued that once FAIS is fully functional, a deregulated remuneration environment would constitute a better model than the LOA proposal. This would also be more consistent with other savings products. If commission continues to be regulated, then other parts of the so-

[47] The responses were received prior to agreement being reached on minimum early termination values. As discussed in section 12, minimum early termination values to indeed shift some of the risk of early termination onto the insurer.

called "value chain" should be similarly controlled (for example, sales through outsourced call centres).

11.10. As discussed in section 12.7, it is envisaged that, as part of the broader retirement fund reform process, individual retirement fund products will be required to offer minimum benefits upon early termination that support the principles of transferability and member protection. Under such an environment, it is likely that there will be a natural tendency for the providers of individual retirement fund products to pay commission on a more on-going basis. While this is the likely future path of commission structures, it is accepted that an immediate shift to a new model that would provide for *only* on-going commission would threaten the survival of existing intermediary businesses and would discourage the entry of new intermediaries into the market. As such, a workable interim model must be found for the regulation of commission.

National Treasury recommendations

11.11. With regards to the possible deregulation of commission levels, the National Treasury team recommends that:

11.11.1. Commission levels remain subject to regulated maxima, until there is evidence that other measures are effectively protecting policyholders, including:

11.11.1.1. a significantly improved system of disclosure;

11.11.1.2. appropriate consumer and intermediary education initiatives;

11.11.1.3. a tried and tested system of enforcement of provisions under FAIS; and

11.11.1.4. a sound financial safety net for policyholders, in the form of enhanced minimum early termination values.

11.12. With regards to the regulation of advisory fees, the National Treasury team recommends that:

11.12.1. The advice fee be a matter for discussion and agreement between the independent financial advisor ("the advisor") and the customer.

11.12.2. The level and structure of the advice fee payable by the customer to the advisor remain unregulated, provided that:

11.12.2.1. a differentiation is made between initial advice and ongoing advice. The fee for ongoing advice should be spread in order to avoid losing the link between payment and advice; and

11.12.2.2. the customer retains the right, in all circumstances, to cancel the agreement with the advisor, either transferring the payment of the ongoing advice fee to another advisor, or stopping it altogether.

11.12.3. Concern is raised that advice fees expressed as a percentage of the assets under management are not necessarily in the best interests of the client, on the basis that they provide an incentive to the advisor to maximise the assets of the customer without proper regard to investment risk.

11.13. With regard to the level and structure of sales commission, the National Treasury team recommends that:

11.13.1. Notwithstanding the longer-term objectives set out in paragraph 11.11.1, the level and structure of the sales commission payable by the insurer to the tied agent or independent broker (“the insurer agent”) be determined by agreement between the insurer and the insurer agent[48,49] but subject to maxima, governed by the principles that:

11.13.1.1. the regulated maximum level of commission should reflect the fact that commission absorbs a higher proportion of fund value in the current low inflation, low return environment;

11.13.1.2. a limited proportion of the commission should be paid up-front, with the balance payable over the term of the policy, to provide an incentive to the sales agent to ensure that the policy is appropriate to the needs of the customer and to service the policyholder throughout the term of the policy;

11.13.1.3. the payment of ongoing commission should be conditional on the provision of ongoing support to the policyholder;

11.13.1.4. the policyholder should maintain the right to re-direct ongoing commission to an alternative agent or discontinue it completely;

11.13.1.5. commission on contractual contribution increases should be paid as and when the increases occur and are conditional on ongoing support to the policyholder; and

11.13.1.6. the structure and level of commission scales should be determined through further discussion with the objective of balancing the interests of all parties, bearing in mind that this is essentially a matter between the insurer and its agent, and that the policyholder will be provided with a degree of protection through other measures, primarily minimum early termination values (as discussed in section 12).

11.13.2. The proportion of up-front commission should be specified as a maximum, below which an insurer and its intermediary agents can negotiate an appropriate up-front element that shares the risks of early termination and allows them to strike an appropriate balance between:

11.13.2.1. on the one hand, being sufficiently attractive to intermediaries to entice new entrants into the industry, promote access to life assurance products and ensure a sustainable industry; and

11.13.2.2. on the other hand, enabling the insurer to sustainably meet regulated minimum early termination values.

11.13.3. Claw back provisions through regulation need no longer apply, because policyholders will be protected by minimum early termination values, although it is recognised that insurers and agents may wish to

[48] Such commissions must be fully disclosed to the policyholder and must be sufficiently flexible to allow for negotiation by the policyholder.

[49] The same regulated commission level and structure should apply to both endowment and retirement annuity policies, as there is no compelling reason to maintain the current differentiation.

include claw back provisions as part of the terms of their contractual relationship.

11.13.4. Changes to the regime impacting on advice fees and sales commission should be applied in a consistent manner to risk products as well as to savings products, because:

11.13.4.1. the fundamental rationale for the change is to remove principal-agent conflicts – this rationale applies equally to risk products and to savings products;

11.13.4.2. a single system for all insurer products is simpler to administer and regulate; and

11.13.4.3. establishing a different set of rules for savings and risk products may run the risk of regulatory arbitrage and distort the products offered to consumers.

11.13.5. A consistent approach should be determined for single premium products that avoids undue incentives for insurer agents or independent financial advisors to motivate the sale of one in preference to the other.

11.13.6. Consideration be given to ways in which access to savings products by low-income investors might be supported, for example, financing arrangement between the insurer and intermediary that do not put fund values at risk.[50]

11.13.7. The LOA and its member firms should be encouraged to carry out independent research to test the appropriateness of product sales and the effectiveness of independent advice, making public the outcome of this research and recommended changes to best practice.

12. Minimum Early Termination Values

12.1. The legislative framework governing insurers as providers of retirement funding products has historically tended to focus on financial soundness. This is clearly an important criterion, in that regulation aimed at financial stability is also part of consumer protection. A volatile financial sector is not in the best interest of the investing public. However, the framework needs to be balanced with a greater focus on market conduct and product regulation. In particular, in the case of an early termination, the current regulatory framework appears to err rather strongly in favour of the insurer and its shareholders. The legislation puts a considerable burden on the statutory actuary of an insurer to certify that the firm does not engage in any practice that has the potential to put it under financial stress. The actuary must establish a set of rules governing every policy. The actuary must also ensure that early policy termination, that legally constitutes a unilateral modification of a long-term contract, does not potentially damage the financial security of the insurer.

12.2. In the past, this framework has been an integral part of actuarial practice, but might be considered rather outdated in the modern environment of consumer flexibility and shareholder ownership. The responsibility for financial soundness should be modified by a set of parameters, including minimum early termination

[50] This could include insurer loans, advanced commissions, or other forms of income support that form part of the insurer's general distribution costs, rather than being charged to a particular policyholder's expense account.

values, that recognises the very different environment of today. This approach helps to ensure that business risks, that have hitherto as far as possible been passed on to the policyholder, are shared more evenly between provider, intermediary and policyholder.

Statement of Intent agreement on minimum early termination values

12.3. The Minister of Finance and the insurance industry reached an agreement acknowledging the issue of poor early termination values and establishing a set of rules defining minima for these values, encapsulated in the December 2005 Statement of Intent.[51]

12.4. This agreement provides for automatic credits to policies already prematurely terminated, as far back as 1 January 2001, to ensure minimum early termination values, as follows:

12.4.1. for retirement annuities, 65% of the investment account of the policy at the date immediately preceding early premium cessation;

12.4.2. for endowment policies, 65% of the investment account at the date immediately preceding premium cessation;[52] and

12.4.3. for reversionary bonus policies and whole life policies with a predominant saving element, an equivalent value as defined above for retirement annuities and endowment policies.

12.5. For existing policies that are still in force, the agreement provides for minimum values in the event of early termination as follows:

12.5.1. for retirement annuities, 70% of the investment account at the date immediately preceding the premium cessation;

12.5.2. for endowment policies with premium cessation or reduction, 70% of the investment account at the date immediately preceding the cessation or reduction;

12.5.3. for surrendered or lapsed endowment policies, 60% of the investment account of the policy immediately prior to surrender; and

12.5.4. for reversionary bonus policies and whole life policies with a predominant saving element, an equivalent value as for retirement annuities and endowments.

Lessons from international experience

12.6. Statutory minimum surrender and paid-up values exist in other parts of the world.

12.6.1. Each state in the United States, for example, provides for minimum values in what is referred to as the Standard Nonforfeiture Law. Every new insurance product must be filed with the state insurance department and must demonstrate compliance with this law.

12.6.2. Australia has a set of minimum surrender and paid-up values in place for insurance products with investment content. These values are

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[51] Some insurers had prior to this date already redesigned products to improve early termination values, voluntarily establishing retirement annuities with ongoing commission structures.

[52] There is no minimum value for endowment policies that were surrendered or lapsed.

defined in detail to achieve the twin objectives of, firstly, providing a minimum basis for paying termination policyholders and, secondly, protecting the interests of remaining policy owners.[53]

12.6.2.1. For pure investment products, the Australian calculation takes the form of "policy value less allowable expenses". This is more precise than the approach used in the Statement of Intent, which sets out a minimum percentage of the policy value. However, it requires specification of maximum expense allowances - and therein lies the detail.[54]

12.6.2.2. The expense allowance in the minimum surrender value must not exceed the specified limits, but it should also not exceed the ongoing charges actually applied to the policy or the charges disclosed in policy documentation and promotional material.

12.6.2.3. Traditional long-term business covering those products that are a hybrid of risk and investment types are set out separately. Here the specification is detailed and precise, including details such as mortality rates and interest rate assumptions and a separate technical description of the calculation. A further specification covers other types of business.

12.6.2.4. Minimum paid-up values are separately specified.

12.6.2.5. Risk business is precisely defined for the purposes of the Australian standard. This type of business does not have a minimum surrender value because the premium is more closely matched to the services provided and the justification for surrender values is reduced.

Enhanced early termination values

12.7. In approaching the issue of providing improved policyholder protection, the Statement of Intent outlines an agreement on the retrospective application of enhanced early termination values. Going forward, effective competition and investor protection require that, if a policyholder is not satisfied with the value being provided by a particular contractual savings product, he or she should be able to transfer their funds to an alternate provider, at low cost to the policyholder.[55]

12.8. From this perspective, there are three phases to the introduction of minimum early termination values. The first covers policies already terminated after 1 January 2001, the second existing policies that have not had a premium reduction or cessation and the third policies sold after the effective date of the regulations. The Statement of Intent covers the first two phases, as discussed in paragraphs 12.4 and 12.5 respectively. The remainder of this section considers principles that would guide regulations covering policies that fall into the third

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[53] Life Insurance Actuarial Standards Board (2002)

[54] The allowance for fixed dollar charges, for example, increases by the official inflation rate from the 1998 values set out in the specification.

[55] The 2004 Discussion Paper on Retirement Fund Reform states that individual retirement funds will be required to allow transfer of retirement savings between funds. It is envisaged that, in order to achieve the objectives of effective portability, the cost of such transfer should be low and not unreasonable in relation to the administrative cost of effecting such transfer.

phase: new contracts that are sold with effect from a future date to be determined in the revised regulations.

12.9. A set of minimum early termination values provides protection for policyholders that should operate in conjunction with the other regulatory modifications proposed in this document. As early termination values are a foundation of policyholder protection, they must be set at levels that appropriately allocate the risk between the parties involved: the policyholder, product provider, the sales agent and the independent financial advisor.

12.10. The minimum early termination values agreed to in the Statement of Intent had to, by necessity, provide a simple and easily implementable solution to redressing past inequalities. The flat scales that form part of the Statement of Intent provide a useful start, but the crafting of regulations to guide the development of new products going forward affords the opportunity for a more nuanced approach to address the following issues:

12.10.1. Insurer costs absorb a smaller proportion of the accumulated investment account of a policy as the term since inception of the policy increases. Minimum early termination values should track this increase in fund value over time. While the terms of the agreement that led up to the Statement of Intent were that the enhanced values payable on early terminations would not be funded through reducing the values of maturing policies (i.e. that the additional insurer costs would have to be met from shareholder resources rather than by changing the terms of existing policies), a framework for minimum early termination values on future policies should address this issue without having to resort to such an agreement.

12.10.2. There is a need to make adequate allowance for differences in charging structure from one product provider to another, or from one product to another. In particular, regulations should be able to cater for contracts with explicit up-front charge deductions.[56]

12.10.3. Regulations should provide an incentive to insurers to control their costs going forward, which may be difficult if the minimum early termination values are expressed in terms of an after-charge value.

12.11. The methodology for determining minimum early termination values could be expressed more flexibly to address the impact of product design set out in paragraph 12.10.2.

12.11.1. A higher set of percentages could be specified for front-load policies. This is the approach that has been adopted in terms of the Statement of Intent, but it is not sufficiently flexible to allow for future product developments.

12.11.2. The terms of the calculation that takes place on early termination could be specified on the assumption that the insurer recoups costs on the more common level-loaded or ongoing basis. This has the advantage of introducing a level playing field, but may then require specification of a maximum set of charges and a more complex calculation by insurers that front-load their policies.

[56] Front-load policies do not result in a significant charge to the fund value on early termination as the policy value already reflects the actual costs incurred by the insurer up until that time.

12.11.3. The calculation could be specified as a percentage of contributions. This exposes the insurer to financial loss and a run on the books during periods of poor returns; the converse is also true, in that it exposes the policyholder to proportionally poorer values during periods of high returns.

12.11.4. The minimum values could be expressed as a proportion of a gross policy value, in others words, the value of contributions with accumulated investment returns but without any allowance for charges. This prevents the insurer from charging whatever it wishes to, but places more financial risk on smaller policies, because insurer costs are usually proportionally higher in these cases.

12.12. Concern has been raised that minimum early termination values have the potential to increase the likelihood of an existing policyholder terminating an existing policy in favour of a new contract, triggering a commission payment in the process. This risk will be partially or completely offset by the proposed changes to the commission structure designed to reduce the incentive for the intermediary to encourage unnecessary policy replacements.

12.13. In the interim, regulations on policy replacements – for instance, forbidding commission in cases where a policy is designed to replace another – would be difficult to police. There is, however, a role for insurers to exercise greater oversight over their agents in this regard.

National Treasury recommendations

12.14. The National Treasury team recommends that:

12.14.1. regulations be promulgated to give effect to the agreement contained in the Statement of Intent on minimum early termination values applicable to existing policies and policies terminated after 1 January 2001; and

12.14.2. regulations covering enhanced minimum early termination values, to be applied to new policies from a date of implementation to be specified in such regulations, be established that meet the following criteria:

12.14.2.1. a graduated set of minimum values, increasing as the term since inception of the policy increases, so as to avoid a transfer of insurer cost from terminations that occur early in the policy term to those that occur later in the policy term;

12.14.2.2. early termination values resulting from the set are high enough to provide an adequate level of portability and protection to the policyholder;

12.14.2.3. these values are sufficiently low to provide some discouragement of early termination, which is seldom in the long-term interest of the policyholder;

12.14.2.4. they appropriately share the risk of early termination between the parties to the contract, namely the policyholder and the insurer, but also taking into account the intermediary, aligning as far as possible the interests of all parties; and

12.14.2.5. they recognise appropriately the incidence of insurer costs, allowing for any envisaged new commission basis.[57]

12.14.3. The basis for the calculation should also take into account differences in product types. Suggestions on the most appropriate approach are invited. The alternative methods identified so far that most closely meet the requirements are

12.14.3.1. an appropriate proportion of the gross-of-fee investment account; and

12.14.3.2. a proportion of the investment account net of maximum ongoing fees, with the added requirement that, for other charging methods, the termination values should be equivalent to those of an insurer with these ongoing fees.

12.14.4. Alternatives to limit the potential for increased policy churning should be considered, including suggestions on the roles of insurance and intermediary associations.

[57] The LOA has calculated the impact of its proposed commission scales on early termination values. They show that a 20-year retirement annuity product under existing commission rules could expect to provide a paid-up value of 47.5% of the policy value two years into the term of the policy and 74.4% of the policy value if conversion takes place after five years. Applying their proposed commission model increases these values to 75.5% after 2 years and 83.8% after 5 years. If insurers make an effort to reduce acquisition expenses as well, say, down to an amount equal to the new commission charge, these percentages would be raised further to 85.7% and 87.0% of fund value for premium cessations after 2 years and 5 years respectively. These percentages provide a useful starting point from which to consider the appropriate scales for the modified minimum early termination values.

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Web Site Addresses

The following list sets out the web sites of a number of the regulators and industry bodies mentioned in this paper:

www.asic.gov.au	Australian Securities and Investments Commission *The consumer web site is available through a link on the main web site or directly at www.fido.asic.gov.au*
www.apra.gov.au	Australian Prudential Regulation Authority *APRA oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry*
www.fsa.gov.uk	Financial Services Authority, United Kingdom *Links on this site provide access to the FSA Library, providing a variety of documents, and to the consumer page, also available directly at www. fsa.gov.uk/consumer/*
www.ifsra.ie	Irish Financial Services Regulatory Authority *This site also provides a menu of options for consumers.*
www.sec.gov	United States Securities and Exchange Commission *The SEC provides extensive consumer education information, available at www.sec.gov/investor.shtml*
www.abi.org.uk	The Association of British Insurers
www.raisingstandards.net	Raising Standards Quality Mark Scheme *Brand accreditation standard established by the Association of British Insurers.*
www.mas.gov.sg	The Monetary Authority of Singapore
www.iaisweb.org	The International Association of Insurance Supervisors
www.fsb.co.za	The Financial Services Board
www.loa.co.za	The Life Offices Association