



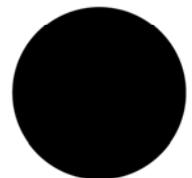
**RETAIL DISTRIBUTION REVIEW**

**INTERMEDIARY ACTIVITY**

**SEGMENTATION AND RELATED**

**MATTERS**

**December 2019**



## 1 PURPOSE

- 1.1 The purpose of this document is to communicate a high-level summary of findings emanating from–
- The intermediary activity segmentation analysis conducted by the Financial Sector Conduct Authority (FSCA);
  - Information gathered through outsourcing notifications and other supervisory activities; and
  - To outline how these findings will inform the FSCA's regulatory and supervisory approach.

## 2 BACKGROUND

- 2.1 During November 2014, the Financial Services Board (the predecessor of the FSCA) (FSB) published its Retail Distribution Review (RDR) which proposed specific regulatory reforms in respect of the distribution of financial products to customers in South Africa. The paper outlined a number of key risks inherent in the current distribution landscape, including distribution relationships and intermediary remuneration models that potentially contribute to poor customer outcomes. The paper put forward a number of proposals aimed at addressing these risks and confirmed that these proposals would be implemented through amendments to the current financial services regulatory framework and supervisory approach.
- 2.2 Proposal J of the RDR provided, amongst other things, that the regulatory framework will delineate more clearly between intermediation activities and outsourced services on behalf of product suppliers and set appropriate conduct standards and remuneration interventions for each of these.
- 2.3 In support of Proposal J and recognising the need to break down the different “activity categories” into a more granular level to ensure that standards and remuneration interventions are appropriate to the types of activities performed, the FSB initiated an activity segmentation project.
- 2.4 As part of this project the FSB, during the course of 2016, in consultation with various short-term insurers and intermediaries, carried out detailed technical work to determine the types of activities for which intermediaries are currently remunerated. The outcome of this work was a

draft intermediary activity segmentation framework (segmentation framework) relating to activities performed within the short-term insurance environment. The segmentation framework demarcates between:

- Advice (a service to the customer);
- Other services to the customer;
- Services that truly “intermediate” between the customer and the insurer;
- Services to the insurer (split between binder services and other outsourced services); and
- Other services to the insurer not explicitly provided for in the current regulatory framework.

2.5 In its RDR update dated December 2016, the FSB communicated its preliminary findings on the segmentation framework.

2.6 In late 2017, the segmentation framework was issued to specifically constituted Short-term Industry and the Long-Term Industry Reference Groups for comment. The FSCA would like to convey its appreciation to all the commentators for the level of engagement and the quality of information and comments that it received.

2.7 In 2018, the following significant regulatory developments took effect in respect of certain distribution and outsourcing activities related to long and short-term policies:

- The capping of the maximum binder fees that an insurer may pay to a non-mandated intermediary (NMI) that is authorised to render advice, at a certain maximum per function performed, the total of which cannot exceed 9% of applicable premiums if all binder functions are performed;<sup>1</sup>
- The introduction of an insurer notification process to the FSCA in respect of -
  - any arrangements where an insurer intends to pay remuneration to an independent intermediary or representative for a function other than services as intermediary or a binder function, including any other outsourcing arrangements;<sup>2</sup>
  - any new binder arrangements that the insurer aims to enter into;<sup>3</sup> and

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<sup>1</sup> Refer to Part 3C of the Regulations under the Long-term Insurance Act, 1998 (LTIA Regulations) and Part 5B of the Regulations under the Short-term Insurance Act, 1998 (STIA Regulations).

<sup>2</sup> Refer to Part 3D of the LTIA Regulations and Part 5C of the STIA Regulations.

<sup>3</sup> Refer to Regulation 6.6(1) of both the LTIA and STIA Regulations.

- The introduction of a requirement on insurers<sup>4</sup> to exercise oversight over the deduction or charging of any fee payable by a policyholder to an intermediary (which would include so-called “broker fees”) and to ensure, amongst other things, that such fee does not result in an intermediary being remunerated twice for the same functions.<sup>5</sup>
- 2.8 Following the above regulatory and supervisory changes, the FSCA has received numerous submissions from insurers, in particular in relation to paying remuneration to an independent intermediary or representative for a function *other than* services as intermediary or a binder function. The majority of these notifications relate to new outsourcing arrangements (outsourcing notifications).
- 2.9 During the course of 2018 and 2019, the FSCA conducted an analysis of the outsourcing notifications and completed an analysis of the comments received from the Short and Long-term Industry Reference Groups on the segmentation framework.
- 2.10 In addition, the FSCA has through its supervisory approach also sourced valuable information relating to insurers’ compliance with and application of Rule 12.4 of the Policyholder Protection Rules (PPRs) under both the Long-term Insurance Act, 1998 and Short-term Insurance Act, 1998.
- 2.11 The FSCA’s findings in respect of the activity segmentation analysis (following the comments that were received) and analysis of the outsourcing notifications and supervisory information gathered in respect of insurer’s compliance with Rule 12.4 of the PPRs (collectively referred to as the analysis) are discussed below.

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<sup>4</sup> As set out in the Policyholder Protection Rules (Long-term Insurance), 2017 and Policyholder Protection Rules (Short-term Insurance), 2017, respectively.

<sup>5</sup> Refer to Rule 12.4 of the Policyholder Protection Rules under both the Long-term Insurance Act, 1998 and Short-term Insurance Act, 1998.

### 3 FINDINGS

3.1 Generally, there is agreement with the FSCA categorisations as set out in paragraph 2.4 above (i.e. that the categories are correct and that, to a large extent, that the placement of the activities into the categories, is correct).

3.2 One of the core findings the analysis revealed was significant duplication and overlaps in activities for which intermediaries are remunerated, posing a real risk that some intermediaries are paid more than once for performing the same activity by the customer, the insurer, or both. Specific activities are discussed in more detail below.

#### 3.3 *Premium collection activities*

3.3.1 Some comments were received regarding premium collection activities being categorised as outsourcing. The FSCA's Position Paper published on 9 April 2019, which sets out proposals on the future regulatory framework for the collection of insurance premiums confirms the intention to reclassify premium collection from being considered as part of services as intermediary, to an outsourced activity through amendments to the regulatory framework. This remains the aim and the FSCA is undertaking further work relating to the development of qualifying criteria for premium collection intermediaries as contemplated in RDR Proposal F.

3.3.2 Pending any regulatory changes in this regard, premium collection activities remain part of the definition of services as intermediary as defined in the Insurance Regulations.

#### 3.4 *Advice related activities*

3.4.1 In some cases industry advised that there is an inconsistent interpretation of the distinction between "advice related services" and "services as intermediary" as defined in the Insurance Regulations on the one hand (both being services currently remunerated through legislative commission) and outsourced activities performed on behalf of an insurer on the other.

- 3.4.2 The FSCA is of the view that advice and most advice related services fall within the definition of “services as intermediary” and must therefore currently be remunerated through commission in accordance with the Insurance Regulations.
- 3.4.3 The FSCA is, however, in the process of considering legislative proposals that will facilitate the charging of advice fees separate from commission. This will entail a clear split between advice and “services as intermediary” as defined in the Insurance Regulations. These legislative proposals will be consulted on during the course of 2020.
- 3.4.4 Pending any regulatory changes in this regard, ‘advice’ remains part of the definition of services as intermediary as defined in the Insurance Regulations.

### 3.5 *Rule 12.4 of the PPRs and “other” activities*

- 3.5.1 Rule 12.4 of the PPRs enables an insurer to facilitate the deduction or charging of fees payable by a policyholder to an intermediary if the insurer is satisfied that the policyholder has explicitly agreed to the fee, that the fee relates to an actual service provided to the policyholder, that such service is something other than services as intermediary and that the payment of the fee does not result in the intermediary being remunerated for a service for which the intermediary is already remunerated by an insurer.
- 3.5.2 Activities that constitute “services as intermediary”, binder functions or outsourcing activities therefore fall outside of the scope of fees contemplated in Rule 12.4.
- 3.5.3 Information gathered through the FSCA’s supervisory activities, however, highlighted various concerns surrounding the implementation of Rule 12.4, including that some insurers:
- Are exercising little to no oversight over the deduction of so-called broker fees in terms of Rule 12.4 of the PPRs;
  - Are adopting a very narrow interpretation of the definition of “services as intermediary” and are not applying their minds to whether the fees charged to customers are related to services for which the broker is already receiving regulated remuneration in the form of either commission (for “services as an intermediary”), binder fees (for binder activities and activities incidental to the binder) or other outsourcing fees. In other words, these insurers are not applying their minds to whether the double remuneration principle is being breached.

3.5.4 Insurers are cautioned that failure to ensure robust oversight of these deductions or the charging of these fees could result in a contravention of the PPRs.

### 3.6 *Outsourcing activities vs binder activities and certain identified industry practices*

3.6.1 In some cases, there is an inconsistent interpretation of the distinction between binder activities and other outsourced activities. Although the FSCA recognises that there is scope for providing further clarity to assist interpretation, the FSCA is very aware that industry practices are artificially creating arbitrage and exacerbating inconsistent application of the law in order to circumvent the binder caps and pay higher fees to secure distribution. This is evidenced by a recent influx of new outsourcing notifications which indicate that binder agreements are being “converted” to outsourcing agreements.

3.6.2 It appears that one of the core activities forming part of these outsourcing arrangements is policy administration.

3.6.3 In some cases, where the binder activities are outsourced to NMIs that are authorised to render “services as an intermediary” only i.e. do not render “advice”, we have noted that binder fees do not adhere to the remuneration principles.

3.6.4 There were also conflicting views regarding the categorisation of various activities that are being remunerated by insurers. Some stakeholders were of the view that these activities are incidental to binder functions, some were of the view that they are “services as intermediary”, whilst others were of the view that these activities should be categorised as (non-binder) outsourced activities.

3.6.5 Several submissions were received which proposed to categorise various activities as outsourced activities (outside of -binder activities). A significant majority of these submissions have been rejected by the FSCA because:

- It was clear that there was not adequate consideration of whether an activity being performed is incidental to or inherently part of another activity for which remuneration is already paid. In many instances this results in the same entity being remunerated more than once for performing a similar function on behalf of

the insurer and/or policyholder. In a number of submissions, for example, the FSCA was of the view that the proposed outsourced activities were either incidental to or inherent services to the customer or “advice” activity, constituted other “services as an intermediary” or were incidental to binder activities (where a binder authority exists);

- The proposed activities were not so out of the norm or unique as to justify additional fees or a different categorisation.

3.6.6 Additional general concerns that the FSCA has identified in relation to outsourcing (including binder functions) include the following:

- Often the proposed outsourcing did not create efficiencies. For example, it resulted in the insurer having to “double capture” the data received from the third party onto the insurer’s policy management system, driving duplication and therefore inefficiency. The FSCA has consistently communicated that improving efficiencies should be one of the main drivers of outsourcing arrangements and that the main reason for outsourcing should not be to create an additional revenue channel in order to attract distribution;
- There was no evidence that the proposed outsourcing could meet the requirement that it would support the delivery of fair outcomes to policyholders, for example, by resulting in lower costs or improved servicing; and
- There was little evidence of robust activity-based costing linked to the actual cost of activities.

## 4 WAY FORWARD

4.1 The FSCA acknowledges that the delineation between the respective activities in the current regulatory framework is in some instances not completely clear.<sup>6</sup>

4.2 The activity segmentation project, however, has been invaluable in assisting the FSCA in understanding the various activities currently being performed in the short- and long-term insurance industry. This work will also assist the FSCA in formulating potential future interventions to provide more clarity regarding the respective activities.

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<sup>6</sup> This was already signaled as far back as 2014 through Proposal J of the RDR.

- 4.3 The supervisory work performed in the context of outsourcing notifications and Rule 12.4 of the PPRs also highlighted various concerning trends. This is likely to result in further regulatory and supervisory interventions.
- 4.4 The proposals and interventions referred to in paragraphs 4.2 and 4.3 above could include, but are not limited to the following:
- Providing further clarity on the respective activities through one or more of the following—
    - amendments to the existing laws by further refining the existing activity definitions;
    - a guidance notice relating to the application of the existing activity definitions; or
    - general ongoing guidance through the FSCA’s supervisory approach;
  - Replacing the current outsourcing notification processes with an approval process;
  - Introducing further reporting requirements in respect of outsourcing;
  - Further consideration regarding how advice and advice-related activities may be carved out of the definition of “services as an intermediary” (see paragraph 3.4.3);
  - Exploring whether the current binder caps should be extended beyond NMIs who provide advice, to other potentially conflicted relationships between NMIs and product suppliers;
  - Introducing an outsourcing fee cap for outsourcing of policy data administration;
  - Potentially developing additional conduct standards in respect of these activities to mitigate potential conflicts of interest and to enhance customer outcomes (relevant RDR proposals refer);
  - Potentially developing additional requirements relating to remuneration in respect of these activities to mitigate potential conflicts of interest and to enhance customer outcomes (relevant RDR proposals refer); and
  - Considering appropriate enforcement measures where the actions of insurers or intermediaries are inconsistent with applicable requirements.
- 4.5 The above regulatory proposals and interventions are subject to further consideration and, where deemed appropriate, will be developed into formal policy proposals or proposed regulatory instruments that will be consulted on in due course.