Making financial markets work for the poor

Case Study: Strengthening Consumer Protection in the South African Microinsurance Market

In support of the Microinsurance Network's (MIN) Consumer Protection Task Force (CPTF), to contribute to the effective implementation of consumer protection in microinsurance.

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GLOSSARY

"*group underwritten scheme*"	refers to an insurance policy that is written on a group of people together as opposed to an individual. The insurance underwriter focuses on the risk profile of the group as a whole, rather than its singular members. Instead of individual polices between the insurer and each policyholder, a master policy is entered into between insurer and administrator of the group. Each group participant is required to complete a short application form which usually consists of the individual's name, address, identification number, dependent information and beneficiary designation. There are typically no medical questions, so that no medical underwriting takes place. It is therefore possible for individuals with poor health to receive group insurance benefits. Indeed all eligible participants may obtain coverage. But underwriting does occur, which helps insurers to avoid adverse selection.
"involuntary insurance"	is an insurance policy which must be taken to satisfy the terms of a related purchase or contract, typically a credit insurance policy for a loan or credit purchase (see voluntary insurance).
"*living standards measure (LSM)*"	refers to the most widely used marketing research tool in Southern Africa, cutting across race, gender and other traditional marketing segments to focus instead on how one lives, taking into account one's general living standards and access to amenities. It divides the population into 10 LSM groups, 10 (highest) to 1 (lowest). The lower-income products would generally span categories 2 through 6 (as those in category 1 would have no disposable income), although 7 is relevant in the context of promoting financial inclusion, as South Africa is adopting a top-down approach to improving access.
"long-term insurance"	is the South African term for life insurance, and may include non-indemnity health insurance products.
"short-term insurance"	is the South African term for asset or general insurance, and may include non-indemnity health products.
"voluntary insurance"	refers to insurance that a consumer chooses to take for him or herself. This is in contrast to involuntary insurance (see above).

1. INTRODUCTION

1.1 Background

Financial services can play a critical role in supporting economic growth and improving a country's living standards. However, market failure can expose financial consumers to exploitation and loss. In particular, the underperformance or loss of savings (through for example a retirement product or bank deposit) imposes an immediate and sustained burden to a consumer's living standards. Moreover, information asymmetry between the buyers and sellers of products means that the quality or appropriateness of certain products like life, asset and income-protection insurance is only established by the consumer sometime after the purchase when the insured event occurs. To deal with these challenges financial regulation serves to better protect consumers by making sure that a financial service or product provider can deliver on its promises made, primarily through prudential regulation, and treats its customers fairly and with integrity, through setting minimum market conduct standards.

From an insurance perspective, the prudential and market conduct regulatory themes are both important. On the one hand, an insurer has contractually committed to pay the insured an agreed amount upon a specified event. Failure to do so through mismanagement or miscalculation of risk would not only hurt the client at his or her time of need, but trust in the insurance market as a whole. On the other hand, even if the insurer is managing its risk appropriately, but it mistreats its customers, then the benefits of insurance are undermined, as exploitive practices also hurt the insured and trust - and therefore participation - in the broader market. Durable and sustained insurance market development requires trust in the insurance industry and its practitioners, which in turn requires that appropriate and fair products are sold to clients, so that they have a positive insurance experience.

These issues are universal to the insurance market, but the impact of market failure is felt all the more acutely in the lower income segment. Individuals and families need insurance products to protect them from falling into poverty, should for example a primary breadwinner lose his or her job or pass away. Yet conversely, client exploitation can instead worsen the daily hardship suffered, as an insurance product may not deliver on its contractual commitment even though premium payments have over time substituted for other much-needed items or services.

Protecting consumers, especially those who are the most vulnerable to exploitation, must therefore be a priority for policymakers and regulators alike. Box 1 summarises good consumer protection practices to be followed, to inform regulatory design. It is against these principles that country responses to consumer protection can be tested.

Box 1. Good consumer protection practices in microinsurance

The international literature as summarised in Lester and McKee (forthcoming) mostly emphasise market conduct and recourse elements when highlighting good practices and principles for consumer protection. We however deem it important to add prudential considerations, in the form of sound risk management, to the framework:

1. Sound risk management should be achieved through appropriate capital reserving, reporting and corporate governance.

2. Transparency requires adequate and comprehensible disclosure about who the ultimate insurer is, the price of the policy (and premium payment obligations), when and how a claim can be made, and how to access recourse mechanisms if the client's experience does not meet up to his or her expectations.

3. Fair treatment of consumers should consider both the pre- and post-insurance sales processes, making sure that the product:

- Is appropriately structured to meet the needs of the consumers it is servicing (for example taking into account what risks a consumer faces, his income and the income's regularity);
- Uses simplified and standardised policy wording; and
- Does not take advantage of low financial literacy levels.

Insurers should be contractually responsible for the actions of tied agents delivering and servicing their products and should ensure that premiums collected are properly secured and recorded. The regulator should monitor claims settlement performance to look for abuse that may be reflected through overly low claim and loss ratios, and too long a time between claim notification and payment.

4. Effective recourse requires a complaints and adjudication mechanism that is internal to the insurer. A consumer should also have access to recourse through an independent ombudsman and the regulator.

All providers and intermediaries should be regulated to ensure that these practices are supported. Policy makers should aim for regulation that is proportionate, well balanced, and tailored to the specific risks that arise, so that it does not unnecessarily undermine market development and financial inclusion. The regulator should be empowered to enforce regulatory requirements.

SOURCE: Lester & McKee *(forthcoming) and author's own views.*

1.2 The origins of South Africa's microinsurance policy debate

The voluntary microinsurance market in South Africa is dominated by funeral cover. Funeral insurance is valued for cultural reasons as traditional African communities consider the quality of a funeral a sign of respect for elders who have passed away. As the insurance industry traditionally focused on the wealthy, white end of the market, the resulting vacuum of appropriate insurance products for poorer black communities has seen a mushrooming of insurance provision in the informal and semi-formal space, with more than 100,000 burial societies and a strong funeral parlour market providing in-house funeral cover.

However since South Africa's emergence as a democratic state in 1994, government policy has emphasised access to financial services for the previously economically and financially excluded. As black persons under apartheid were largely excluded from the formal financial service sector, in 2004 a Financial Sector Charter was negotiated between government, industry and labour that was intended to transform the sector to ensure greater black participation, both at the levels of entity ownership and product consumption. As part of the charter, broad targets have been set for financial sector entities, to include the financing of low-income housing, small and medium size enterprise finance, transformation infrastructure, and improved access to affordable banking, insurance and savings products.[2] These targets, combined with an industry-wide consolidation of microinsurance providers and a growing middle class made up of previously disadvantaged black South Africans (thereby stimulating insurance demand), have motivated formal insurance providers to build their business into the lower-income market, albeit still focussing largely on the established funeral insurance market. In any event, many entities have continued to operate outside of the regulated insurance space and formal players, although regulated, have at times behaved opportunistically. Both environments expose consumers to abuse.

In 2003 the South African government heard parliamentary testimony of abusive practices prevalent in the funeral insurance market in South Africa.[3] These related in particular to the increasing number of funeral parlours offering group schemes not underwritten by a registered insurer, thereby leaving the scheme's members vulnerable to under-payment of claims, over-charging of premiums and commission, and problems associated with payment-in-kind (rather than cash). Instances of fraud were also reported, for example where an administrator or intermediary did not cancel a policy on request. Parliament then requested that the National Treasury as financial sector policymaker, and Financial Services Board (FSB) as insurance regulator, to investigate these abuses in order to propose regulatory reform that would better protect vulnerable consumers of insurance products, especially those in the lower income segment. What followed was a consultative regulatory review that resulted in a policy discussion paper in 2008 and in 2011 a final policy document describing the intended regulatory framework going forward.

Since the parliament enquiry in 2003 South Africa's regulatory analysis of the microinsurance regulatory challenge adjusted in two ways. First, the National Treasury recognised the value that informal insurance providers have played in extending financial services to those economically marginalised under apartheid, facilitating financial inclusion. This meant that the policy process evolved from finding ways to shut down illegal operators to one which acknowledged the worthy role that these entities have played in growing the market. It therefore focussed instead on how to formalise informal or illegal operators, levelling the regulatory playing field across different providers and supporting competition. Second, the project scope was extended to consider a dynamic and growing market, to prioritise market development. This has meant designing a regulatory framework that supports the extension of a broad range of insurance products, rather than one specifically orientated around the status quo – funeral insurance. A final consideration is the increasing attention given to credit insurance, which is a product that credit providers require of their borrowers, to protect their loan books against risk of default.[4] Abusive practices observed in this insurance segment impact the insurance market as a whole, but as lower income consumers rely more heavily on credit, and these individuals tend to be less financially literate, the impact of abuse is largely concentrated in the microinsurance market.

[2] While adoption of the charter is voluntary, compliance is incentivised through this being a prerequisite in being awarded government contracts, as well as the potential for reputational damage associated with non-compliance.
[3] Report of the Portfolio Committee on Finance on Hearings on the Funeral Industry, 2003.
[4] Because consumer credit insurance is required of the borrower as part of the credit agreement, it is considered an involuntary insurance purchase (see the glossary for a more detailed explanation).

1.3 Purpose and structure of the case study

This case study reflects on regulatory developments in the South African microinsurance market intended to better protect lower income consumers of insurance and extracts learning in this regard that can inform other jurisdictions embarking on a similar path.

We proceed as follows. Section 2 provides a snapshot of the existing microinsurance market in South Africa, taking into account the degree of financial inclusion, typical products and which entities provide them, and the regulatory landscape. Section 3 explains common practices in the South African microinsurance market that have undermined consumer protection. The success of steps taken by the regulator to address these are explained and critically assessed in Section 4. Section 5 explains South Africa's policymaking process to date, considers the envisaged policy response to protecting microinsurance consumers going forward, and benchmarks the existing and proposed regulation against the consumer protection standards introduced in Box 1 above. Lastly, Section 6 concludes by summarising lessons learnt by the National Treasury over the policy making process.

2. MARKET CONTEXT[5]

To understand the South African microinsurance market, one needs to consider consumer behaviour and market penetration of this segment, the functioning and behaviour of its market participants, and the governing regulatory framework. This review follows.

2.1 Market penetration

According to the latest FinScope South Africa survey, 49.7% of all South African adults have insurance.

South Africa is a middle income country with a per capita income of about US$10,700. But with about 1 in 4 adults unemployed[6] and an income distribution heavily skewed towards the wealthy, almost half of South Africans fall below the poverty line. Indeed, survey evidence suggests that almost as many South African adults - 31.5% - regard money received from a family member or friend as their main source of income as do money from an employer (32.2% of adults list wages or salaries as main income source). Against this backdrop South Africa's 49.7% insurance penetration rate looks solid but is heavily weighted by funeral insurance, the demand for which is driven by cultural preference. Indeed, 44.4% of South Africans above the age of 16 claim to have some form of funeral cover, up from 39.1% in 2006[7].

Interestingly this expansion is increasingly effected through formal rather than informal cover – those taking cover through a burial society increase from 2006 to a peak of 29% in 2007, after which it declined to 15.5% of adults in 2010. Formal cover (obtained through a funeral parlour, insurer or bank), on the other hand, has increased by almost 9.5 percentage points since 2006.

Stripped of its funeral component, South Africa reflects a relatively low but improved insurance penetration rate of 25.6% of adults (up from 15.5% in 2006). This is driven across asset and life business that in certain segments have nearly doubled penetration since 2006. Over that period asset insurance (comprising mostly vehicle, household/building and cell-phone insurance) has

[5] Figures cited in this section are sourced from the FinScope South Africa 2010 survey. First published in South Africa in 2003, this survey has expanded its geographic footprint across the continent, to provide annual snapshot measures of the financial climate in a country and showing how financial access and use of financial services is changing.

[6] Employment figures are published by Statistics South Africa, the entity responsible for the collection, production and dissemination of official and other statistics, and are available on their website, www.statssa.gov.za.

[7] The earliest year for which comparable data is available.

increased usage from 8.2% to 15% of adult South Africans and life insurance (again excluding funeral related cover) from 10.2% to 20.7%[8].

Although the distribution of insurance take-up remains skewed towards the wealthy, progress has been made towards providing financial services to lower income households (measured for the purposes of this study as LSM 2-6; see the glossary for an explanation in this regard). Between 2006 and 2010 formal insurance penetration in these households increased from 20.8% to 26.4%.[9]

The improved take-up of insurance may be attributed to the government's policy to support financial inclusion, the growing black middle class and generally improved attitudes towards insurance (arguably a consequence of financial education and the design of more appropriate, innovative products that better meet the needs of the average South African).

However, as reported in the National Treasury's 2011 policy document, of concern is that "*the importance of insurance for personal risk reduction is understood, but not necessarily translated into behaviour…evidenced by the low number of South Africans covered by insurance, as well as the mismatch between what is perceived as the biggest risk to families – a loss of income through death or job loss of the primary breadwinner – and the dominant insurance product held being funeral cover*."

From a policy perspective, improved financial inclusion should not be at the expense of consumer protection. Low literacy and numeracy skills of the low income market mean that regulators must be especially vigilant; what is right for the higher income markets will not necessarily be so for the lower income market, although improved consumer protection is important for all. While attitudes in South Africa towards insurance appear positive – 3 out of every 4 people believe insurance to be important in managing their daily threats[10] - sustainable market development requires that consumers have a positive first-hand experience with financial services. As highlighted by the National Treasury, currently consumers are not necessarily getting the right products to manage their risks.

2.2 Insurance providers and intermediaries

The South African insurance market is made up of formal, semi-formal and informal providers, including burial societies, funeral parlours, credit providers and insurers (with which some banks and retailers are closely linked), as well as administrators and brokers. Co-operative insurers do not yet play a role, largely due to regulatory barriers. These entities and their role in South Africa's microinsurance market are explained in Box 2.[11]

[8] Note that there will be some overlaps between usage of different figures, implying that the components add up to more than the total.
[9] CENFRI analysis of Finscope South Africa 2010 data.
[10] FinScope South Africa 2010, Survey Highlights.
[11] The legislation referred to in this box is explained in Section 2.4 to follow, as summarised in Figure 1.

Box 2. The role and functioning of insurance providers in South Africa[12]

Burial societies are an informal risk-pooling mechanism whereby members within a community contribute money into a central pot that is then drawn upon when a member or a relative passes away. Benefits are not guaranteed and members are subject to receive what is in the pot at that time. These structures help to mitigate the risks associated with funerals that would otherwise rest on the members of those societies, and on their families. They also offer much needed emotional support and in doing so support the community, building trust.

Both “for-profit” and “not-for-profit” ***insurance cooperatives*** are provided for under the Cooperatives Act of 2005. But this Act requires that a cooperative that offers insurance must have a full life or asset licence. The insurance legislation in turn requires a corporate form which immediately excludes the cooperative structure. As a result, the cooperative form has not been used to provide insurance.

Friendly societies (also known as mutual or benevolent societies) are formalised mutual associations for insurance, pensions, savings and loan-like purposes. Composed of a body of people who join together for a common financial or social purpose these bodies provide financial and social services to individuals, often according to their religious or political affiliations. In South Africa they are registered and regulated by the FSB under the Friendly Societies Act of 1956, and to assist their risk management are subject to a benefit limit of R7,500. However societies with fewer than 100,000 members are exempted from the regulatory requirements. Benefits are guaranteed, but in practice may not be paid out should the society have too few funds available (permissible in terms of the governing legislation). As a result, to help manage its risks a friendly society may be underwritten either fully or in part, with a formal insurer playing a reinsurance role, although even in these instances remain have remained subjected to the regulated benefit limit.

In order to support the provision of funeral services to their customers ***funeral parlours*** offer various funeral related financial services, with a focus on lay-by and insurance options. Unless the parlour has an insurance licence, financial products should be underwritten by a licensed insurer, but in many instances are not. Parlours are also subject to the market conduct requirements under the Financial Advisory and Intermediary Services (FAIS) Act.

Similar to funeral parlours, ***retailers*** offer various financial services to support their primary retail business, including credit extension and credit insurance. For the most part these entities are underwritten by a registered insurer, thereby acting as an intermediary and/or administrator for the insurer.

Administrators are organisations that administer and process insurance policies and claims on behalf of an insurer, in what is effectively an outsourcing arrangement. Because the insurer retains the underwriting risk, administrators do not need an insurance licence, although they are subject to requirements under the insurance and market conduct legislation (see Table 1). However in South Africa certain large administrators have “captured” the client, as interface between funeral parlours and large brokers, and the underwriter. This means that it is this entity that the insured person sees and not the insurer. As a result administrators have the potential to unlawfully insure a part of the insured book of the funeral parlour.

Insurers are corporates underwriting insurable risk and issuing insurance policies that cover asset, life and in-life risks, and as such are regulated under the Short-term and Long-term Insurance Acts (depending on the product line) as well as the market conduct legislation – the FAIS Act. With the exception of funeral cover, to date these entities have concentrated on traditional insurance models and product lines, although have begun to explore the lower-income market. Funeral policies are generally written as “assistance business,” which refers to a category of life licence restricted in its maximum benefit permitted (currently set at R18,000) and enjoying the advantage of streamlined intermediation regulatory requirements. There is no equivalent asset/non-life licence.

Intermediaries (brokers and agents) are also regulated under the FAIS act, and generally service the traditional, higher income markets. While assistance business policies have enjoyed FAIS requirements designed to meet the specific features of the low-income market, all other life and non-life policies are subject to the full FAIS requirements, potentially crowding out intermediation into the lower-income market.

2.3 Types and structure of policies

As indicated, life assurance for the low income market is dominated by funeral policies. Issued in order to support a consumer’s desire for a respectable funeral, these are issued on a short-term

[12] South African legislation referred to in this box are more fully contemplated in Section 2.4, and Figure 1 in particular.

basis; policies are renewable at least annually and in some instances monthly, meaning that an insurer can effectively manage its risk and re-price where this has been calculated incorrectly. Waiting periods of at least 6 months are common practice to minimise anti-selction. High administration costs for cash collections means that insurers have implemented alternative collection methods, increasingly relying on funeral parlours and retailers for distribution. Regulatory costs associated with the giving of advice required in the sales process have incentivised no-advice sales, where policies are sold "off the shelf", as one would sell bread or mobile phone air-time.[13]

Policies are primarily underwritten on a group scheme basis meaning that the insurance contract between the administrator and the insurer is often unknown to the end consumer. As undertakers better understand the insurance component of their business (especially as pertains to risk and claims management), many funeral parlour policies are designed to remove the cash benefit and shift risk management from the insurer to the funeral parlour. Today many funeral parlours are underwritten only in part by a registered insurer and in some cases not at all.

Although funeral policies make up the biggest demand for policies in the low income market, the preceding section shows that other risk and savings products are also sold into this segment, including life, medical, cell-phone, credit and legal protection. As with funeral policies, irrespective of whether written under a life or non-life licence, these policies are generally issued on a short contract term basis and face similar intermediation challenges relating to high cost, low premium policy features.

A low penetration rate (only 1.3% of LSM1-6 adults report some kind of credit life insurance usage in 2010)[14] masks the significant exposure of the consumers to involuntary credit insurance, which policies are issued by retailers, banks and money lenders in order to support a loan or credit purchase. These policies are imposed on the borrower as a condition of the lending transaction, and protect the lender against default. Credit insurance is typically underreported in demand-side surveys, as people may not know that the insurance is added to their loan repayments, or may not regard it as insurance but rather as a prerequisite to the loan. Credit insurance policies may also include funeral or other types of cover, but such cover will only last while there is an outstanding loan amount. Policies can be written under both a life and non-life licence, although in most instances fall under the latter on account of preferential regulatory treatment of remuneration for intermediaries and administrators (this issue is expanded upon in Section 3 to follow).

In South Africa clear regulatory lines are drawn between health insurers that offer indemnity insurance products, in other words products that compensate beneficiaries for their actual economic losses, versus those that offer non-indemnity products, that is, products that pay a fixed specified amount on occurrence of the insured health event. Life and non-life insurers can only offer the latter, within strictly defined parameters, whereas the former is the domain of medical schemes, regulated separately.

2.4 Current regulatory protection

The corporate insurance market is governed by the prudentially orientated Long- and Short-term Insurance Acts of 1998 and market conduct regulation under the Financial Advisory and Intermediary Services (FAIS) Act of 2002. The Friendly Societies Act of 1956 provides for a statutory legal identity for mutual-type insurers, and although providing little prudential or market conduct guidance, exempts these entities from the insurance and FAIS Acts. The FAIS Act, along with the FAIS

[13] The strength of cultural preferences for funeral cover in particular are strong enough to render the market for funeral cover "demand driven," in contrast to the traditional broker-driven model.
[14] CENFRI analysis of FinScope South Africa 2010 data.

Code of Conduct and various Board Notices issued under the FAIS Act, governs the market conduct of all financial service providers. These four acts are administered and enforced by the FSB.

Besides ensuring financially sound and well governed insurers, the insurance legislation provides for Policyholder Protection Rules to help a policyholder make informed decisions in regard of insurance products and ensure that intermediaries and insurers conduct business honestly and fairly and with due care and diligence. These rules ensure that the underwriting, selling and management of insurance policies is done so in accordance with sound insurance principles and in the interests of policyholders and policy beneficiaries. This overlaps somewhat with the FAIS legislation, although efforts have been made to avoid regulatory duplication:

- *The Policyholder Protection Rules* have a narrow market application and are relevant only to insurance, but look at the whole insurance transaction, from product features rules around waiting periods, to making sure that these features are communicated in the sales process, and that claims are processed fairly.
- *FAIS requirements,* on the other hand, apply to all financial service providers and intermediaries, including insurance, but which content is more narrowly located in the intermediation process and the giving of advice. In particular the FAIS Act deals with:
    - Fit and proper requirements, considering aspects of integrity, experience, education and continuous professional development;
    - Codes of conduct which ensure that insurance intermediaries deal with their clients with fairness and integrity;
    - Disclosure in the sales process, requiring full disclosure about the terms of the insurance contract as well as how advice to the client should be done, taking into account the relevance for the client of an insurance product following from a financial needs assessment; and
    - Record keeping that supports enforcement and accountability.

For microinsurance this means that policyholder rules should apply a minimum, fair standard to policy contracts by focusing on issues like waiting periods, claims processes and exclusions to assess whether these product features are fair and appropriate. FAIS on the other hand focuses on the calibre of sales staff and the sales process, in effect attempting to regularise the way in which insurance business happens.

The FSB is furthermore implementing a UK-learnt "Treating Customers Fairly" strategy to strengthen market conduct in the South African financial services sector. Intended to complement the FAIS Act, this programme builds on and extends the insurance orientated Policyholder Protection Rules to apply to the financial sector at large. It seeks to ensure that fair treatment of customers is embedded within the culture of financial firms at all stages of the product life cycle, including design, marketing, advice, point-of-sale, and after sales processes. It will use a combination of market conduct principles and rules to, in the words of the regulator, "drive the delivery of clear and measurable fairness outcomes, and enforce the delivery of these outcomes through visible and credible deterrents to unfair treatment."

Also relevant to protecting insurance consumers through governing the behaviour of insurance firms are the Financial Services Ombuds Schemes Act of 2004, the National Credit Act of 2005, the Consumer Protection Act of 2008 and the Competition Amendment Act of 2009. Box 3 explains these Acts in turn.

Box 3. General legislation impacting consumer protection in the microinsurance sector

Financial Services Ombuds Schemes Act: Provides for the role and obligations of statutory and voluntary ombud schemes, in particular accommodating the statutory FAIS ombud that adjudicates market conduct complaints cases, and the voluntary, self-funded insurance ombuds that adjudicate complaints of alleged contraventions of the Long-term and Short-term Insurance Acts.

The National Credit Act: Applies to all retail credit and related transactions (including credit insurance), governing the sales and post-sales processes to prevent irresponsible lending (to those who cannot pay the loan back), and promote understanding by the borrower of contract terms and costs.

The Consumer Protection Act: Establishes a single and comprehensive framework for consumer protection in South Africa. The scope of the framework is far reaching, and includes banking and financial services. Notably though, insurance has been granted an 18 month exemption to give the FSB time to revise the sectoral regulation to at least match and where necessary build on the general act's requirements, where after the sector should be permanently exempt to avoid conflicting policy interpretation and regulatory arbitrage. This exemption was granted on the basis that insurance business is already subject to considerable market conduct regulation, under the Long-term, Short-term and FAIS Acts.

The Competition Amendment Act: Deals with the structure of the market, seeking to promote competition through the monitoring of merger and acquisition transactions and market practices.

South Africa's consumer protection financial regulatory landscape is summarised in Figure 1:

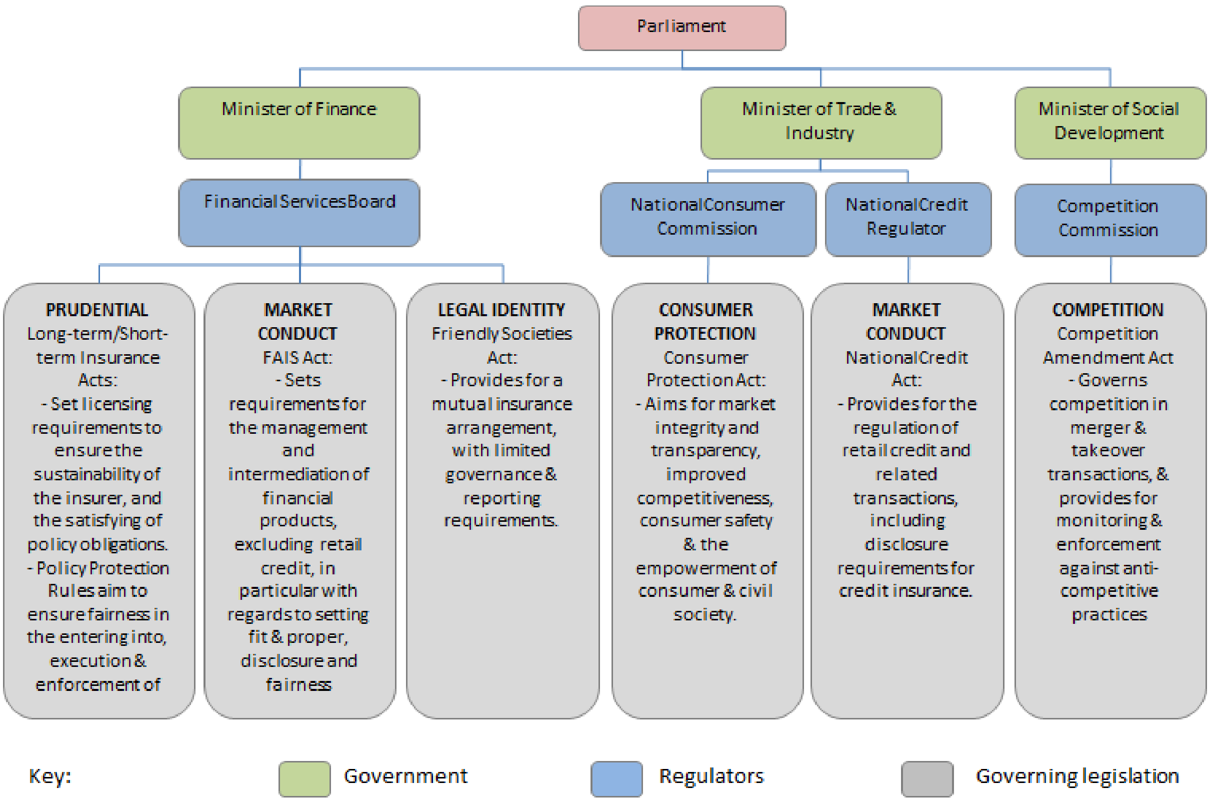

Figure 1. South Africa's financial regulatory landscape as applicable to microinsurers

2.5 Summarising market participation in the South African microinsurance market

To conclude this review of the South African microinsurance market, Table 1 summarises market participation and the implied applicable regulatory requirements. The large number of participants on both the demand and supply side poses a significant challenge to effective regulation.

	No. of entities	No. of members / policyholders	Annual premium income	Policies issued (ave. size of benefit)	Regulatory requirements
Burial societies	Est. 150,000	Est. 6 million	Est. R6 billion	Funeral related (R5,000-R10,000)	None. May be registered as friendly society
Friendly societies[15] (2008)	198 (107 exempt from submitting regulatory returns as <R100,000 contributions pa)	104,000 (this figure includes only those societies that have submitted returns)	R58 million (incl. only return submitting societies)	Mostly funeral, some education and savings (R7,500, the regulated maximum limit)	Friendly Societies Act
Funeral parlours	Est. 3,000-5,000 (approx. 1,500 registered with relevant health authorities)	Not available	Est. R5 billion (may be underwriter and/or intermediary)	Funeral (R18,000, the regulated maximum limit)	Long-term insurance Act, FAIS Act (as applicable)
Retailers (2008)	Approx. 2,700 dealers	11.7 million credit accounts, 3 million people have credit insurance. Only 1.15 million people in LSM 1-6 claim to have a credit contract, while only 710,000 claim to have a related insurance policy	Consumer credit insurance: R3 billion, funeral: unknown (may be underwriter and/or intermediary)	Est. consumer credit insurance - micro-loans (R5,000), vehicle financing (<R85,000), mortgages (<200,000), credit cards/loans (R10,000) Funeral (R18,000, the regulated maximum limit)	National Credit Act, Long-term Insurance Act, Short-term Insurance Act, FAIS Act (as applicable)
Insurers, for LSM 1-6 only (2009/10)	Long-term assistance policies: 31, long-term other: not available, short-term: not available	Long-term: 9.6 million, short-term: <1 million	Long-term assistance policies: R4,2 billion, long-term other: not available, short-term: not available	Long-term assistance policies: R18,000, long-term other: not available, short-term: est. R10,000-R180,000 (determined by value of assets, mostly cell phone, legal & household structure/contents)	Long-term Insurance Act / Short-term Insurance Act, FAIS Act (as applicable)

Table 1. Providers of microinsurance in South Africa[16]

Source: Data compiled from FSB 2010 Annual Report, FinScope 2010, National Credit Regulator 2010 Annual Report, and a 2008 report on Consumer Credit Insurance in South Africa

[15] These figures refer only to registered friendly societies. Many societies are exempt from regulation because they have fewer than the regulated threshold membership of 100,000.

[16] While data taken from different years impedes comparability across these market segments, this variability is necessary in the absence of complete data.

3. CONSUMER PROTECTION CONCERNS

To protect consumers, regulation should ensure that an appropriate and affordable product is sold to a consumer to proportionately meet his or her identified risk or savings needs. Unfortunately, low financial literacy, inappropriate product design and mis-selling of insurance products continue to undermine this objective. While these abuse features are relevant across the traditional and microinsurance markets, the effects of such are exacerbated for clients struggling with poor education and exclusion from the formal economy.

To explain abusive practices in the microinsurance market in South Africa, the diverse nature of market participation means that it is useful to assess the consumer protection concerns as stemming from each of these providers in turn.[17] Examples of commonly heard ombud cases are cited to further explain how these practices impact consumers in their day-to-day lives:[18]

Burial societies: The incidence of common law crimes is low given the informal governance structures and large numbers of members. The most significant challenges relate to members not paying what is owed, the society running out of money, and to a lesser extent members not cooperating amongst themselves in the interests of the society; consumers in these instances may be making regular contributions in the belief that they are covered but in reality may not be.

Friendly Societies: As with burial societies, the mutual nature of these entities tends to protect members against fraud and abusive practices common to other structures. However, although subject to some regulation, governance and risk management requirements under the Friendly Societies Act are virtually absent, exposing members to non-payment should the society run out of money. Also, large societies may not enjoy the benefits typically associated with the mutual structure, as the members do not have a personal relationship with either their management or each other. Over recent years friendly societies have been struggling to compete with insurers on the basis of their smaller size and the regulated maximum benefit that they can offer (of R7,500, compared to R18,000 permitted under an assistance business licence and no cap under a full life or asset licence). As a result the size of these societies in terms of members and annual contributions continues to shrink, threatening their longer-term sustainability.

Funeral Parlours: Abusive practices relate mainly to the fact that the insurance coverage is a secondary (and significantly less important) purchase to the funeral itself. Generally these entities lie partly or fully outside of the insurance regulatory net, leaving the consumer exposed to the consequences of poor prudential and market conduct practices, with few or no recourse options. Specifically, the following practices are observed:

- *Monetary benefit:* In South Africa the common practice among funeral parlours offering funeral protection is to provide the funeral service, rather than a cash payment. Although a cash option is required by law, few funeral parlours (with the general exception of parlours affiliated to formal insurers) offer clients the option of a monetary benefit, and where this is offered, it is often not disclosed to the client. Clients may then forfeit the benefit should an insured person hold multiple policies or pass away in a region away from the funeral parlour. The client is also prevented from looking for a better-value funeral service from competing parlours.

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[17] This review is taken mostly from the report "*A regulatory review of formal and informal funeral insurance markets in South Africa*," and is supplemented by a report of the 2002 parliamentary hearings into abusive practices in funeral insurance, interviews conducted for this case study, as well as the author's own experience.

[18] These examples reflect common complaints of ombud cases over the past year. The complainant names and exact offences have been altered to reflect the most common elements across those cases, and should not be understood to accurately reflect any one case in particular.

- *Price behaviour:* Benefits are defined in terms of the aggregate funeral service, to which a Rand value is attached, making it difficult for the consumer to know and compare the true value of offerings amongst the various potential providers. In other words, as the funeral service is not standardised, it is difficult for consumers to compare value being derived from the insurance benefit (which translates into the funeral itself, rather than the monetary benefit).

- *Set funeral package*: Individual components of the funeral package are not negotiable downward at the time of death, and the client can only upgrade to more expensive options, usually at substantial cost.

In combination, these features weaken competition and foster an environment where funeral parlours compete on how the funeral looks rather than value or price. This in turn inflates funeral costs and implies a welfare loss to consumers.

Administrators: Although in contravention of FAIS regulatory requirements, the underwriting insurer and policy-related charges may not be adequately disclosed to the client, substantially weakening his or her ability to hold either the insurer or the administrator responsible for market misconduct. Sometimes, the administrator will also move the book to a different insurer without the clients' knowledge. It may even be that such a move means that the clients are without cover for a time. See Ms Kekana's complaint to the ombud as an example of what can go wrong.

Common ombudsman case I: Undue power of administrator

Ms Kekana has lodged a complaint with the long-term insurance ombud as her claim has been repudiated. Although she is informed of the reason for the non-payment, she does not understand it. She is no longer insured with the insurer that her administrator, the holder of the master policy, initially contracted with, and does not know that the policy has been moved without her knowledge or permission. The ombud is struggling to trace which insurer, if any, was underwriting the funeral parlour's book at the time of the claim event. The administrator in this case is a repeat offender – he has been disbarred from providing financial services in terms of FAIS, but with the broad support of his community continues to operate with various fronting persons and entities.

This control over the client gives undue power to the administrator; any pressure placed on the administrator by the insurer in terms of charges or disclosure encourages the administrator to move its book to a different underwriter. This is particularly easy if the administrator does not comply with regulation requiring the consent of each policyholder to do so, or where the policyholder is given incorrect information to garner consent. The administrators are also able to "split the book," underwriting the healthy part themselves (often without a license) and passing the riskier section on to the insurer, undermining the credibility and sustainability of the microinsurance market as a whole.

Formal insurers: As these entities are strictly regulated and supervised for prudential soundness, consumer protection issues here relate mainly to the way in which a product is structured.

Long-term (life) insurance

- *Product features:* Even if explained, exclusions (for example of certain existing conditions) and complicated rules around waiting periods (like reintroducing a waiting period should a client miss a premium payment) confuse consumers and undermine their insurance experience. Historically waiting periods were problematic where a consumer wanted to switch insurer to get a better product, but was discouraged from doing so as he or she would then be subject to another period of non-cover – the Policyholder Protection Rules have since outlawed this practice.

- *Policy or premium guarantee period*: As only the insured and not the insurer is permitted under insurance legislation to cancel a policy, in the assistance business market insurers get around this by offering policies with a short contractual period, which can be just 1 month. To exit from a policy the insurer does not have to cancel the policy, but just chooses not to 'renew' it for the next contract period. Although arguably necessary to manage underwriting risk, this is not always in policyholder interests and may be used to entrap a consumer onto the book in that premiums are set artificially low and then rapidly raised after the first contract term has passed. The policyholder will be disincentivised from switching insurer if he or she has to endure another waiting period.

- *Paid-up value*: As most assistance business policies do not have a paid-up or investment value, policies are payable for life and the full benefit is forfeited on lapsing. This is problematic if a policyholder has an extended period of illness before death and cannot work. He or she may as a result miss successive premium payments, so that even if there are built in "grace periods" to accommodate an irregular income, the policy lapses. This is especially common in South Africa given the high prevalence of HIV/AIDS. However, insisting on paid-up values on all policies is probably not appropriate as it substantially increases underwriting costs, inevitably crowd out the lower premium part of the market to the detriment of providing lower-income consumers with risk mitigation tools.

- *Bundled products*: Funeral insurance sold through retail (and to some extent bank-tied) distribution is provided as an add-on to other products. This can increase mis-selling of funeral and other cover, especially in the instance of involuntary credit-life insurance, which costs and value are rarely disclosed to the client (on this issue see also the discussion on short-term insurance to follow).

- *Linkages with funeral parlours:* As discussed, a cash benefit option is required by law and as a result is in principle offered. However, certain insurers structure their agreements to force customers who have taken out insurance policies to use the services of their associate parlour, for example by offering discounts to insurance clients on the service offered by their parlour, or by only paying cash into the estate of the deceased instead of directly to the beneficiaries.

Short-term (asset/general) insurance.

Consumers are most at risk in the consumer credit insurance segment, where in general very low claims ratios matched with too high premiums reflect an abusive, even extortive, relationship between the borrower and the frequently aligned retailer, at the expense of the credit/policyholder.[19] In particular, the following practices have been observed:[20]

- Regulatory arbitrage between the life and non-life legislation, largely driven by differing remuneration requirements and monetary caps on intermediaries and administrators;

[19] The reader is reminded that although credit insurance can be written under both licences, providers have mostly favoured the non-life licence to do so, largely because they are permitted a higher commission charge under the applicable governing regulation.

[20] A 2008 report on *Consumer Credit Insurance in South Africa*, prepared in response to media allegations of severe misconduct in this market segment.

- Unclear delineation of branding and responsibilities between the insurer and its intermediaries/administrators, and an associated blurring of what remuneration is appropriate;

- Increasing overall premium rates (to include fees to the insurer and intermediary), although claims ratios remain near zero;

- Lack of proper disclosure to the insured about the terms of the policy, its costs, and in many instances even its existence, compounded by ambiguous and obscure policy language;

- Conflicts of interest between the product supplier, the credit provider, the administrator and the intermediary; and

- Capitalising monthly premiums upfront as a single amount as part of the principle debt.

More generally, the omnipresent problem experienced in the short-term insurance market relates to inconsistent and inappropriate use of terminology, compounded by misleading marketing and complicated contracts that are not in a client's vernacular (see Dr. Sitole's complaint in this regard). Besides the threat of mis-selling, these features undermine product comparability and therefore competition.

Common ombudsman case II: Insurance contracts are designed for regulatory compliance and to protect the insurer; they are poorly understood by clients

Dr. Sithole has lodged a complaint with the short-term ombud. His accident claim has been rejected on the grounds that his daughter, who was driving the vehicle, was deemed by the insurer to be its main driver; the policy however is in his name, and as such his daughter is not covered by the policy. The complainant does not understand the different meanings of the terms used like "regular" driver compared to "main" or "primary" driver.

Contractual requirements of premium payments are also manipulated by some insurers. In these arrangements an erratic income is not well acknowledged or accommodated by insurers, to the detriment of the consumer who does not know that he has lost his cover until a claim is repudiated (see for example Mr Prins' ombud complaint).

Common ombudsman case III: Insurance contracts are misleading and against consumer interests

Mr Prins has also complained to the short-term ombud. The client knows that his claim has been repudiated because he has missed a payment but believed that he would enjoy continuous cover provided that he made up the missed payment, which he has done. However the claim was made for a house theft that occurred over the month that he had not paid, and the small print of the contract provides this as basis for non-payment (even though it has been repaid).

Intermediation:

In the sales process, the regulator remains concerned with small to medium sized providers of insurance. These entities do not adequately disclose product terms and conditions to clients, report poorly to the supervisor of steps taken in the sales process, fail to keep requisite records of sales transactions and internal processes, and use unregistered or improper sales personnel. In addition the structure of the market continues to support the ability of administrators or intermediaries to come between the client and insurer. Finally the current prevailing practice of products being sold "off-the-shelf" can result in consumers not fully understanding the product that they purchase, threatening high lapse rates. This highlights the need to not only understand problems associated with the way a product is designed, but crucially also in how it is sold (and whether it appropriately meets the needs of the policyholder on both fronts).

These market features result in the prevalence of *over- and mis-selling of policies.* For example individuals may hold multiple funeral policies that may not all be paid out if the contract terms specify against this practice, or purchase policies that are inappropriate for their economic circumstances (see Mrs Sithole's case below). On the asset side, multiple policies are generally not honoured by the incumbent insurers (which are informed of such by market–wide databases), so that the first policy will be paid out, but the remainder will be rendered void. This means that premiums paid on the forfeited policies have been for nought.

Common ombudsman case IV: Insurance broker misleads client, gives bad advice

Mrs Sithole has been saving to send her son to university. She has lodged a complaint with the long-term insurance ombud because a 5-year endowment policy has yielded less money after costs than the sum of the contributions. This is due primarily to the short contractual period that resulted in contributions being significantly eroded by fees, as well as a 30% tax obligation on the product (even though as an individual Mrs Sithole lies below the tax threshold). This complaint is incorrectly placed, and is referred through to the FAIS ombud. As mis-selling of these types of policies into the low income segment appears to be an increasing trend, the long-term insurance ombud also communicates the nature of the complaint to the regulator, to support regulatory enforcement.

4. PROTECTING THE POOR – WHAT HAS WORKED, WHAT HAS NOT

The preceding sections provided an overview of the South African microinsurance market context, the consumer protection regulatory framework and common consumer protection concerns experienced in microinsurance. In the rest of this document, we turn to the regulator's response to consumer protection concerns, the role that consumer protection considerations have played in the design of a new microinsurance regulatory framework for South Africa and the lessons learned for the policymaker and regulator across the process to date.

4.1 A decade of reform

Protecting consumers through prudential and market conduct regulation is a South African policy priority:

- On the **prudential** side, the ability of an insurer to meet its contractual commitments is at the heart of protecting insurance policyholders, and registered insurers in South Africa have a solid track record. Prudential regulation is continually assessed and strengthened, and is currently moving towards a principles-based approach to regulation, consistent with the European Solvency II standard.[21]
- In response to poor **market conduct** across the insurance sector, the National Treasury and FSB have introduced more stringent and complete regulation, improved enforcement and centred consumer education on financial literacy. The past 10 years have seen notable enhancements to South Africa's market conduct legislative framework, through implementation of the FAIS Act,

[21] Principles-based regulation is about the outcomes or ends of that regulation i.e. what impact will the regulation have. In contrast a rules-based approach focuses on the requirements – effected through rules – that are believed to deliver on the desired outcomes. Where the former can be difficult to police, the latter typically leads to a tick-box approach to compliance that may result in an outcome far removed from the spirit of the regulation, and indeed what was intended by the regulator.

the Financial Services Ombuds Schemes Act, and the National Credit Act (keeping in mind that the Consumer Protection Act will probably not apply to regulated insurance business).[22]

It is however noted that a regulatory framework is only as strong as its enforcement. Given the multitude of burial societies, funeral parlours and other financial service providers in South Africa, enforcement can be challenging. To support regulatory enforcement, 2008 amendments to the insurance legislation gave administrative powers to the regulator through an enforcement committee. As a result the FSB is better empowered to hold violators of the law accountable and subject to administrative penalties, without having to go through criminal proceedings in the courts that are costly, take up a lot of time for the regulator and public prosecutor alike, and are generally (and understandably) considered low priority for under-resourced prosecutors relative to other crimes like murder and assault. This is necessary to hold illegal insurance providers, like funeral parlours, to account, although its effectiveness is undermined by ongoing communal support for these prosecuted entities. We return to this issue in the sections to follow.

In addition to these legislative changes, the FSB continues to refine the regulatory environment to address observed shortcomings. Recent improvements include:

- ***FAIS code of conduct.*** Improvements have been made relating to conflicts of interest prevalent in the product delivery channel, especially around insurers using non-cash remuneration to circumvent commission regulations.

- ***Policyholder Protection Rules.*** It is within these requirements that a client can switch his policy and not be subjected to a new waiting period (see the discussion in Section 3 in this regard). A new requirement is that in the event that a claim is repudiated by an insurer, an explanation of "why" must be given to the insured. This has gone a long way in assisting consumers hold insurers accountable, and more effectively use the ombuds complaints mechanism (as evidenced in the ombud cases described).

- ***Outsourcing agreements.*** An insurer can outsource part or parts of the insurance value chain, most commonly for premium collection, claims assessment and/or payment, and back-office functions like IT. To date these outsourcing arrangements have not been well regulated, leading to a blurring of responsibility and accountability between the insurer and the contracted third-party for the underlying insurance contract and policy holder. These agreements are to be better regulated under the insurance legislation. However there is concern that in the funeral space these requirements won't be understood or heeded, highlighting the need for regulation to be written in a way that assures the buy-in of those who should comply.

4.2 Challenges to effective supervision

Unfortunately, while steps have been taken to address the abusive market practices observed within the microinsurance market, for the most part consumers remain vulnerable to the same exploitation.

For example, losses suffered by consumers for holding multiple policies and regulatory contraventions emanating from group underwritten schemes remain problematic. Ombudsman

[22] However as the exemption requires insurance regulation to at least match its protection features, the Consumer Protection Act may have an indirect effect on insurance business going forward. Moreover, insurers and intermediaries who are not suitably registered and regulated by applicable legislation will not fall within this carve-out, meaning that funeral parlours and retailers may be facing increased regulatory pressure and risk through the Consumer Protection Act provisions.

complaints cases against funeral parlours and administrators in particular continue to rise.[23] While impacting only credit insurance, the National Credit Act and awareness created in 2008 by an enquiry into abusive practices prevalent in the consumer credit insurance market, have together improved consumer protection, mainly through greater transparency across the credit sales process. But it remains unclear whether full value is yet being derived from these products, motivating the National Treasury and regulator to consider more stringent regulation, especially with respect to product standards and commission allowed.

Most worrying is that, across the market, consumers continue to purchase policies that they do not need, and the terms and conditions of which they do not fully understand. Furthermore, there continues to be a number of informal insurance providers. For this one has to ask, "why"?

In reflecting microinsurance market participants on a spectrum that considers their degree of formalisation against their primary market role, the schematic illustration below goes some way towards an answer:

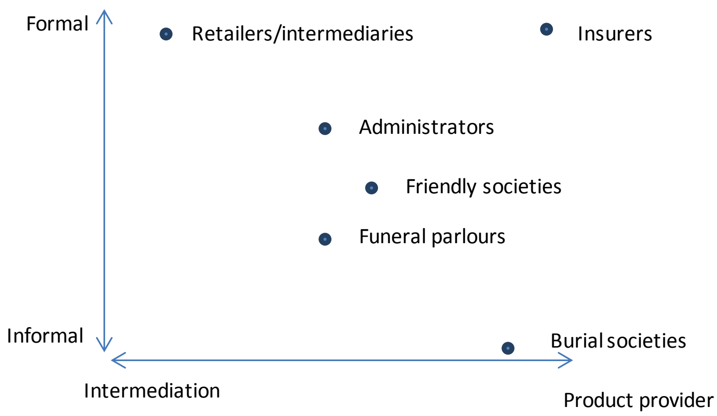

Figure 2. Degree of formalisation of market participants[24]

Figure 2 shows that:

- There are many different providers in the low-income market, each at different stages of formalisation and indeed legality; and
- This means that for these different providers, the current institutionally driven approach to regulation implies incomplete regulatory coverage and different regulatory standards for market participants.

On a day-to-day basis, this in turn implies the following:

4.2.1 Regulatory requirements are in too many instances incomplete, inconsistent and ignored

Indeed, the wide participation of non-financial entities and small businesses means that many entities are not fully or meaningfully captured by the regulation. For example, friendly societies are allowed to guarantee benefits but governing requirements do not impose prudential standards. Only recently have rules relating to administrators been tightened (examined in Section 4.1), in an attempt to curb their manipulation of the insurer-insured relationship. On the other hand, although the regulation provides for it, many funeral parlours and retailers are not willing or able to meet insurance prudential or market conduct regulatory requirements. Where upfront capital

[23] Although it is noted that this could be a result of improved knowledge of this recourse mechanism rather than their being more cases of abuse in the market.
[24] Cooperatives are excluded from this graph on the basis of their non-operation.

requirements are out of reach of most small to medium sized businesses, market conduct requirements relating to the education of brokers have been argued impractical in an environment of casual sales labour subject to high staff turnover (particularly where the insurance product is a secondary purchase to support either the credit or funeral offering, meaning that the inevitable focus of the sales transaction is on the principle purchase). Having said that, in many instances non-compliance may be a result of mis-information rather than intent.

To better explain the point being made, it is illustrative to consider the FAIS registrations. Approximately 250 intermediaries and 8 administrators are registered under the FAIS categories that service the low income market, although these numbers are expected to be understating the true size of the market on account of a pervasive reluctance within the market to regularise its activities. Lapsing licences are prevalent, thought to be because of a lack of capacity to comply (although efforts by the FAIS department to support compliance have been poorly supported). Attempts to empower and up-skill the sector have also been slow to yield results, largely due to the reluctance for employers to train staff who are believed will leave the position for a better one when qualified to do so.

Industry participants and the short-term ombud have also proposed that the existing FAIS requirements for the low-income market may be too greatly orientated around "advice". The FAIS Act requires a full suitability analysis, which is not necessarily appropriate for all clients or products. What has been proposed instead by these stakeholders is to rather incentivise communication about what the product is and what it is not, as well as who would need it and who would not. This message can be overshadowed by the existing focus on advice, in its current traditional form.[25]

4.2.2 Resources available for compliance and enforcement are stretched

While the enforcement mechanism has been improved with a risk-based approach to supervision and the implementation of the enforcement committee, more perhaps could be done to remedy market practices that impede consumer rights and undermine fairness. Consider as illustrative the example given in Section 3 of endowment policies being sold into the low income market, driven by commission rather than what is best for the consumer. FAIS requires that a sales person conduct a needs and suitability analysis, and yet the intermediaries in these cases have generally not been held to account, perhaps because supporting evidence is difficult to obtain. The Treating Customers Fairly strategy is expected to go some way towards improving the enforcement accountability of market conduct transgressions, as it will require evidence of procedures followed across the product design and sales process. In the meantime onsite visits, together with assessing the quality of returns, assist in monitoring the effectiveness of regulation – in other words, help to reflect on the extent to which regulation is working to improve the protection of consumers. However this rests heavily on the quality and focus of the inspection. In an ideal world all market participants keep appropriate records and there are effective and ongoing supervision visits to make sure that they do so. But in reality capacity for both the regulator and the regulated may be constrained.

[25] This is not to say that regulatory advice requirements should be removed altogether, but that the concept of advice could be reconsidered within the context of the low income market. The UK for example has developed a role for "simplified advice," which is used to describe a streamlined advice process that aims to meet straightforward needs of consumers. It intends the advice process to focus on one or more specific needs of the client, like where a consumer wants to protect his or her family against loss of income of the primary earner through death or job loss. It does not involve analysis of the consumer's circumstances that are not directly relevant to those needs, although could result in a specific product recommendation.

4.2.3 Recourse options are unknown, confusing or unavailable

A crucial leg to protecting consumers is empowering not only the regulator to hold practitioners accountable, but also the consumers themselves. South Africa's ombud system is effective but complicated, as every financial service segment has its own ombud, whose rights and responsibilities differ. This complex system confuses consumers, who don't always know which ombud has jurisdiction to adjudicate over his or her complaint. Of concern to consumers and certain stakeholders is that the insurance ombuds are voluntary - in contrast to the statutory FAIS ombud - meaning that these are funded and accountable to their boards made up of the industry that they are meant to be adjudicating over. Whether this threat to independence is real or just perception, statutory bodies may be preferable. Moreover, voluntary ombud offices only have jurisdiction over their members. This means that should a consumer want to complain against a non-member, he or she would need to do so through the statutory (FAIS) ombud, even if it is against an insurance provider, confusing consumers further about the correct ombud channel to follow. These issues are presently an open debate in South Africa – while acknowledging the shortcomings of the voluntary ombud system, policy makers are cognisant of challenges of funding and operating efficiencies for statutory ombuds. At the very least there may be room for better coordination between each of the ombud offices and the regulator. In any event the ombuds form a critical leg to consumer protection in South Africa, as recourse through the courts lies beyond the affordability and reach of most South Africans.

The conditions explained in Section 4.2 collectively explain the policy approach outlined in Section 5.

5. A LONGER TERM SOLUTION - THE FUTURE OF MICROINSURANCE IN SOUTH AFRICA

5.1 The policy decision making process

As mentioned, South Africa has proposed a radical overhaul of the regulatory environment for microinsurance, the details of which are contained in a policy document published in July 2011. However the process towards this milestone has not been an easy one. First and foremost was the challenge of fully and appropriately articulating the market, policy and regulatory "failures" that needed to be addressed, as summarised in Sections 2 through 4. This was informed by widespread engagement between industry participants, the ombudsman offices, and the National Treasury and FSB.

To better understand the market, the National Treasury drew initially from donor funded research on the funeral insurance market in South Africa, and built upon this knowledge with research commissioned of consultants to answer questions and explain issues raised by the National Treasury in its policy review at that time. These inputted into a widely disseminated discussion paper. A national public road-show raised awareness of - and explained - the proposals, facilitating broader stakeholder participation in the process than would have been the case if just relying on engagement through industry associations (the process generally followed by government to avoid perceived bias shown towards any individual player). Feedback received from the roadshows and comments on the paper (both through written submissions and face-to-face meetings) fed into the revised policy statement.

The policy design process is summarised in Box 4.

Box 4. South Africa's microinsurance policy design process

2003	Parliament hearings on abuses in the funeral benefits industry.
2005	FinMark Trust investigative study into funeral assistance business, entitled *"The regulation of assistance business in South Africa."*
	National Treasury / FSB task team set up to direct the assistance business reform process (parliament updated to these developments).
2006	Project extended beyond funeral assistance business to consider the broader microinsurance market.
2007	Inter-department forum to ensure alignment across government.
2008	National Treasury / FSB discussion paper released for public comment, entitled *"The Future of Microinsurance Regulation for South Africa."*
	National public roadshow to widen engagement on discussion paper, followed by written submission and further consultation phase
2011	National Treasury policy statement entitled: "*The South African Microinsurance regulatory framework: Policy Document."*
	National Treasury / FSB steering committee set up to oversee implementation.
	FSB establishes its Microinsurance Regulatory Unit.
2012	Draft legislation scheduled to be released for public comment,
	Scheduled tabling of Microinsurance Bill to parliament

To be clear, engagement has not meant that the policymaker required complete market consensus of the regulatory parameters - such consensus would be unlikely and could only serve to paralyse the decision making process. Its purpose was to understand the market and its role players, and focus discussion on the proposed policy and regulatory principles. Reaching across formal, semi-formal and informal market participants promoted buy-in to the reform principles. One can only get market support for regulatory requirements if the underlying principles to these are not contested. The policymaker and regulator have therefore been informed by stakeholder views, while remaining the ultimate decision makers in the adopted way forward.

The National Treasury has played an important coordinating role amongst public entities relevant to the microinsurance regulatory debate including the Departments of Health (for funeral parlours) and Trade and Industry (for cooperatives), the South African Revenue Services (for tax matters), and the Cooperative Banks Development Agency (to consider a potential formalisation-support role). Less expected, perhaps, has been the role played by the unit within the National Treasury responsible for this project in coordinating decision makers across the National Treasury and the FSB, where different operating units can hold polarised views of the preferred way forward which, if not aligned, can foster regulatory fragmentation and inconsistency.

5.2 The proposed regulatory framework: consumer protection themes

Improved financial inclusion comes with the risk of the most vulnerable consumers being exploited. Consequently, policies supporting access to financial services must be supported by an active consumer protection strategy. South Africa has come a long way in understanding its problem areas in the lower-income insurance market. Its policy response, through the recently published policy document on microinsurance regulatory framework proposals, is intended to extend the range of appropriate and affordable products to lower income persons to support financial inclusion, increase competition and improve institutional governance by facilitating formalised insurance provision by currently informal providers. In addition, the policy aims to reduce barriers to entry for regulatory compliance, thereby further supporting formalisation and small business participation in the market.

The regulatory roadmap contained in the 2011 policy document relies heavily on product and regulatory standardisation as consumer protection tools. Product standards and parameters are deemed necessary to resolutely regulate away misconduct, on the basis that disclosure alone may not be effective in protecting the client, who in addition needs a simplified and understandable product. Regulatory standardisation, on the other hand, ensures a level regulatory playing field. The issue currently is not that the rules to protect consumer do not exist, but that the regulatory architecture lends itself towards regulatory avoidance and arbitrage.

It is therefore intended that all microinsurance providers and intermediaries will be brought under the regulatory net, onto a level playing field. This suggests that regulation should be functionally driven so that regulatory treatment is derived from what the entity does rather than its institutional form. Given the spectrum of formalisation and the different skill-sets and resources available for regulatory compliance that this implies, the principle of proportionality is critical; proposed regulation should try to be proportionate to the risks faced by consumers, relying upon a simplified product environment so as to not crowd out market participation or erode financial inclusion (see also Lesson 7 in Section 6 in this regard).

The overarching features of the strategy are to combine prudential and market conduct requirements to cohesively support better protection of consumers, taking into account South Africa's specific market strengths and weaknesses. This is to be complemented by a holistic view of the institutional and tax environments, as well as targeted enforcement and consumer education campaigns.

These themes, developed in parallel, should build on and complement existing regulatory protection. Below, each is considered in more detail:

Theme 1: Coordinating prudential and market conduct regulation[26]

Effective consumer protection requires regulatory standards that address both prudential and market conduct in a streamlined, coherent and proportionate way. South Africa seeks to achieve this through the following:

Increasing competition and levelling the playing field. South Africa views microinsurance as a market segment distinct from the traditional market in terms of its target market, product design, intermediation channels and regulation. The FSB observes that part of the regulatory challenge

[26] It should be observed that to enhance consumer protection features of regulation, South Africa is migrating towards a twin-peaks model of regulation, characterised by separate and specialised prudential and market conduct regulators. However, the powerful inter-linkages between prudential and market conduct supervision of the microinsurance market mean that it is likely that all aspects of regulation for this insurance segment will remain within the latter of these – the market conduct regulator.

relates to the architecture of the governing requirements for products servicing the low income market. These are embedded in various pieces of governing legislation, the principle purpose of which may be something other than microinsurance, which distinct features are then overlooked. Fragmentation also supports regulatory arbitrage. This highlights the needs for a single licence for the microinsurance market that can generate improved information about the segment and align regulatory requirements. This license will be accessible to any market participant that guarantees its benefits and can meet the regulatory requirements, including burial societies, credit providers, funeral parlours, retailers, administrators and of course the existing registered insurers.

A rules-based approach to product regulation. South Africa proposes to limit risk to the product provider through a product definition that allows only risk products (although these products can be across the life, in-life and asset segments), and restricts the term of the contract and the benefit. Regulation will impose simplified product standards (like prohibiting exclusions and waiting periods if a client moves his or her policy to a new insurer), and simplified policy documents, such that the complaints procedures must be clearly stated in the policy summary alongside other key information as may pertain to waiting periods and claims processes. A product that is easier-to-understand from both a risk management and client perspective creates scope to streamline both the prudential and intermediation requirements. Prudentially, providers of microinsurance will face a significantly lower upfront capital charge of R3 million (compared to R5 million and R10 million for non-life and life insurers respectively). These entities will also enjoy more simple capital reserving, reporting and corporate governance requirements.

Similarly, intermediaries of the simplified product will need to comply with simplified requirements relevant to the characteristics of this market. Such simplified requirements are intended to support a sales process that includes a face-to-face dialogue, in addition to the current prevailing practice of products being sold passively "off-the-shelf" (of which mis-selling and high lapse rates may be a consequence). The concept of "simplified" intermediation requirements to better protect consumers may seem counter-intuitive. However this issue should be considered with four market features in mind:

- Firstly, traditional benchmarks of what constitutes an appropriate sales person and process may not apply in this market - a full needs analysis is unlikely to benefit the consumer, who in most instances will not need to be guided across the range of investment and risk products available for short, medium and longer-term financial planning, and in any event could not afford this service. Requiring a needs-analysis is likely to price "advice" out of the market altogether. Should this happen, consumers may be severely limited in their access to any information about the scope and features of products available, a perverse outcome from what was intended.

- Related to this point, and as highlighted in Section 3, what is most critical is that the sales person understands the features of the product that he or she is selling, can (and does) communicate these features to the client (and makes sure that the client in turn understands such), assists the consumer in partnering an affordable and appropriate product for his or her needs, and further assists the consumer in filling out the requisite policy information. By way of example, consider then that a minimum school-education level may not necessarily deliver on these outcomes and may prevent potential sales persons from being able to comply[27]. South Africa is therefore considering instead a basic read/write/calculate requirement complemented by testing the product and sales-process knowledge of the sales person.

[27] Experience has shown that thousands of insurance sales representatives in the low-income end of the market do not meet the education requirements initially set.

- Thirdly, intermediation requirements for certain market segments (namely assistance business, the life insurance category with a regulatory benefit limit) have, in recognition of the point just made, already amended the intermediation requirements to better suit the market. This implies an unlevel playing field for market participants operating beyond the life-insurance market, including asset insurers and cooperatives.

- Lastly, as much of the market lies outside of the regulatory net, and noting that closing down these unregistered entities has not yet proven an effective or sustainable solution towards non-compliance, a starting point is to encourage formalisation through manageable regulatory requirements, that can be raised over time should this be seen as necessary or appropriate to further enhance consumer protection.

This rules-based approach towards product regulation is intended to give a market participant a much clearer view of how it should be regulated, in other words as an underwriter versus as an intermediary. This is in contrast to the current practice of funeral parlours underwriting their own books although only registered as an intermediary, or not at all. Moreover, the simplified requirements mean that market participants can no longer argue that the requirements are unnecessarily onerous. Together these features should promote regulatory compliance.

Given the prevalence of abuse associated with group underwritten schemes, these will be subject to additional controls that clarify the role and regulatory obligations of the administrator and insurer in relation to each other and the policyholder, and give the policyholder the right to cancel the policy at any time (draft regulations governing the relationship between the administrator and insurer across the insurance market have already been released for public comment).

Theme 2: Connecting insurance regulatory requirements with the broader regulatory and tax frameworks

As microinsurance providers can be insurers, banks or credit providers, and in many instances lie outside of financial services altogether (like with funeral parlours or agricultural cooperatives), regulatory coordination is imperative to support compliance. The National Treasury continues to engage the various regulators in this regard, for example the Council of Medical Schemes and the National Credit regulator, on health insurance and credit issues respectively.

Probably the most significant of these relates to taxation, where illegal operators may be reluctant to formalise as they will then also be subject to tax. Important also is the need for tax equivalence – different structures should not afford a different tax treatment as this incentivises tax arbitrage. South Africa has committed to minimise the tax burden on regulated entities, in particular for entities that may be overdue on their tax obligations, considering a tax amnesty.

South Africa remains conscious of other regulatory processes that could impact the microinsurance framework, and is working towards alignment. Thus, while insurance prudential regulation for the traditional market is moving towards principles-based regulation, microinsurance will remain rules-based. To support consumer-friendly market conduct across the financial services sector, the FSB is also implementing its Treating Customers Fairly framework, within which microinsurance will have specific treatment.

The National Treasury acknowledges the high standard set for the protection of consumers by the recently implemented Consumer Protection Act. Although expected to be exempt from this legislation in order to avoid regulatory duplication and arbitrage, in crafting the microinsurance legislation and subordinate regulation, attention will be paid to the Consumer Protection Act to ensure that its components are given effect. More importantly, perhaps, is the recognition that the role and impact these products have in alleviating poverty or conversely fuelling economic degradation, suggests that generally the financial services industry should be held to a higher standard than other sectors.

To promote financial inclusion, the Financial Sector Charter has worked towards developing product standards for products that should be seen to qualify towards charter compliance.[28] It is important that these standards are reasonably consistent with those provided for under the microinsurance licence, and efforts are underway to make sure that this remains the case.

Theme 3: The role of regulatory enforcement

Many product suppliers in the lower income market have continued to ignore regulatory requirements despite outreach efforts by the regulator. In some instances this has been argued on account of what could be seen as overly onerous and cumbersome requirements, where attempts to comply have proven futile, thereby incentivising regulatory apathy. Under the new framework this can no longer be a reasonable response, and an innovative and active enforcement strategy, penalising contravening parties to the full extent of the law, is essential to supporting the broader framework.

The enforcement strategy will be developed by the National Treasury and the FSB, and is intended to develop an approach to implementation and compliance support that will cut across the microinsurance and FAIS frameworks. Part of this strategy will be a broad enforcement campaign aimed at facilitating formalisation and protecting consumers. It will also include ongoing supervision of registered microinsurers. Intergovernmental coordination will further support enforcement, for example working with the health regulators to get funeral parlours into the regulatory net, and the tax revenue service to detect operators trying to conduct their business out of sight of tax and other regulatory authorities.

Theme 4: The role of consumer education and recourse

Even with the best regulation and enforcement, ultimately it is the consumer that makes his or her own insurance choices and should be empowered to hold unfair or improper conduct accountable. This can only happen with improved financial literacy, especially as pertains to insurance. Accordingly the National Treasury, working through the FSB's Consumer Education Department, is designing an education strategy that focuses on insurance. As a first step, a pilot programme will this year begin to test ways in which to best communicate messages about the daily risks that a family is confronted with (like the loss of a primary breadwinner, or schooling costs in years to come), insurance products available to help mitigate these risks, and precautions to take when purchasing an insurance product (like making sure that there are no exclusions, understanding waiting periods and the like). Consumers must also be made more aware of complaint and recourse mechanisms. Microinsurers will be compelled to have mechanisms by which its clients can reasonably question product practices, and will be housed within the existing ombud system.

To further support consumer advocacy, South Africa is also considering the need for an independent consumer watch body to better represent consumer rights in the financial services sector. This should be seen within the context of the roles played by the existing consumer protection entities.

[28] As discussed in the introduction to this case study, South Africa's Financial Sector Charter sets targets for the financial industry in order to stimulate black participation at ownership, employment and consumption levels. Only products that meet the agreed product standards satisfy charter obligations. These standards try to minimise product features that undermine consumer protection in this market, taking into account for example exclusion limitations and irregular premium payments linked to irregular incomes of the policyholders.

Where the FSB enforces the regulatory requirements and the respective ombuds adjudicate between providers and consumers of insurance, a gap remains insofar as levelling the informational asymmetry and power between providers and users - no entity at present represents the rights of consumers.

5.3 Benchmarking South Africa against the consumer protection standard

To consider the anticipated impact of South Africa's microinsurance policy response on consumer protection, Table 2 benchmarks the expected impact of current and planned regulation on market behaviour against the principles of good consumer protection summarised in Section 1.

Under the new regulatory framework, all providers and intermediaries will be regulated to ensure that these practices are appropriately supported. The National Treasury has striven for regulation that is proportionate, well balanced, and tailored to the specific risks identified in the low-income insurance market, to protect against unnecessarily undermining market development and financial inclusion. In parallel, the intention is to better empower the regulator to enforce regulatory requirements:

	The regulatory status quo	The planned policy
Sound risk management and governance	Good risk management and governance requirements for registered insurers, but gaps in regulatory coverage especially with respect to funeral parlours and friendly societies. Insurance cooperatives are not accommodated.	Full regulatory coverage and a level playing field for insurance providers. Reduced upfront capital requirements and simplified reporting and corporate governance requirements should promote regulatory compliance and broader [lawful] participation in the market, in turn supporting competition.
Transparency	FAIS Act imposes minimum disclosure standards but these differ depending on the legal form of the insurance provider. For example requirements for an assistance business category product will differ from other life as well as asset categories. Consumers do not adequately understand a product's terms and conditions. There remains poor compliance by intermediaries of regulatory requirements.	Standardised and simplified requirements, tailored to proportionately meet the risks associated with a regulated microinsurance product, should facilitate broader regulatory compliance and improved product understanding by consumers.
Fair treatment of consumers	As with disclosure requirements, the FAIS Act imposes market conduct standards but these differ depending on the legal form of the insurance provider. Problems also remain with obtuse policy wording, lack of understanding of a product's terms and conditions by policyholders, and general poor-compliance by intermediaries of regulatory requirements imposed.	Standardised and simplified requirements, tailored to proportionately meet the risks associated with a regulated microinsurance product should improve conduct and facilitate broader compliance. This will be complimented and supported by the "Treating Customers Fairly" strategy. A targeted consumer education campaign should improve the capacity for consumers to hold insurance providers and intermediaries accountable for misconduct.
Effective recourse	Although required of regulated entities, poor regulatory coverage and enforcement challenges mean that for much of the market consumer recourse channels do not exist or, if they do, are ineffective.	Full regulatory coverage and a level playing field for insurance providers should ensure that all consumers of insurance products, irrespective of the provider, have recourse mechanisms available to hold wrongdoing accountable. Simplified and standardised policy wording will better inform consumers of their rights and the channels through which to hold the provider accountable. This to be supported by a targeted consumer education campaign, as well as an inter-agency enforcement campaign that addresses prudential, market conduct and tax issues, across the market spectrum, at both provider, administration and intermediation levels.

Table 2. Benchmarking South Africa's present and future microinsurance regulation against desired consumer protection outcomes

The regulatory proposals are the first step in a long path towards industry reform that will serve consumer protection. Good policy must be reinforced with good legislation, subordinate regulation and effective supervision. The danger is that policy can be incorrectly translated by legislative drafters and regulators with unintended consequences. In particular, drafters must be mindful of the intention of the policy. An example of this in South Africa could be the contemplated streamlined intermediation requirements that include a regulatory exam. These should be orientated around making sure that the intermediary understands the product that he or she is selling as well as the related regulatory obligations (like record keeping), but could easily morph into more sophisticated subject matter that will by implication serve as a regulatory barrier to compliance that the policy had sought to overcome.

Complete regulatory compliance will also require ongoing engagement, information sharing and regulatory and operational support between the regulator and market participants. It is expected that regulatory enforcement will remain a challenge. The FSB as regulator will need to work collaboratively with representative industry bodies and other key stakeholders to find innovative ways to incentivise and support compliance. To this end, the regulator is considering expanding its powers (within tight parameters) to allow it to attach personal assets of violators of the financial law, in order to compensate policyholders for losses suffered.

6. LESSONS LEARNT BY THE POLICYMAKER

In developing its microinsurance policy, six lessons have stood out for the National Treasury on consumer protection:

1. **Understand the market.** Historical, cultural and political features have shaped South Africa's microinsurance market to yield a unique landscape of participation and insurance usage. These features have brought similarly unique strengths, weaknesses and challenges to the consumer protection framework. Learning from this, in developing its microinsurance policy a country must understand how its market functions and fails, to inform what mischief should be addressed, and how responses to these practices should be prioritised. As reflected in Section 5.1, South Africa employed a rigorous, transparent and inclusive engagement process in order to achieve this.

2. **Know what you want.** The National Treasury has explored a long road towards policy clarity. Indeed much of the challenge has been to think beyond the obvious, which in South Africa's case was to simply deal with regulatory transgressions in the funeral insurance sector. Rather, South Africa has envisaged a wholly new environment, deemed necessary to meet the - at times - competing policy objectives of inclusion through market development, consumer protection through market conduct and prudential regulation, and a level playing field across providers to support small business and competition. To the extent possible a country should be clear about what its policy is intended to achieve. Without this, regulatory requirements will lack direction and are likely to increase the costs of insurance provision at the expense of financial inclusion without better protecting consumers.

3. **Acknowledge change**. Over a policy review of eight years, National Treasury's signalled policy intention itself ignited market development, as formal insurers re-orientated their businesses towards the new framework, and some illegal operators have tried to formalise towards regulatory compliance. Moreover financial inclusion efforts appear to be working, changing the demand side of the market, as consumers are now more aware of their life and asset insurance needs. To ensure a relevant policy framework, policymakers and regulators must be aware of changing market developments and needs on the demand and supply sides of the market.

4. **Prioritise stakeholder engagement.** The generally low impact of South Africa's regulatory response on the un-formalised market to date should be a warning. Communities will tend to resist regulation introduced without their support or understanding, again emphasising the need for a transparent and inclusive engagement process. South Africa's intermediation requirements serve as illustrative here, as sustained misinterpretation of these have significantly undermined compliance (retailers for example have systematically incorrectly categorised their sales staff to benefit from lower qualification requirements). As policymakers and regulators, there is much to be learnt from the market players, and buy-in through engagement is essential for success. South Africa's policy response going forward takes into account stakeholder views from both the formal and informal sides of the market, paying extra attention to the funeral sector, and hopes as a result to harness a collective buy-in for the reform process.

5. **Obtain political buy-in and get the process right.** However weak the status quo, governments, regulators and market participants fear change. At the end of the day, it is the Minister (or equivalent decision maker) that must give the final approval for any policy design. Recognise that policy reform can be as much about political buy-in to the process as it is about getting the technical detail right, so make sure to be keeping the right decision makers up-to-date with the process. This can be achieved by positioning the project within the broader policy objectives of the relevant government department or agency, which in South Africa's case were the objectives of financial inclusion and consumer protection in the financial sector policy unit of the National Treasury. South Africa's public documents required Ministerial approval ahead of their release which ensured that the relevant decision-makers within the National Treasury, including the Minister, were informed of and in agreement with policy developments.

6. **A holistic solution.** There are generally no quick fixes to strengthening consumer protection, especially in markets like South Africa where providers include both financial and non-financial entities, and consumers lack education and financial security. South Africa's solution is holistic, informed by:

   - Government's financial, tax and business development policy objectives;
   - Characteristics and idiosyncrasies of the local microinsurance market including the roles played by all market participants;
   - Different regulatory response options (that address for example prudential security, market conduct or consumer education);
   - International standards as set by organisations like the International Association for Insurance Supervisors; and
   - The regulatory experiences of other countries facing similar market development challenges.

7. **Balance policy trade-offs.** Consumer protection measures may have a transaction cost, potentially working against financial inclusion efforts and implying a policy trade-off. One has to be careful not to try to protect consumers out of the market, or set the regulatory bar so high that consumers end up not getting any service or protection, as market participants ignore regulation and operate outside of the regulatory net. Managing conflicting policy objectives can as a result become a main theme in the policy design process. Having said that, it is possible to reposition these seemingly conflicting policy goals to be instead mutually reinforcing. In South Africa's example, proposed product regulation of microinsurance is intended to limit the prudential and market conduct risk associated with

microinsurance products. By making sure that products are easier to understand from a consumer and risk management views, consumers are offered a more appropriate microinsurance product to meet their insurance needs, in a protected environment. Product features and regulatory requirements in effect combine to protect consumers and promote sustainable market development.

Regulatory reform in South Africa is taking a long time, exposing already vulnerable consumers to exploitation. An overarching consumer protection policy strategy for financial services and microinsurance in particular would perhaps ease some of these constraints – the National Treasury believes this to have been one of its shortcomings over recent years, and is working to fill this gap.[29]

Moreover, to be effective, reform cannot be something simply imposed on a sector, and requires the buy-in from those needing to change their attitudes and behaviour. Considerable effort has been made by the policymaker and regulator to better protect consumers of microinsurance. But the market remains bifurcated between legal and illegal, and formal and informal operators, reinforced by the *ad hoc* nature of regulatory and enforcement responses. Rightly or wrongly, lower income communities continue to trust their local businesses more than they do an unknown or unimagined regulator. Therefore real change must be driven by a very different relationship between the FSB and those entities it regulates. In the words of the FSB'S FAIS department: "*The fact that the industry role-players are recognising that there is value in being regulated, and that they are as a result ensuring that they get proper underwriting, is a win for us. More people in the industry realise they can approach us, and that we are there to help them. This is further supported by consumers starting to understand that they have rights and if they do business with an authorised entity then they have recourse to the Registrar and the Ombud if treated unfairly.*"

[29] While it may appear to the reader that the Consumer Protection Act would have achieved this, that act is a generic piece of legislation that does not specifically address risks to consumers relating to financial services.

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ANNEX A: LIST OF MEETINGS, 2011

23 August	Insurance Directorate and Market Conduct and Financial Inclusion Chief Directorate, National Treasury
	Financial Advisory and Intermediary Services (FAIS) Department, Financial Services Board (FSB)
26 August	Long-term Insurance Ombudsman
29 August	Insurance department of the FSB, Compliance and Regulatory
30 August	Short-term Insurance Ombudsman
01 September	Telecon with the Association for Savings and Investment South Africa (ASISA), industry association for the long-term insurers
05 September	Telecon with the South African Insurance Association (SAIA), industry association for the short-term insurers.
21 September	Email correspondence with Hollard insurance company