

A TECHNICAL REVIEW OF THE CONSUMER CREDIT INSURANCE MARKET IN SOUTH AFRICA

Stakeholder Workshops

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Overview

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2. Case for regulatory intervention
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4. Focus areas under consideration
5. Next steps

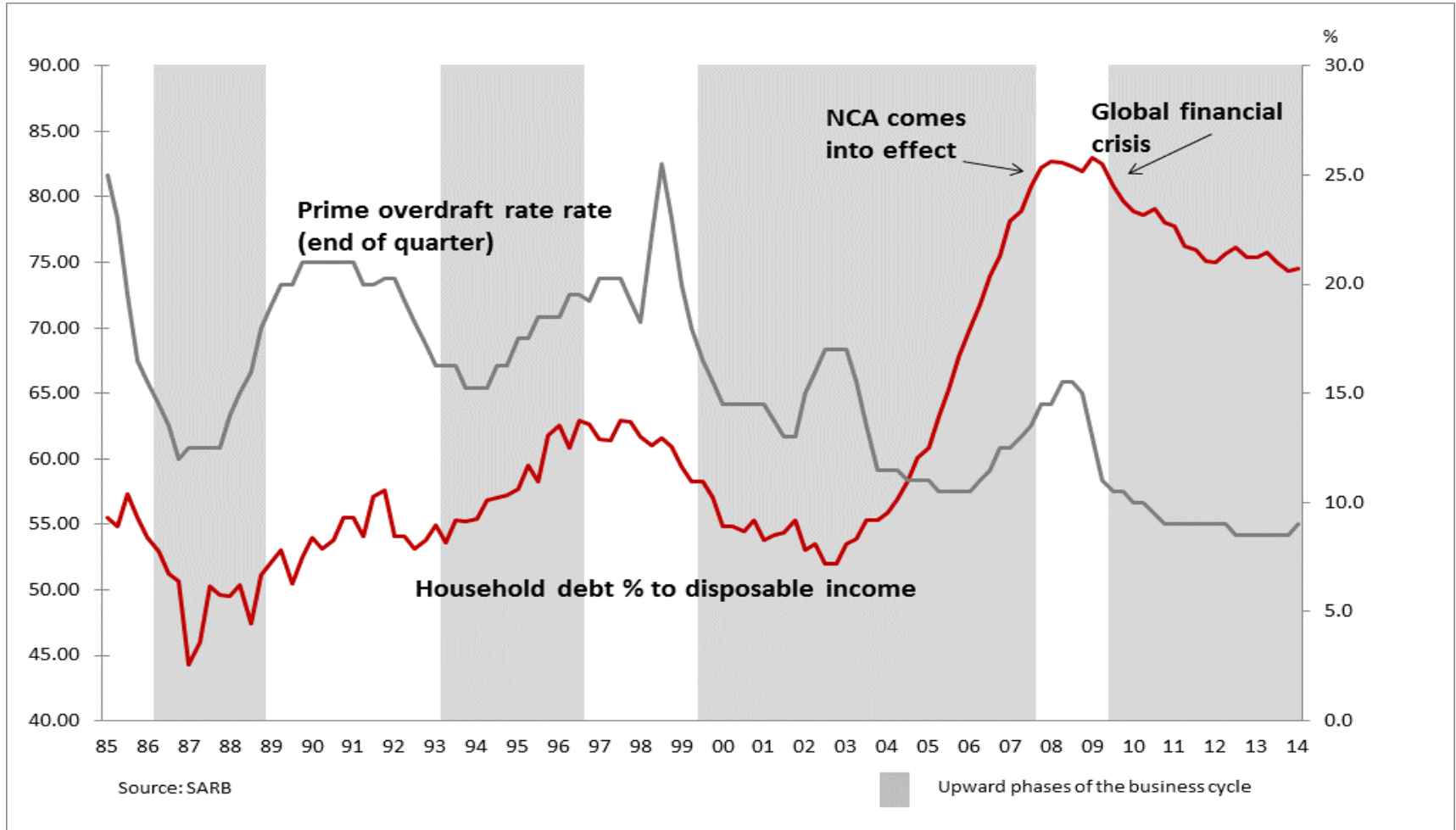
Background and context of CCI review

- The NT and FSB initiated a review of business practices in the Consumer Credit Insurance (“CCI”) sector in South Africa.
- Technical Report released for comment on 3 July 2014. The review looks at the:
 - market structure as well as the existing policy and regulatory framework for the CCI sector.
 - CCI landscape post the National Credit Act and other regulatory developments.
 - Comparative international examples such as UK, Australia, Chile, Italy.
- The review builds on the 2007 Nienaber Panel of Enquiry.
- The report lays the basis for engagement with the CCI industry– in order to inform and finalise the CCI policy framework.

Household over-indebtedness– joint approach to implement Cabinet’s decision

- The review forms part of the wider Government initiative to deal with household over-indebtedness:
 - In December 2013, Cabinet authorised the Ministers of Finance and Trade and Industry to take measures to assist over-indebted households and also prevent them from becoming over-indebted in future.
 - Inter governmental oversight committee (DoJ, dti, NT, FSB, NCR, NCC, SARB) established.
- National Credit Amendment Act No. 19 of 2014 empowers the Minister of Trade and Industry, in consultation with the Minister of Finance, to prescribe a limit in respect of the cost of credit insurance that a credit provider may charge a consumer.

Increase in household debt as a percentage of income to 74.5% in March 2014



Case for regulatory intervention in the CCI market

- Is the CCI market delivering on its objectives of protecting customers & credit providers?
- Are premiums, profit margins and commissions excessive or reasonable?
- How does CCI support the extension of credit and asset accumulation. What are the linkages to household indebtedness and financial inclusion?
- Why the need for mandatory CCI with credit & how does it add to the total cost of credit?
- When is mandatory CCI appropriate? For e.g. high value transactions?
- Is CCI designed in a way which meets the needs of customers & delivers on fair outcomes?

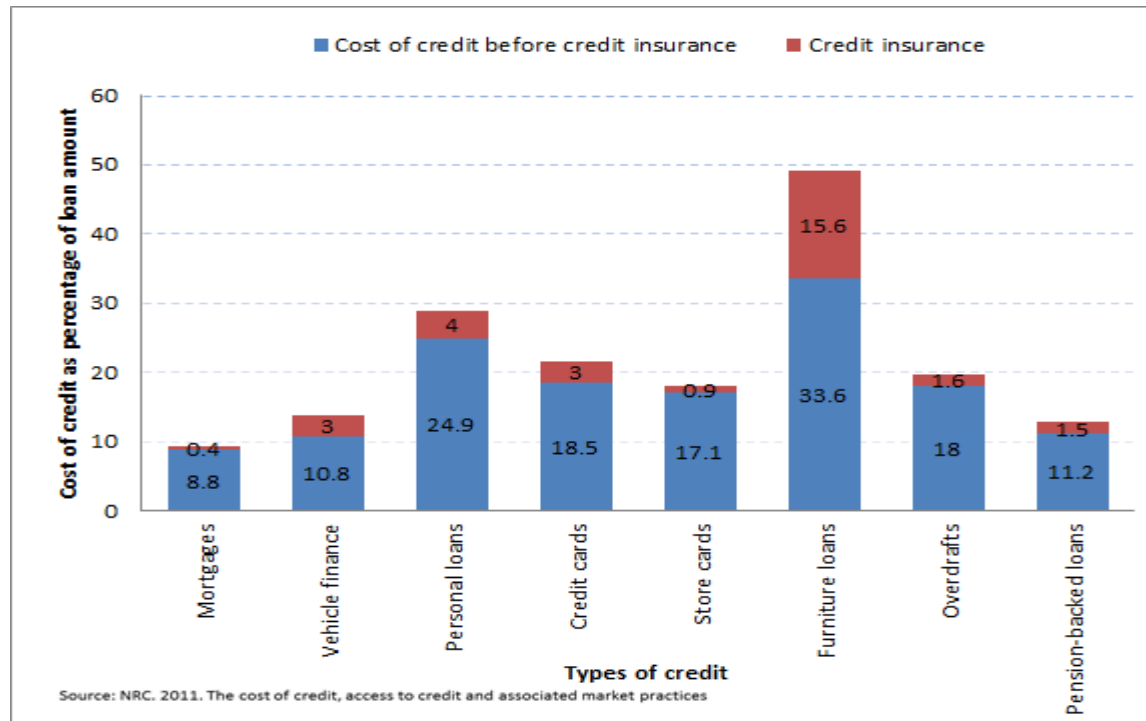
MAIN FINDINGS

Size of the CCI market

- The CCI market was worth approximately R16 billion in premiums in 2012.
 - Of this amount, around R11 billion accrues to life insurers, implying that life insurers underwrite more than 60% of credit insurance business.
 - Credit life accounts for approximately 14% of the total risk business of the life insurance industry.
- Asset cover for immovable and movable property account for 21% and 11% of CCI premiums, respectively.
- Seventy active insurers in CCI market, dominated by 16 insurers.

CCI has a significant impact on total cost of credit

- CCI increases the overall cost of secured and unsecured credit. The impact is greatest for furniture loans, where it increases the cost of credit by about 16%.



Low claims ratios

- The data indicate a wide range of claims ratios between insurers.
 - Credit life: claims ratios vary from 0% to as high as 159%, with an average claims ratio of 20%. This compares to 45% on average for pure risk long-term insurance.
 - Movable property: claims ratios range between 0% and 91%, with an average of 12%. This compares to a 60% claims ratio for the short-term insurance industry.
 - Immovable property: average claims ratio is 61%.
- Less than a fifth of premiums on credit life and movable property CCI is paid back to clients in the form of claims.
- Less problematic in the immovable property CCI segment - higher-income market with average cover at R2 million.

Commission and claim rejection rates

- Commission ratios of up to 40% in both the credit life and movable property and up to 20% in the immovable property CCI market, with average commission rates:
 - Credit life: 12%
 - Immovable property: 15%
 - Movable property: 21%
- On average, 16% of credit life claims (by number) is rejected, decreasing to 12% for movable property and 10% for immovable property claims.
- Information submitted to the NCR indicates that roughly 600,000 CCI claims are settled p.a.

Interconnected value chain

- Conflicts of interest in many CCI distribution models.
 - The credit provider and credit insurer are often in the same group, with the credit provider often acting as the intermediary distributing the product.
 - In group scheme models, the credit provider is also the owner of the credit insurance policy.
- Difficult to assess the contributions of different parts of the value chain, to the overall cost of credit, to the customer value proposition and to the earnings/profits of the financial services groups.
- Profits of the credit insurance arm subsidises less profitable credit/retail parts of the group.

Products are not always appropriate

CCI products are not always designed with the target customer in mind.

- **Mis-sold benefits:** Some products contain benefits that many in the target market might not actually be eligible for.
 - For example, self-employed or informally employed or unemployed consumers (such as social grant beneficiaries) are sold CCI cover that includes retrenchment cover.
- **Inflexible group scheme models:** Offer a “one-size-fits-all” product, with poor flexibility and substitutability. Also qualify for higher commissions.
- **Product “differentiators” that inhibit choice:** Credit providers insist on a particular type of product feature that is only available from their associated insurer.
 - Examples include cover for specific employment related events.

Weak disclosure which inhibits comparison

- Information is provided at point of sale, with minimal information during the product life cycle, compromising the customer's ability to assess on-going suitability of the product
- Providers adopt a compliance-based approach to disclosure, at the expense of considering the customer's information needs - "quantity over quality"
- This undermines the customer's ability to make informed decisions, compare products in order to exercise freedom of choice, and appreciate the benefits, costs and risks of CCI offerings.

Higher premiums in CCI market

- Risk premium rates for credit life insurance higher on average than the rates applicable to free-standing insurance.
 - For example, credit life is priced at around ten times the cost of commercially available single life funeral cover.
- One would expect premium rates to be reasonably consistent with those applied to other types of “group underwritten” insurance products sold to similar groups.
- It is debatable whether the acknowledged differences in business model justify the extent of these pricing differentials.

Main Conclusions

- Competition in the CCI market is not effective, with both the supply and demand side weaknesses, including:
 - **Captive customers** due to the ancillary, mandatory, bundled offering through a conflicted value chain
 - **No customer choice in practice**, exacerbated by information asymmetry, advice bias, poor comparability and substitutability
 - **High/opaque prices and low claims ratios**
 - **Inadequate benefit realisation**
- The combined effect is that the value proposition of CCI is called into question, with the market seeming to serve credit provider interests at the expense of fair customer outcomes.

FOCUS AREAS

Focus Area 1: Regulating the pricing of CCI

- This approach allows credit providers to continue to require CCI cover as a condition of granting credit, but within a framework where there is explicit regulation of credit and/or CCI pricing. Sub-options are:
 - **Regulating the premium rate.** Prescribe a “band” of reasonable risk premium rates for different CCI cover types, or place a regulated cap on premium rates for different CCI cover types.
 - **Regulating the interest rate.** Introduce a maximum interest cap set at a lower level than the “unsecured loan” interest rate cap, for loans where the credit provider insists on mandatory CCI.
 - **Placing a regulated cap on the total cost of credit,** including interest, CCI premiums and other charges.

Focus Area 2: Regulating non-pricing conduct

Regardless of any pricing intervention, there is a need to deal with market conduct failings. Sixteen potential regulatory measures are proposed, including but not limited to:

- **Prescribing product standards:** to facilitate product comparability and improve competition
- **Strengthening disclosure standards:** a simple standardised Key Information Document; improved ongoing disclosure during the product life cycle
- **Addressing low claims ratios:** set a “band” of recommended reasonable claim ratios for different CCI cover types; require public disclosure of claims ratios and/or claims rejection rates
- **Promoting competition at point of sale:** unbundling the insurance and credit offerings (different models discussed).

Focus Area 3: Insurance cover for credit providers

- Encourage or require credit providers to "self-insure" against "bad luck" loan default risks through purchasing insurance cover from insurers in their own names.
- This approach seeks to strengthen customer protection by potentially addressing a number of the market weaknesses:
 - the credit provider and consumer will still have protection against so-called "bad luck" defaults, while reducing the complexity of the CCI value chain.
 - obviating the need to undergo the complex exercise of determining what constitutes a "reasonable" CCI premium for mandatory cover.
 - mitigating the risks to consumers arising from poor disclosure.
 - reducing the opacity and cross-subsidisation currently surrounding the profit and cost contributions of the different components of the value chain.

CCI Review: Next steps

- There is a strong case for regulatory intervention in the CCI market – probably in a way that is distinct from regulation of the broader insurance market, given its unique characteristics.
- Mandatory provision of CCI is only defensible if it is fairly and transparently priced and products and business practices ensure that CCI achieves fair customer outcomes.
- None of the proposed focus areas are mutually exclusive, and could all be considered in parallel, or to complement one another.
- The CCI market is not homogenous – input on impacts on specific business models is strongly encouraged.
- This paper forms the basis for engagement on final proposals, with comment closing on 30 September 2014.

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