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TECHNICAL REPORT ON THE CONSUMER CREDIT INSURANCE MARKET IN SOUTH AFRICA

3 July 2014

EXECUTIVE SUMMARY

The National Treasury ("NT") and Financial Services Board ("FSB") initiated a review of business practices in the Consumer Credit Insurance ("CCI") sector in South Africa. The review looked at the market structure, as well as the existing policy and regulatory framework for the sector.

This technical report is published as an initial step – with the aim of highlighting concerns with respect to consumer abuses and to seek more input and data from the industry – in order to inform and finalise the policy framework to regulate the CCI industry more effectively. The technical paper also lays the basis to initiate a more intense engagement and consultation with the CCI industry. The aim of this process is to ultimately enable Government to deal decisively with abuses in the CCI market. This forms part of the wider initiative taken by Government to deal with the problem of household over-indebtedness, and to ensure that consumers are treated fairly by financial sector providers.

While the above process will be completed later this year, Government has already started to act by taking various regulatory steps to deal with a number of abuses already identified, having taken into account recommendations emerging from the 2008 Nienaber Panel of Enquiry. Steps taken by Government and the regulators include:

- development of the Treating Customers Fairly ("TCF") outcomes driven framework;
- the 2011 Insurance Binder Regulations, the FSB Insurance Outsourcing Directive, as well as certain tailored dispensations under the Financial Advisory and Intermediary Services ("FAIS") Act; and
- amendments to section 106 of the National Credit Amendment Act No. 19 of 2014 which empowers the Minister of Trade and Industry, in consultation with the Minister of Finance, to prescribe the limit in respect of the cost of credit insurance that a credit provider may charge a consumer.

The NT and FSB recognise that while the above measures will deal with many of the poor practices and abuses in the CCI sector, further steps will be necessary to ensure that abuses in the CCI sector are dealt with more comprehensively. For this reason, the NT and FSB today release the initial report of the joint Task Team which was appointed in 2011 to investigate whether the CCI market in SA is delivering fair customer outcomes. The Task Team was established by the NT and FSB. Though not involved in preparing this report, nor necessarily agreeing with the approach of this report, a number of key stakeholders were consulted, including the Department of Trade and Industry ("DTI"), National Credit Regulator ("NCR") as well as the Competition Commission.

This initial report provides a review of the current market structure and business practices of the CCI sector in SA including the prevailing policy and regulatory framework. The report is confined to a review of the regulatory framework for credit insurance policies that are sold with, or linked to, consumer credit. It presents key findings emerging from the review and explores how the existing regulatory framework may be enhanced to achieve better outcomes for the consumer.

The purpose of this report is to elicit input from key stakeholders and the wider public, on both the risks identified by the review and the menu of policy options under review. This will enable the Task Team to complete their report and submit to Government for its consideration proposals on what further policy measures are required to improve the current CCI business environment, to deliver better outcomes for consumers. After consideration of the inputs received, and further technical work, the final policy proposals and draft legislation will be published by Government for public comment and adoption.

Key issues highlighted in the report

This report has been prepared against the backdrop of increasing concerns about poor market practices and fair consumer outcomes in the CCI market, especially for consumers in the lower-income market[1], and includes:

- **Lack of transparency in the total cost of credit**: The full cost of credit, including the cost of CCI is not fully disclosed. The fact that CCI is bundled together with the credit offering and the inclusion of add-on products such as warranties and "club" membership fees make price comparisons difficult. In addition, disclosure of commission and fees is opaque.
- **High premiums and different pricing**: Premiums tend to be higher when a risk is insured under a CCI policy.
- **Product differentiation limits comparison**: Variance between CCI product features limits product comparability and substitutability, with questionable competition benefits. Examples include different forms of cover for employment related events.
- **CCI cover does not meet the needs of the target market**: Some business models offer policy benefits that many in the target market might not actually be eligible for and by implication can never claim against. An example is retrenchment cover benefits offered to customers who are self-employed.

International comparisons indicate that the above concerns are not unique to SA, and need to be dealt with through effective regulatory interventions and supervision.

The Task Team recognises the benefits, to both consumers and credit providers, of appropriately designed and delivered CCI. The report highlights that in addition to pricing abuses, other weaknesses exist in the structure and operation of the CCI market which result in poor outcomes for the consumer, some of which are due to the lack of effective competition in the market. These include weaknesses in terms of the ability of consumers to exercise an informed choice due to the nature of the product offering (asymmetry of information and resources), as well as in terms of the structure of the CCI market and its interconnected value chain. The combined effect is that the value of CCI is questionable, with high prices and low realisation of benefits.

[1] Broadly defined as the LSM 3-7 group, as the LSM1-2 categories may be outside the scope of the market.

These initial findings are based on three sources:

- An analysis of data reported to both the NCR and the FSB revealed generally low claims ratios in the CCI market. This may be indicative either of low claims, high premiums, or a combination of both. In some instances, claims rejection rates are also high.
- A mystery shopping and consumer interview exercise highlighted the barriers that customers face, in practice, to exercising their legislated freedom of choice of CCI provider. Limited if any real alternatives are available, pricing is often opaque and it is difficult for customers to compare product options. Indications are that there may also be "advice bias" by sales staff eager to promote credit provision.
- An analysis of qualitative market information reported to the FSB confirms these market weaknesses. Amongst others, it illustrates the way in which a highly interconnected value chain inhibits competition both at the point of sale and during the life cycle of the credit relationship. It also indicates that the basis of pricing in the CCI market is different to that on the "open" market, leading to higher premiums than for freestanding cover.

Key focus areas for public comment

The key finding of the initial report is that there is a role for CCI, but also that there is a need to strengthen the current regulatory framework for such products in order to stamp out widespread abuses. There is therefore a need for a policy response that addresses the identified weaknesses in the credit insurance market, to improve the value of CCI to consumers. The report proposes three areas of focus, and seeks comment on these approaches:

- ***Focus area 1:*** **Regulating the pricing of CCI:** This approach allows credit providers to continue to require CCI cover as a condition of granting credit, but within a framework where there is explicit regulation of credit and/or CCI pricing. This approach already has a legal basis, following the amendments made to section 106 of the National Credit Act. Three further sub-options are considered under this approach, namely:
    - **Regulating the premium rate**. Prescribe a "band" of recommended reasonable risk premium rates for different CCI cover types, or place a regulated cap on premium rates for different CCI cover types.
    - **Regulating the interest rate**. Introduce a maximum interest cap set at a lower level than the "unsecured loan" interest rate cap, for loans where the credit provider insists on mandatory CCI.
    - **Placing a regulated cap on the total cost of credit**, including interest, CCI premiums and other charges.
- ***Focus area 2:*** **Regulating market conduct non-pricing practices**: The report recognises that in addition to the possibility of price limits, there is a need to also deal with market conduct failings through sixteen potential regulatory measures which are set out in this report. Some of the proposed market conduct interventions include but are not limited to:

- **Prescribing product standards**: to facilitate product comparability and improve competition.

- **Requiring consistent disclosure standards**: a simple standardised Key Information Document will compel differentiation between the cost of insurance and the "normal" loan repayment, but also clearly demonstrate the total all-in cost.

- **Improving ongoing disclosure**: ensure CCI customers are provided with appropriate and meaningful information regarding their cover at regular intervals during the life of a CCI policy and/or on the happening of specific contractual events through for example a monthly statement.
- **Addressing low claims ratio**: prescribe a "band" of recommended reasonable claim ratios for different CCI cover types. Insurers should then be obliged to justify levels outside these bands to the regulator and consumers. Require public disclosure of claims ratios and/or claims rejection statistics of all comparable insurers in such a way as to ensure comparability of claims ratios or rejection rates of different insurers.
- **Promoting competition at the point of sale**: unbundling the insurance and credit offerings and requiring credit providers to explicitly offer a "panel" of at least three CCI cover providers, with clear disclosure of the differences between the options to enable an informed decision.

- ***Focus area 3:*** **Protecting consumers through insurance cover for credit providers:** It is recognised that for reasons related to both protecting the consumer, and to lower the risk to credit providers, an appropriate mechanism for insuring against credit risk is necessary, especially for relatively large credit transactions. The initial report notes the need to encourage or require credit providers to consider how to "self-insure" against loan default risks through purchasing insurance cover from insurers in their own names.

It is important to note that the above approaches may also be differentiated for different CCI sub-sectors. For example, it may be appropriate to retain the credit provider's right to insist on CCI cover for larger credit (and hence, larger sums insured) such as mortgage and motor-car loans, and unsecured loans above a certain threshold. Arguably, consumers in these transactions are somewhat less vulnerable to market conduct abuses than those applying for credit in respect of small unsecured loans or relatively small retail purchases (such as furniture, white goods, clothing, cell phones, etc.).

It should be noted that none of the above focus areas are mutually exclusive, and could all be considered in parallel, or to complement one another. In the interim, while consultation is ongoing, NT and the FSB are already considering the extent to which certain of the measures described under focus area 2 could be used to mitigate risk to consumers in the shorter term.

Process

Comments on the paper "*Technical Report on the Consumer Credit Insurance Market in South Africa"* may be submitted by 30 September 2014, to Ms Reshma

Sheoraj, Director: Insurance, Private Bag X115, Pretoria, 0001 or by fax to 012 315 5206 or by email to cci@treasury.gov.za

The report and accompanying documents are available on the NT (www.treasury.gov.za) and FSB (www.fsb.co.za) websites. Comments should follow the format of the comment template provided in Annexure F.

To improve the quality of public consultations, workshops will be convened with key or interested stakeholders.

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List of abbreviations and acronyms

ASISA	Association for Savings and Investment South Africa
ASIC	Australian Securities and Investments Commission
ADI	Authorised Deposit-taking Institution
CCI	Consumer Credit Insurance
CC	Competition Commission
FAIS	Financial Advisory and Intermediary Services
FCA	Financial Conduct Authority
FSB	Financial Services Board
KID	Key Information Document
LT	Long-term
LTIA	Long-term Insurance Act
NCA	National Credit Act
NCR	National Credit Regulator
NT	National Treasury
OFT	Office of Fair Trading
PPI	Payment Protection Insurance
PPR	Policyholder Protection Rules
RDR	Retail Distribution Review
SA	South Africa
SAIA	South African Insurance Association
ST	Short-term
STIA	Short-term Insurance Act
TCF	Treating Customers Fairly
UK	United Kingdom
UMA	underwriting management agent
USA	United States of America

1. INTRODUCTION

This initial report is the outcome of a review of the current market structure and business practices, as well as the prevailing policy and regulatory framework for the CCI sector in SA. This review comes against the backdrop of increasing concerns about market practices in the CCI market.

A Task Team was established by the NT and FSB to determine if the CCI market in SA is delivering on its intended objectives. These objectives include, on the one hand, protecting credit takers and their dependants against insolvency and the repossession of their assets in times of financial difficulty brought on through death, disability or loss of income of the credit instalment payer or theft or loss of assets purchased on credit and, on the other hand, protecting credit providers against default, which in turn facilitates the extension of credit and contributes to the potential for asset and wealth accumulation by in particular low-income groups.

Though not involved in preparing this report, nor necessarily agreeing with the approach of this report, a number of key stakeholders were consulted, including the DTI, NCR as well as the Competition Commission.

To facilitate a clearer understanding of the CCI market, the NCR issued a request for information in November 2011 in terms of Section 16 of the NCA for registered short and long-term insurers (Annexure A)[2] and the FSB issued Information Request 3/2011 (Annexure B) to insurers to gather additional information. The information requested by the NCR is primarily quantitative, while that requested by the FSB is primarily qualitative.

The Task Team used the requested information alongside other sources to identify the focus areas discussed in this report. These focus areas take into account the need to support the policy priorities of NT's 2011 policy paper *"A safer financial sector to serve South Africa better"* and the FSB's Treating Customers Fairly (TCF) initiative.

Box 1. Consumer protection: main policy tenets

NT's 2011 policy paper *"A safer financial sector to serve South Africa better"* lists the four key financial sector policy priorities as:

- Financial stability
- Consumer protection and market conduct
- Expanding access through financial inclusion
- Combating financial crime

To ensure fair treatment of customers, the paper recommended the implementation of the comprehensive *Treating Customers Fairly initiative*, with clear principles for market conduct backed up by rules. Over time, this initiative is

[2] The request for information in terms of Section 16 of the NCA is to be completed and submitted on a quarterly basis by insurers.

expected to ensure consistent standards of consumer protection across the sector.

The *TCF framework* embraces six outcomes for the fair treatment of customers:

- Outcome 1: Customers can be confident that they are dealing with firms where TCF is central to the firm culture.
- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly.
- Outcome 3: Customers are provided with clear information and kept appropriately informed before, during and after point of sale.
- Outcome 4: Where advice is given, it is suitable and takes account of customer circumstances.
- Outcome 5: Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect.
- Outcome 6: Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint.

In the CCI market, the expected TCF outcomes would entail appropriate product design as central to delivery of good outcomes for consumers. When designing, pricing and distributing CCI products, firms should (i) identify the target market requiring protection, (ii) ensure that the cover offered meets the needs of that target market, and (iii) ensure that the product and the way it is distributed and serviced enable customers' reasonable benefit expectations to be met and do not create barriers to comparing, exiting, claiming or switching cover.

The following principles guided the NT and FSB review of the CCI market:

- CCI offers benefits to customers, provided it is appropriately designed and delivered. CCI can be a valuable risk mitigation tool for those covered under the policy and can positively support the extension of credit and asset accumulation; and
- Market failures and abuses undermine the extent to which these benefits are realised in practice and pose significant risks to consumers; these failures and abuses must be identified and understood to design an appropriate regulatory response.

Key review findings

Appropriate consumer protection is a policy priority for NT and the FSB. This report recognises the importance of the CCI sector in terms of its size and impact on middle and low income groups. Accordingly, from the perspective of risks to fair treatment of customers, appropriate regulation and supervision of the conduct of business in the CCI market is a priority. At the same time, CCI products are often the first exposure that consumers have to insurance, and hence appropriate and affordable CCI products and services are also important in terms of supporting financial inclusion.

The review findings suggest that the CCI market is falling short of the expected TCF outcomes and is not supportive of appropriate financial inclusion. In response, three potential areas of focus for the development of a policy response are put forward for comment.

Structure

This initial report is structured as follows:

- Section 2 outlines the background to the market review, including the rationale for the review, an overview of current regulatory provisions applicable to CCI, the outcomes of the Nienaber Panel of Enquiry into practices in the CCI market and subsequent regulatory developments, as well as an overview of international approaches to CCI regulation.
- Section 3 provides an overview of the landscape and key features of CCI based on an analysis of reported data and qualitative information, as well as on the basis of a mystery shopping and consumer interview exercise conducted to gauge the customer experience of CCI.
- Section 4 summarises the findings of the review regarding the most significant market concerns.
- Section 5 outlines potential focus areas to inform policy responses to the identified concerns.
- Section 6 concludes the assessment and proposes the next steps in the process.

2. BACKGROUND TO THE REVIEW

2.1. Rationale for the review

The generally accepted value proposition of CCI is that it provides protection to consumers if an unforeseen event affects their ability to meet their credit repayments. Typically, CCI covers consumers in the event of death, disability, or loss of income due to injury, illness or involuntary unemployment (credit life insurance) or theft, destruction or damage of the asset in respect of which the debt is incurred (credit asset insurance). Clearly it is in the interests of credit providers to mitigate the risk of bad debts arising from these causes. Equally, it is in the interests of credit consumers (or their dependants) to have their outstanding credit balances settled when these events occur. In this way, CCI supports the extension of credit for both consumption and wealth accumulation. Importantly, CCI is typically not actively sought out by consumers. It is, by its nature, ancillary to the granting of credit and is in most instances taken out at the insistence of the credit provider as a pre-condition for granting credit.

Credit life insurance may be the first type of insurance that many low-income consumers encounter. As such, it can offer an opportunity for introducing consumers to the concept of insurance and, if it offers value to them, can lead to uptake of other insurance products in future – a phenomenon that can be termed positive market discovery. However, credit life insurance can also lead to unfair

outcomes for consumers if they are not aware that they have insurance, or if the existence of a captive market enables exploitation through excessive pricing or unfair claims handling practices. Such practices may lead to disillusioned customers, thereby disincentivising uptake of other insurance products – known as negative market discovery.

The CCI market in SA reflects specific characteristics, namely:

- compulsory cover – SA law allows credit providers to insist on CCI cover as a condition of granting credit. Though consumers must by law be allowed to choose a preferred insurance provider, evidence as outlined below suggests that this choice cannot easily be exercised in practice;
- a captive market – a consumer buying for example a television on credit from a retailer is not going to shop around for a better insurance deal as their focus is on acquiring the asset and the insurance is a secondary purchase;
- practical constraints – particularly in the case of retail goods purchases and small unsecured loan applications, the "point of sale" nature of the credit transaction makes it highly impractical for the consumer to enter into a separate insurance transaction with an unrelated insurer. This is exacerbated in cases where the credit provider requires the mandatory CCI cover to contain certain specific product features that are typically not included in free-standing insurance policies (for e.g. retrenchment cover)
- conflicts of interest – the credit provider (whose interests are protected together with those of the customer) and other entities in the CCI value chain are frequently aligned to the insurer; and
- information asymmetry and lack of product understanding - in many CCI business models, the target market comprises unsophisticated customers, with low or relatively low levels of financial capability and literacy. Even in the case of middle to higher income target markets, the compulsory, ancillary and usually bundled nature of CCI entails an increased risk that customers may not appreciate the features and implications of CCI products they purchase. This increased risk of information asymmetry results in material bargaining power imbalances between consumers and product suppliers.

On the supply side, problems are generally linked to particular distribution arrangements. Although various distribution models exist for CCI, most models involve principal/agent relationships where the insurer is the principal and the credit provider/merchandise retailer is the agent. The principal/agent arrangement usually involves CCI being sold by intermediaries (such as furniture retailers, financiers or car dealers) for a commission or similar incentive, in conjunction with a loan transaction. Another distribution arrangement involves CCI being sold by the insurer's (or a subsidiary's or affiliated company's) own employees.

On the demand side, problems tend to occur most frequently for consumers who are inexperienced, less sophisticated, less educated, in financial need, and/or who have a poor credit rating (vulnerable and disadvantaged consumers).

The specific characteristics of the CCI market suggest that it may be necessary to regulate the CCI market in a way that is distinct from regulation of the broader insurance market, especially with respect to products and services directed at lower income customers.

2.2. Current regulatory framework for CCI

The FSB is the lead regulator of insurers and insurance business, as well as financial intermediaries, while credit providers (and certain additional requirements relating to credit insurance) are regulated by the NCR.

The Long-term Insurance Act, 1998 ("LTIA") or the Short-term Insurance Act, 1998 ("STIA") applies concurrently with the National Credit Act, 2005 ("NCA"). The LTIA and the STIA provide the overarching legislative framework for insurance business generally, with the NCA providing additional requirements relating to credit insurance.

CCI can be conducted under the LTIA or the STIA, depending on the nature of the insurance cover. CCI as such is subject to the existing legislative provisions for short-term and long-term insurance business in general, including the regulations[3] made under each Act (that *inter alia* regulate remuneration) and the Policyholder Protection Rules[4] (that *inter alia* regulate conduct of business).

Section 106 of the NCA permits credit providers to insist on mandatory credit insurance[5] cover as a condition of granting credit, providing that such cover is not unreasonable or at an unreasonable cost, having regard to the actual risk and liabilities involved in the credit agreement. Section 106 goes on to provide that, in addition to any such mandatory cover, the credit provider may also offer optional insurance cover relating to the credit agreement and/or the goods concerned.

Recent amendments to section 106 of the National Credit Act empower the Minister of Trade and Industry, in consultation with the Minister of Finance to prescribe the limit in respect of the cost of credit insurance that a credit provider may charge a consumer.

Specific provisions that apply to CCI are found in Section 44 of the LTIA and Section 43 of the STIA, in terms of which a prospective policyholder, who is required to take out insurance as security for a loan, must be granted the choice in certain circumstances, of arranging alternative insurance cover to the

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[3] The Regulations made under the Long-term Insurance Act No. 52 of 1993, as published in GN R1492 of 1998 and amended by GN R197 of 2000, GN R164 of 2002, GN R1209 of 2003, GNR.1218 of 2006, GN R186 of 2007 and GN R952 of 2008GN R1493 of 1998, and substituted by GN R1077 of 2011 and the Regulations made under the Short-term Insurance Act 53 of 1998, as published in GN R1493 of 1998 and amended by GN R462 of 2008 and substituted by GN R1076 of 2011 and Part 6 of the Regulations made under the Long-term Insurance Act 52 of 1998, as published in GN R1492 of 1998 and amended by GN R197 of 2000, GN R164 of 2002, GN R1209 of 2003, GNR.1218 of 2006, GN R186 of 2007 and GN R952 of 2008GN R1493 of 1998, and substituted by GN R1077 of 2011.

[4] Policyholder Protection Rules, issued under Section 62 of the Long-term Insurance, 1998 and Section 55 of the Short-term Insurance Act, 1998 respectively.

[5] The NCA defines "credit insurance" as "an agreement between an insurer, on one hand, and a credit provider or a consumer or both, on the other hand, in terms of which the insurer agrees to pay a benefit upon the occurrence of a specified contingency, primarily for the purpose of satisfying all or part of the consumer's liability to the credit provider under a credit agreement as at the time that the specified contingency occurs, and includes-
(a) a credit life insurance agreement;
(b) an agreement covering loss of or damage to property; or
(c) an agreement covering-
(i) loss or theft of an access card, personal information number or similar device; or
(ii) any loss or theft of credit consequential to a loss or theft contemplated in subparagraph (i);"
Credit life insurance is defined as including "cover payable in the event of a consumer's death, disability, terminal illness, unemployment, or other insurable risk that is likely to impair the consumer's ability to earn an income or meet the obligations under a credit agreement".

insurance cover proposed by the credit provider. However, these sections do not apply if a short-term or long-term policy or its policy benefits is made available for the purpose of protecting the interests of a creditor under a credit agreement to which the NCA applies.

The NCA definitions of credit and credit insurance constitute liability policies under the STIA and life policies under the LTIA. The NCA (Section 106(4)) confirms the right to choice by stating that the consumer must be given, and be informed of, the right to waive the proposed policy (whether mandatory or optional) and substitute a policy of the consumer's own choice.

2.3. The Nienaber Panel of Enquiry [6]

In 2007 a Panel of Enquiry ("the panel") chaired by retired judge and former Long-term Insurance Ombudsman, Judge Peet Nienaber, was set up to investigate abuses in the CCI market. This investigation was an industry coordinated response to media allegations that certain long-term and short-term insurers active in the CCI market were persistently contravening commission regulations. The panel was commissioned by the Life Office's Association (subsequently merged into ASISA) and SAIA.

The panel was mandated to undertake an investigation to identify and eradicate undesirable practices prevalent in the CCI market that impact negatively on consumers.

Annexure D provides an overview of the main panel findings and recommendations, as well as subsequent regulatory developments relevant to each. On the whole, the panel found that CCI has a bad name – and not only in SA – and that this perception may relate to various factors, including a lack of proper disclosure. Though CCI does fulfil a real need for the consumer, it is in the first instance designed to serve the interests of the credit provider and there are a number of imperfections in the system that may be exploited by unscrupulous providers. However, the panel cautioned that CCI comes in a variety of forms and is issued by a variety of insurers, making generalisation difficult.

The main panel findings and recommendations, as well as regulatory developments relevant to each, can be summarised as follows:

Market conduct

Findings and recommendations: The panel found that, although adequate market conduct legislative requirements are in place, regulation alone is not sufficient to ensure compliance and that, although individual insurers strive to comply with market conduct regulation, they don't always do so in practice. Hence the panel recommended that proper disclosure be emphasised.

Subsequent regulatory developments: A dedicated market conduct regulator under the new Twin Peaks framework will focus on appropriate market conduct

[6] A copy of the report, published in 2008, is available at: www.treasury.gov.za

standards, including but not limited to adequate disclosure outcomes through the TCF framework initiated by the FSB in 2010. In addition to – and in support of – the TCF framework, the current review is aimed at specifically addressing market conduct, including disclosure, with regard to CCI. Another, more specific, response relates to a variation to both the Long-term and Short-term Policyholder Protection Rules, gazetted in December 2010, to deal with communication with policyholders following the rejection of claims.

Intermediary remuneration

Findings and recommendations: The panel did not find explicit contravention of intermediary remuneration regulation, but concluded that regulatory requirements in this regard are complex and unclear, giving rise to inconsistent legislative interpretation among industry players. Hence these requirements are in need of revision. The principal uncertainties relate to the payment of remuneration by insurers to third parties for the outsourcing of intermediary services and to additional payments made pursuant to Section 48(2) of the STIA.

Subsequent regulatory developments: The FSB's ongoing cross-sector Retail Distribution Review ("RDR"), against the background of the broader TCF framework, speaks directly to this panel recommendation. Furthermore, aspects of the issue of improper incentives are addressed through amendments to the FAIS General Code of Conduct relating to conflicts of interest, the insurance Binder Regulations and Outsourcing Directive, as well as guidance on the definition of intermediary services in FAIS.

Cell captives, underwriting managers and profit sharing arrangements

Findings and recommendations: The enquiry included an investigation into the operation of cell captives, underwriting management agents (UMAs) and profit sharing arrangements in the CCI field. It was noted that such operations and arrangements had the potential for conflicts of interest and could be exploited to circumvent intermediary remuneration restrictions, leading to inflated premiums. The panel emphasised that any profit-sharing agreement with intermediaries is illegal. Though the panel did not make any specific recommendations with regard to cell captives, UMAs and profit-sharing arrangements, these findings suggest a review of such arrangements.

Subsequent regulatory developments: The two most notable regulatory developments in this regard are: the Binder Regulations of 2011, preceded by amendments to the insurance laws in 2008 to provide for binder agreements, as well as Directive 159A.i, known as the Outsourcing Directive. These provisions set out the conditions for binder agreements and outsourcing arrangements, respectively, in order to ensure effective consumer protection outcomes. In addition, the FSB has undertaken a review of third party cell captive arrangements and published a discussion paper in this regard in June 2013.

The current review

The current review acknowledges the distinct features of the CCI market as highlighted by the panel. Though a number of the panel recommendations have already been implemented, the discussion in Section 3 below shows that a

number of concerns regarding the CCI market remain. Taking the panel's report as a point of departure, this review serves to further test the effectiveness of the CCI regulatory framework, explore additional issues and elaborate on the focus areas to address challenges in the CCI market.

2.4. Comparative international examples

The Task Team selected various jurisdictions for a benchmark review of CCI regulation and market practices. Below, a summary is provided of lessons for SA. A more detailed overview of the approach and lessons from each jurisdiction is provided in Annexure E.

Issues raised are not unique to SA. What is evident from a review of comparative international examples is that concerns regarding market conduct issues of disclosure and consumer education in the CCI market are widespread. Issues highlighted in other jurisdictions include:

- Consumers pay excessive prices
- The protection consumers buy is partial, with evidence of high pressure and unfair sales tactics
- Remuneration caps are circumvented
- Claims administration can be slow and unfair, and can leave consumers facing additional charges or serious debt enforcement action
- There is limited competition at the point of sale and a lack of free choice for consumers
- Sales agents are not properly trained
- Disclosure of information to consumers is insufficient or inappropriate
- Content and coverage of policies are problematic
- Mis-selling takes place

Various regulatory responses. The experience of the different countries suggests various policy options to address concerns in the CCI market:

- *United Kingdom ("UK"): point of sale ban coupled with enhanced disclosure requirements*. In the UK, a point of sale ban was placed on all payment protection insurance ("PPI") except retail PPI[7] for seven days after the credit sale or the supply of a personal PPI quote. Additional measures to introduce competition in the PPI market include: an obligation to provide a personal PPI quote, setting out the cost of PPI along with details of the cover provided; an obligation to provide information about the cost of PPI as well as other key messages, such as that PPI is optional[8] and available from other providers;

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[7] Retail PPI covers a percentage of the outstanding balance owing on a customer's retail finance account/loan. The type of retail finance sold in conjunction with the PPI defines the type of PPI policy. There are two types of retail finance:

- 'Personal loan' retail finance, which is a personal loan provided by or on behalf of the retailer granting credit to the consumer to purchase a specific good (or goods, usually of high value) sold by the retailer of that good.
- 'Credit account' retail finance, which is a running account credit facility provided by the retailer to the consumer to purchase goods from the retailer. The consumer typically buys goods at different times, such that their credit balance rises and falls over time.

[8] In the UK and Australia, credit providers are not permitted to insist on cover as a condition of granting credit.

an obligation to report information to the regulators for monitoring and publication, as well as to provide information on claims ratios to any person on request; a prohibition on the sale of single-premium PPI policies; and an obligation to provide customers with an annual review setting out the cost of PPI and including a reminder of the consumer's right to cancel. The largest providers must also submit themselves to independent mystery shopping exercises.

- *Australia: drive to improve disclosure*. In 2002, the Australian regulator released a report on disclosure of fees and charges. The ultimate aim was to obtain industry consensus on a standard good practice model for disclosing fees by addressing issues such as: use of common terms; standardised descriptions; the purpose of particular fees; improved disclosure of adviser remuneration arrangements; and transparency of fees. In 2011, it released a report regarding the sales practices of Authorised Deposit-taking Institutions that sell CCI in conjunction with home loans, personal loans and credit cards. Recommendations include the implementation of various market conduct and disclosure requirements, including that consumers should be informed how their premiums will be structured, that the CCI premium should be quoted separately from the underlying loan, that distributors should ensure proper and ongoing training of staff, and that distributors should have documented monitoring systems in place that comprise a range of systems to detect non-compliant sales of CCI.

- *United States of America ("USA"): premium regulation*. Most American states publish a *prima facie* rate for CCI, which is presumed to be reasonable without any further proof required of the insurer. An insurer may use any rate up to the *prima facie* rate. To use a higher rate, the insurer must demonstrate that the rate satisfies the reasonableness standard, which is calculated according to a minimum loss ratio test. A few states require insurers to annually file and adjust the premium rate schedules to reflect the prospective attainment of the loss ratio standard predicated on recent loss experience (usually three years).The USA experience illustrates that premium regulation could be an option, provided that any price regulation is carefully designed so as not to distort the market, and that it is combined with effective monitoring of market practices, with claims as a benchmark.

- *Italy: ensuring choice by requiring multiple quotations*. Since 2012, Italian regulation requires that, before issuing any consumer credit contract that requires the consumer to take out a life-insurance policy, banks and other financial intermediaries must provide the consumer with at least two quotations from two different insurance providers *not* linked to the credit provider. Furthermore, the regulation sets out minimum requirements for consumer credit-linked life insurance so as to enable the customer to make an informed choice. Notably, the consumer has the right to choose any alternative policy available on the market and is allowed 10 working days following receipt of the quotation from the bank/financial service provider to buy such alternative cover. Insurers must also provide a free online service where consumers can find and compare policies, as well as access the detailed terms and conditions of policies. The details of such websites are to be provided to the regulator for monitoring purposes.

- *Chile: open bidding for credit provider CCI contracts*. In Chile, regulatory requirements introduced in 2012 require mortgage credit insurance contracts

entered into by banks and other financial institutions on behalf of their debtors (that is, where the financial institution is the policyholder) to be awarded based on an open bidding process, of which all local insurers must be informed, and subject to a number of provisions. Debtors may also choose to individually contract mortgage loan insurance. Though the Chilean case applies specifically to mortgage insurance, it presents an interesting case for consideration in the South African context regarding policy options when the credit provider is the policyholder on behalf of its debtors.

Cross-country lessons. Key lessons across the various jurisdictions include:

- the merits of a thorough review of market practices to inform any policy response;
- the need to recognise the distinct nature of CCI;
- the importance of disclosure and standardisation of such disclosure with regard to both remuneration and the presence and terms of CCI;
- the value of a multi-pronged response to ensure consumer choice and proper market conduct; and
- the importance of monitoring of market practices to inform a regulatory response.

3. THE SA CCI LANDSCAPE

3.1. Introduction

This section provides an overview of market practices in the South African CCI market based on the following sources:

- an analysis of data reported to the FSB and the NCR ;
- a mystery shopping and consumer interview exercise to better understand the CCI customer experience; and
- an analysis of qualitative market information.

3.2. Methodology

Data analysis[9]. In 2012, the CCI task team commissioned True South Actuaries & Consultants to perform a focused assessment of the CCI sector in SA. The analysis is based on the following information:

- Quarterly information submitted to the NCR for 2012
- Information submitted to the FSB under information request 3/2011
- CCI information contained in annual statutory submissions to the FSB for 2011 and 2012 (statement B7 of the short-term quantitative returns and B10 of the long-term quantitative returns).

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[9] This analysis is based on reported data. Reasonable steps have been taken to ensure the validity of the data and information.

The objective of the assessment was to inform the CCI Task Team of:

- Trends, patterns and issues identified from information collated from NCR data submissions and FSB Information Request 3/2011 to assist the review of CCI practices in the South African market; and
- Any market conduct shortcomings in CCI business identified from the information collated, including
  - whether premiums and profit margins are excessive;
  - the payment of excessive commissions or other improper fees and incentives to intermediaries;
  - the adequacy of the overall value provided to consumers;
  - questionable marketing and distribution practices;
  - the fairness of standard terms and conditions; and
  - consumer awareness, more particularly whether consumers are always made aware that they are paying for CCI cover.

Mystery shopping. A mystery shopping and consumer interview exercise (Annexure C), commissioned by FinMark Trust and used as input to the work of the CCI Task Team, was conducted to better understand the experience of CCI customers, including whether they are in practice able to exercise their right to choose an insurance provider.

The mystery shopping exercise focused on a broad range of furniture retail and micro-finance outlets operating in the LSM 3-7 space in an attempt to understand how consumers in this market segment experience the purchase of CCI[10]. In addition, in-depth interviews were conducted with low-income consumers who had entered into a credit agreement or taken out a micro-loan[11]. The exercise focused on the whole process of purchasing CCI, beginning with the application for credit, in order to understand at what point in the process and in what manner CCI is being sold. The purpose was to establish to what extent credit providers are complying with legislation and how this is impacting on the consumer experience of CCI.

The mystery shopping and consumer interviews included three categories of questions, the first of which related to credit checks, affordability assessments and the credit offer itself. The second category related to the CCI component, including add-ons, riders, "club" membership and documentation and the third related to disclosure regarding claims, complaints, and commissions.

Qualitative market information. Lastly, the qualitative information submitted to the FSB based on Information Request 3/2011 (Annexure B) was analysed, covering:

- disclosure throughout the product life cycle;

[10] Note that clothing retailers were not included in the scope of the exercise. These will be considered as a potential second phase of the research.

[11] The mystery shopping involved 35 visits to furniture retailers, 27 visits to micro-finance outlets and 47 in-depth consumer interviews. For more details on methodology refer to the full report (Annexure C).

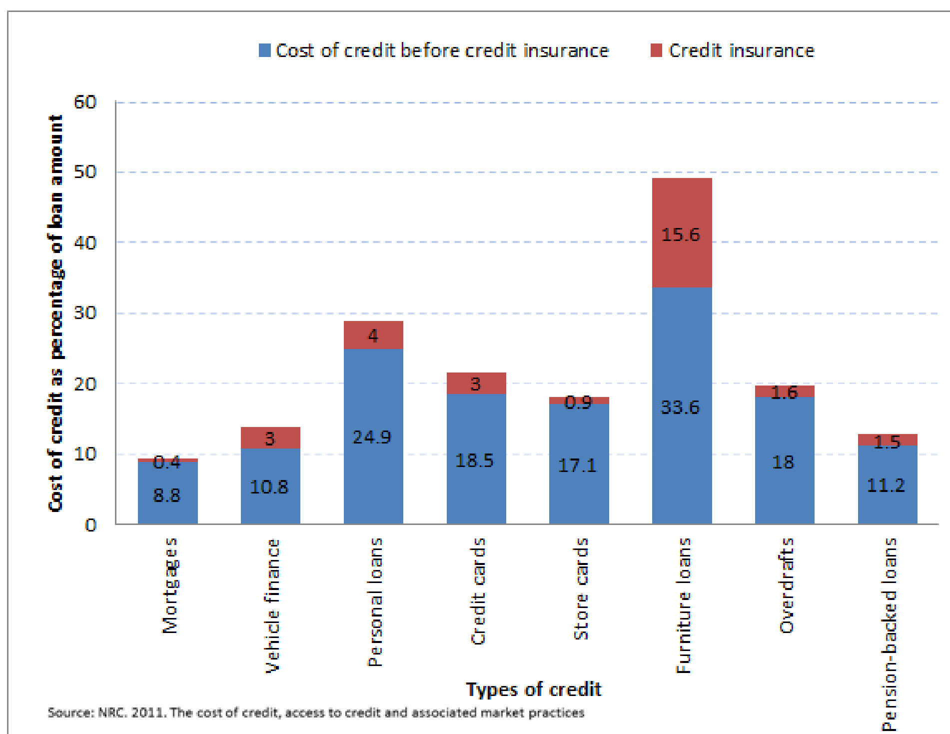
- product standards, including underwriting practises and a breakdown of premiums;
- claims and complaints handling, including reasons for claims being rejected;
- market structure, including distribution models and who the target market is for CCI; and
- remuneration.

3.3. Findings: data analysis

The CCI market was worth approximately R16 billion in premiums in 2012 and almost seventy insurers are active in CCI business. Of these, the 15 largest insurers account for about 90% of premiums. Credit life cover comprises 67% of the CCI market by premium, while CCI cover for immovable and movable property account for 21% and 11% of premiums, respectively[12].

CCI has a significant impact on total cost of credit. CCI increases the overall cost of credit of both secured and unsecured lending (see Figure 1)[13]. The impact of CCI is greatest for furniture loans, where it increases the cost of credit by about 16%. The increase in cost of credit for personal loans is 4%. The smallest increase is for mortgages, store cards and pension-backed loans.

Figure 1. Cost of credit before and after CCI



[12] The CCI data reported to the NCR is disaggregated into credit life insurance, movable property and immovable property credit insurance. As described on p.4, the NCA defines credit insurance as incorporating credit life insurance and credit insurance on property. The latter can be further disaggregated into credit insurance for *immovable* property (defined as an item of property that cannot be moved without destroying or altering it, namely land and real estate) and *movable* property (any other property).
[13] Note that this example includes extended warranties.

The higher the overall cost of credit, the greater the debt-servicing burden placed on consumers. The key issue is whether this increase in cost reflects value-add for consumers. Furniture loans and personal loans appear to be the main areas of potential concern.

Key CCI ratios. Below, data reported to the NCR is analysed for the credit life, immovable property and movable property segments of the CCI market respectively. This is followed by an analysis of the data reported to the FSB for long-term and short-term insurers active in the CCI market. Broadly speaking, long-term insurers constitute the majority of the "credit life" market segment in the NCR data, with short-term insurers accounting for CCI insurance on movable or immovable property.

The tables below consider total and average cover, the claims, commissions, expense and net cash flow ratios for each class, as well as some statistics regarding claims and claims rejections.

Box 2. Explanation of key ratios

Claims ratio: One of the ways in which the value of cover to policyholders can be assessed is in terms of the value of claims paid relative to the premiums (known as the claims ratio). A higher ratio means the aggregate amount paid back in benefits to policyholders represents a higher proportion of the aggregate premiums received. It follows that disproportionately low claims ratios are attributable either to disproportionately high premiums (which could imply an incorrect assessment of risk), disproportionately low claim payments, or a combination of both.

Expense ratio: A lower claims ratio may be indicative of inflated expenses, leading to disproportionately high premiums. In the case of CCI, this could relate to high fees paid to credit providers for managing the credit life business or expensive policy initiation, administration and claims processes. It is therefore also relevant to track the expense ratio, defined as incurred expenses as a percentage of earned premium. A more efficient product provides more value to the customer if cost efficiencies are passed on to policyholders in the form of lower premiums[14].

Commission ratio: The commission ratio is calculated as commissions paid as a percentage of premium received. Note that it may be difficult to calculate or interpret the total commission ratio, as various added fees can inflate the amount that the client pays in practice, even if not termed "commission".

Net cash flow ratio: Net cash flow is an indication of how much of the premium remains after claims, commission and expenses have been paid; it is thus an indicator of the profitability of the product.

[14] Wipf, J., Kelly, E. and McCord, M.J., 2011. Improving credit life micro-insurance. ILO Micro-insurance Innovation Facility: Geneva

Table 1. The three main market segments as reported to the NCR

	Cover for credit life	Cover for immovable property	Cover for movable property
Market share (premium)	67%	21%	11%
Cover			
In-force cover (total)	R242 billion	R1 693 billion	R90 billion
In-force cover (average)	R17,000	R2 million	R19,000
Claims ratio			
Minimum	0%	48%	0%
Average	20%	61%	12%
Maximum	159%	88%	91%
Commission ratio			
Minimum	0%	6%	0%
Average	12%	15%	21%
Maximum	40%	20%	40%
Claim rejections by value of claims			
Minimum	0%	0%	0%
Average	17%	2%	10%
Maximum	55%	4%	23%
Claim rejections by number of claims			
Minimum	0%	3%	2%
Average	16%	10%	12%
Maximum	69%	15%	33%
Reasons for claim	63% death 24% unemployment 13% disability	93% damages 6% theft/loss 1% other	25% damages 60% theft/loss 15% other

Low claims ratios. The data indicate a wide range of claims ratios between insurers. In the credit life market, claims ratios range from virtually zero per cent to as high as 159%. However, the average claims ratio is only 20%. This

compares to 45% on average for pure risk long-term insurance, based on 2012 LT returns. In the movable property CCI market, claims ratios range between close to zero and 91%, with an average of 12%. This compares to a claims ratio for the short-term insurance industry that generally tends to be in the region of 60%.

An average claims ratio of 20% and 12%, respectively, means that less than a fifth of premiums on credit life and movable property CCI is paid back to clients in the form of claims – in contrast to the 61% average claims ratio for immovable property CCI cover. Thus there are marked differences between the claims ratios in the immovable property CCI segment, that deals with a higher-income market segment (average cover at R2 million), on the one hand, and the credit life and movable property CCI cover segment on the other hand.

Average commissions in line with regulatory limits, but with significant variations. Likewise, commission ratios range significantly, with a maximum of up to 40% in both the credit life and movable property CCI segments and up to 20% in the immovable property CCI market. Average commission rates are 12% for credit life insurance, increasing to 15% for immovable property and 21% for movable property. Maximum regulated commission allowed for property insurance (whether movable or immovable) is 20%; thus higher figures on movable property are indicative of the effect of added fees. For long-term insurance (credit life), maximum regulated commission rates vary depending on the business model (individual or group scheme models; group schemes with or without administration, etc.). Some "credit life" business is also written on short-term licenses. It is thus difficult to draw meaningful sector-wide conclusions regarding average commission ratios for credit life insurance.

Varied claims rejection rates. The same broad range is also witnessed in terms of claims rejection statistics. On average, 16% of credit life claims (by number) is rejected, decreasing to 12% for movable property and 10% for immovable property claims. Information submitted to the NCR indicates that roughly 600,000 CCI claims are settled in a year.

FSB data confirm insights generated by NCR data. Table 2 shows average claims and commission ratios, as well as expense and net cash flow ratios, as reported to the FSB.

Table 2. Long-term and short-term CCI statistics reported to the FSB

	Claims ratio	Commission ratio	Expense ratio	Net cash flow ratio
Long-term insurers	22%	12%	10%	55%
Short-term insurers	25%	21%	24%	30%
Total	23%	14%	14%	49%

The average claims ratios for CCI are similar for long-term and short-term insurers, at 22% and 25% respectively. The claims ratio for long-term insurers is more or less aligned with the claims ratio experience in the credit life component of the CCI market as per the NCR data. Commission ratios, at an average of 12% for long-term insurers and 21% for short-term insurers, once again align with those reported for credit life and movable property, respectively, in the NCR data.

Among insurers engaged in CCI, expense ratios are significantly higher for short-term insurers than long-term insurers and net cash flow ratios significantly lower[15].

These average figures mask some nuances across insurers, as becomes apparent when considering the largest insurers active in the CCI market:

Largest long-term and short-term CCI insurers show low claims ratios and generally high expense and profit ratios[16]. More detailed analysis of the claims and expense experience for the ten long-term insurers with the largest CCI premium volumes (net premiums of more than R200 million) reveals that:

- claims ratios are between 5% and 39%, with six insurers having claims ratios below 20%
- commission ratios range between 0% and 27%, with four insurers having commission levels of more than 20%
- expense ratios range between 0% and 26%, with three insurers showing expenses of greater than 20%
- the net cash flow ratio ranges between 25%[17] and 89%, with five insurers showing a ratio of greater than 50%

The same holds for the largest short-term CCI insurers. Analysis of the claims and expense experience for the six short-term insurers with the largest CCI premium volumes (net premiums of more than R100 million) reveals that:

- claims ratios are between 2% and 44% with three insurers having claims ratios below 20%
- commission levels range between 13% and 29%, with two insurers having commission levels of more than 20%
- expense ratios range between 4% and 48%, with four insurers showing expenses of greater than 20%

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[15] Note, however, that a number of large long-term insurers reported nil commission and expense amounts, making these numbers difficult to interpret. This does not seem reasonable as there should be some level of management expense and allocation to contribution to overheads for CCI business. Several large long-term insurers reported commission levels below 5%. In comparison, management expense ratios were about 25% and commission ratios were about 11% for assistance business in 2011 and 2012 (FSB Quarterly report for Long-Term insurers, March 2013). In contrast, large short-term insurers generally reported commission levels above 15% and expenses above 30% for CCI business.

[16] Premium is constituted by claims, expenses and profit. It is counterintuitive for both expense and profit ratios to be high. Where this is the case, it can largely be ascribed to a low claims ratio.

[17] Note that expenses are double the claims amount for the insurer reflecting the 25% net cash flow ratio.

- net cash flow ranges between 3%[18] and 79%, with two insurers showing a ratio of greater than 50%[19]

All of the insurers that show claims ratios of 0% have premium volumes of less than R100 million. For smaller insurers more volatile experience is expected over time. Thus it is challenging to draw conclusions based on a data snapshot and it is desirable to monitor the results of smaller as well as new/start-up insurers over time.

In summary:

Claims ratios: Claims ratios are generally low in the CCI market, especially for movable property and credit life cover. There is not sufficient data over time to see the variability of claims ratios and whether higher claims ratios are also experienced by insurers in certain years. Should claims ratios persistently be below 25%, it would seem unreasonably low. The immovable property market seems to be less of a concern[20].

Note that a number of insurers indicated that premiums for CCI policies are determined by considering the expected claims, expenses and required profit margin. In future, it will be useful to analyse the actual claims and expenses compared to the expected claims and expenses assumed in the premiums.

Commissions and expenses: The findings indicate that most of the insurers pay commission according to the maximum commission scale.

In terms of the assessment of fees: outsourcing and binder regulations do not set maximum fees to partners for administration services, but follow a principle-based approach in that fees need to be reasonably commensurate with the cost of the services provided. Because service providers in the CCI market often belong to the wider group of companies, it is important to carefully consider what would constitute a reasonable outsourcing or binder fee for CCI business. The current statutory returns do not show fees to service providers separately from other expenses, making it difficult to determine reasonability of fees for services rendered, as well as to assess internal expenses relative to the level of outsourcing of administration functions[21].

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[18] Note that expenses are more than double the claims amount for the insurer reflecting the 3% net cash flow ratio.

[19] Note that net cash flow could be used as a proxy for profit in the short-term space (for policies less than one year) if earned premiums and claims incurred are used to calculate cash flow. However, the returns analysed here do not reflect earned or incurred data. In the absence of data to enable the calculation of profit, net cash flow is used as an indication of how well current liabilities are covered.

[20] Note, however, that an assessment of the claims experience for home loan business (part of immoveable property) using claims ratios might not be reasonable, since the term is usually 20 years. Under such a time-frame, actual mortality experience versus expected experience is important.

[21] In response, the FSB issued Information Letter 7/2013 on 12 September 2013. It calls for information on binder arrangements, specifically including on fees payable in respect of each function performed under these agreements. The information is being analysed and will inform the supervisory approach for 2014. The FSB is in the process of developing an insurance conduct of business return that will require information on all fees paid by insurers to be submitted on a quarterly basis.

3.4. Findings: mystery shopping and consumer interview exercise

The findings of this exercise can be summarised from two perspectives: the credit offering and the insurance offering.

Key findings: credit offering

Though the primary purpose of the exercise was to establish practices in the CCI industry, the exercise also covered a basic understanding of the credit offering so as to position the CCI findings. Key findings with regard to the credit offering include:

- **Easy access to credit**: The findings suggest that access to credit has increased in the last five years, as has the ease of obtaining credit. In the majority of consumer interviews (42 out of 47), consumers indicated that it was easy to obtain credit and 30 out of 47 consumers indicated that they already had credit with more than one provider. More than 70% of consumers said they had been phoned and offered more credit towards the end of their repayment period: *"...if there is about, for example, two payments left, they would call and offer credit purchase with no deposit upfront."*

  In addition, half of the furniture retail mystery shoppers were offered more credit than they required. This was offered in the form of a top-up loan or more expensive items in the store. One fieldworker recollected: *"Sales staff try to convince you to buy a bigger item than you came in for when they realise you can get more credit than you applied for. 'Why do you want this, when you can have something bigger and better?'"*
- **Inconsistency regarding affordability assessments:** To address issues of reckless lending and promote responsible credit granting, affordability assessments should be conducted by credit providers. In terms of the NCA, the onus is on the credit provider to ensure that consumers are able to afford the credit and are not going to become over-indebted as a result of it[22]. However, detailed financial information was not required by 30% of the furniture retailers in the mystery shopping, and only 50% of micro-finance outlets asked for any financial expenditure information. In the consumer interviews, 36% said they were not asked to provide this information.
- **Lack of transparency regarding total cost of credit**. Effective competition requires that consumers are able to make comparisons between credit offers. However, it was found to be complex to compare bundles of goods, credit and insurance. Quotations are also not easily obtainable. Only half the mystery shoppers were able to get quotations from their trips to furniture retailers. Many of these quotations were incomplete, while some just pointed out what the monthly instalment would be. All the fieldworkers complained that they were not given proper quotes and that they were asked to first apply for credit

[22] Section 81(2) of the National Credit Act stipulates that a credit provider may not enter into a credit agreement with a consumer without first taking reasonable steps to assess the consumer's debt re-payment history, existing financial means, prospects and obligations, their understanding of the risks and costs of the proposed credit, and their rights and obligations under a proposed credit agreement.

before a quote would be forthcoming. One of the fieldworkers remarked: *"They did not appear to have a system for giving out a quotation".* The full cost of credit, inclusive of initiation fees, administrative fees and credit life cost is also not being fully disclosed.

Part of the problem is that some of the quotation items are variable depending on the credit check. For example, the rate of the credit life insurance can be dependent on how credit worthy a customer is. Hence, the credit check is done first before the quotation is produced. The stores have to pay the credit bureau for each credit check they conduct. Thus they may be reluctant to produce a quotation without an assurance that it will lead to a purchase.

Key findings: insurance offering

Choice on paper vs. in practice. In terms of the NCA, credit providers may require consumers to take out credit life insurance, but it should be made known to consumers that they can choose an insurance provider of their choice; they do not have to use the credit provider's one. However, the mystery shopping exercise strongly found choice to be limited in practice. A number of issues emerged:

- *Inconsistent disclosure*. Shoppers were told of the credit life component in only 21 of the 35 mystery shops conducted. Moreover, only 5 out of 35 were told they would be allowed to substitute it for their own policy. Consumers interviewed were also asked to recall if they had been told about credit life when they took out credit. 26 out of 47 said they were told about it and 24 out of 47 said they were given details. 19 out of 47 recalled being told that they could choose not to use the CCI proposed by the retailer and only 9 out of 47 recalled being advised that the proposed CCI could be substituted with a product from another provider.
- *Limited consumer incentive for shopping around*. Mystery shopping revealed that some consumers regard CCI as just another finance charge offering no real value to them. Because the amount for the credit life insurance appears very small as a monthly sum on the credit account, customers are unlikely to bother seeking other insurance alternatives. Consumers furthermore tend to use the credit provider's options as this speeds up the credit application process.
- *Limited alternative options*. It is not possible to buy CCI from one distributor to cover a credit account with another retailer. In theory, a stand-alone CCI policy or a life insurance policy could be used as alternatives. However, only one provider offers stand-alone CCI and it is aimed at the higher-income market.
- *Practical challenges to shopping around.* The research found that the actual process of shopping around for CCI is not easy, as there is a lack of standardisation of forms and quotes where CCI is concerned. Furthermore, since the CCI purchase cannot be separated from the credit purchase the resulting multiple enquiries at credit bureaus have a negative impact on a person's credit rating.
- *Product features further limit alternatives.* Even if they had an existing life insurance policy and wanted to substitute it, mystery shoppers and

consumers interviewed were advised that they needed retrenchment cover, which most life insurance policies do not have. In the case of furniture retail credit, they could also need a separate household content insurance policy. This is a problem for consumers living in informal housing, as most providers are unwilling to insure the contents of such housing. Mystery shoppers indicated that while they were told that they could substitute the policy offered through the retailers for their own policy, they did not feel that this could be easily done in reality. Feedback includes: *"They didn't specifically say its compulsory, only that it's included and if I have my own insurance it will take months to approve my credit". "She said it might affect my chances of getting the credit approved."*

- *Active discouragement of choice.* As the quotation above indicates, in practice, choice is often discouraged by sales staff. Only 5 out of 35 mystery shops offered shoppers any alternative to the CCI policy offered in-store. Mystery shoppers were even actively discouraged from substituting a life insurance policy for the CCI offered in-store. Fieldworkers made the following observations: *"No other insurance was accepted. My insurance would not offer what hers does". "If you bring your own credit life insurance it is going to take months for us to approve your credit".* Mystery shoppers were asked to record what they were told when they said they wanted to shop around for CCI before accepting their credit offer. Feedback includes: *"The salesperson told me that I wouldn't find any better offer than theirs". "I was told that the life insurances are all the same in every furniture store, and I will be offered the same amount and the same policy". "She said that this might affect my chances of getting credit approval".*
- *Bundling and add-ons challenge price comparisons*. Other types of cover are often bundled with CCI. Add-ons encountered during the mystery shopping exercise include: product/asset insurance; product insurance for cash customers; life insurance for credit customers whose life partner's income is taken into consideration during the credit affordability test; and "club" membership. A third of the furniture retail shoppers were offered product insurance and 14 out of 35 were offered funeral insurance. Extended warranties were actively sold to half the mystery shoppers: *"They (sales staff) know more about extended warranties than they do about credit life".* The micro-finance outlets offered 10 out of 27 of the mystery shoppers funeral insurance and more than half of the consumers interviewed said they had been offered either funeral or product insurance. A bundled product offering is more difficult to compare and makes for lack of transparency in pricing of the CCI component.

CCI more expensive than "open market" options. The mystery shopping exercise and consumer interviews rendered the following insights regarding the cost of CCI:

- *Cost of CCI not clear.* On the whole, consumers did not know the cost of their CCI or how it was calculated. Only 30% of consumers interviewed said they knew the cost, and none knew how it was calculated. *"I am not sure and I have no idea how it is calculated."* An analysis of quotes received showed that

the cost of CCI accounts for up to 50% of the cash price of the goods bought[23]. However, as long as they can afford the monthly total, the consumers interviewed do not appear to be concerned: *"I have no idea but I'm fine with the instalment." "Insurance is part of the package."*

- *Multiple policies imply higher costs for consumers*. Having multiple policies, each with a different credit provider, means a consumer can pay far more than if the total sum of their credit was covered in a broader life insurance policy. Arranging cover on the basis of a number of small decreasing term insurance policies, each attached to a particular loan, is not the cheapest option for the consumer. Moreover, the cover expires at the end of each separate insurance term as opposed to a broader life insurance policy which continues to provide cover.
- *Mixed consumer views of value for money*. Customers interviewed gave both positive and negative responses to the question: "does CCI offer value for money?"

Box 3. Consumer interview responses regarding whether CCI offers value for money

- "... I do not see the use of it. It is just a waste of money, because these things they mention do not just happen..."
- "No I don't see its importance because they don't fulfill their promises. It's just a waste of money."
- "No, you pay more for a long period of time".
- "I do not think so because it is an additional amount that does not return when I have finished paying my loan".
- "Yes, it is essentially to protect me from paying when my financial situation changes."
- "Yes, anything can happen. I wouldn't want my family paying for my debts after I have passed."
- "Yes, because if something happens, your loan is fully paid".

Limited disclosure. The research findings suggest that disclosure in practice is limited on three fronts:

- *Policy documents and details*. The research found that details of the CCI policy are not being properly disclosed to consumers. When asked if they received a copy of the insurance policy document, only 27 of the 47 consumers interviewed said they had. Only 7 out of 35 of the furniture retail and 4 out of 27 of the micro- finance mystery shoppers said they were shown or given a copy of the policy.

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[23] According to one quote obtained, a typical credit transaction for R2 500 would attract R893.42 in interest and R1 218.96 in CCI, as well as several other fees, bringing the total repayable amount to R6, 295.68. The CCI therefore amounts to around 20% of the total repayable amount, or almost 50% of the cash price of the goods bought.

- *Commission and fees.* Disclosure of commission and fees is still largely neglected. Results from all three components of consumer research indicated the absence of disclosure. Only 15% of the total sample was informed of commission or fees being paid to an intermediary.
- *Complaints and claims procedures.* The mystery shopping and consumer interview findings suggest that complaints and claims mechanisms are not properly disclosed. Half the furniture retail and micro-finance mystery shoppers reported being told about a complaints mechanism or how to go about making a claim; less than half of consumers interviewed reported being told about a complaints mechanism and only 15 out of 47 remembered being told how to put in a claim.

3.5. Findings: qualitative review

The qualitative information submitted to the FSB largely confirms the data analysis and mystery shopping findings and reveals a number of further insights into the CCI market and the value that it offers to clients:

A highly interconnected value chain. At least two sets of regulated activities are carried out for CCI – insurance business under the LTIA and/or STIA and credit provision under the NCA. In addition, in most business models, financial advice and/or intermediary services under the FAIS Act are also present. In most models the same entity within a group, or closely associated entities, acts in more than one legal capacity in relation to the same customer transaction. Frequently, the credit provider and CCI insurer are members of the same group, with the credit provider (or another group entity) also fulfilling the role of the FAIS regulated intermediary distributing the product. This results in a highly interconnected value chain for CCI.

In some models, the credit provider is also the owner of the CCI policy. This is particularly prevalent in "group scheme" models. In these models, the CCI cover does not take the form of separate individual policies entered into in relation to each credit customer. Instead, a single grouped master policy is taken out by the credit provider. Credit customers are then added and removed as insured lives from time to time as their credit arrangements with the credit provider start and end. Typically, the cover provided by the group policy is the same for all insured lives on a "one-size-fits-all" basis, with no or limited flexibility, customer choice or substitutability.

Instances of strong sales of additional optional cover. Credit providers may offer both mandatory and optional CCI. In both cases, the consumer must be informed of the option to substitute a policy of their choice. There is evidence of strong additional sales of optional and ancillary benefits. Crudely, it seems around 50% of consumers take up optional cover where it is offered, with 20% of consumers taking ancillary benefits when offered. Typically, the optional cover is more extensive than the mandatory cover, as it insures a wider range of risks than only covering the outstanding loan amount (which is the only risk the

mandatory cover is permitted to insure[24]). As a result, the optional cover typically has a higher premium than the mandatory cover. It is not clear from responses received whether consumers appreciate the differences between mandatory cover and optional cover, and their rights and options in relation to each[25].

Non-advice sales. Typically, the CCI product as an ancillary product is purchased either as part of a face-to-face “in store” interaction (for e.g. in a furniture or clothing store, at a motor dealer, in a bank branch) or telephonically through a call centre as part of closing a telephonic credit transaction. CCI is seldom, if ever, purchased through a financial adviser or as part of a financial plan, and the transaction is therefore generally not preceded by a financial needs or suitability analysis.

Many credit providers structure their distribution model to ensure that the individual the customer deals with does **not** provide advice, but only provides factual information in the course of rendering a “pure intermediary service”. This approach reduces the compliance costs and liability risk the credit provider would incur under FAIS if advice were to be provided. The staff members or agents concerned are usually trained to inform customers that, if they require advice, they should talk to a financial adviser before transacting. In some models, the credit provider appoints a small number of financial advisers to whom the customer is referred if they do request advice.

Products are not always appropriate for the target market. A number of the business models offer a “one-size-fits-all” product, often containing a benefit that many in the target market might not actually be eligible for. For example, self-employed or informally employed or unemployed consumers (such as social grant beneficiaries) who take CCI cover that automatically includes retrenchment cover will not be able to claim the retrenchment benefits despite the cost of these being included in the premium.

Product differentiation inhibits choice. In certain instances the credit provider requires cover that is only available under the product of a particular provider. In these cases, while the consumer theoretically has freedom of choice, the practical reality effectively precludes choice of any other provider. An example hereof in the credit life market is an insurer that extended the definition of retrenchment cover to also include “short-time cover”. The associated credit

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[24] Mandatory cover in respect of mortgage agreements is an exception to this rule, as the NCA permits mandatory cover in respect of the full asset value of the insured property.

[25] In the furniture retail environment, for example, the majority of customers apparently elect optional cover which will provide a “new for old” replacement of the insured asset if the asset is stolen, lost or damaged. The cheaper mandatory cover, on the other hand, only covers the outstanding debt, but does not replace the lost or damaged asset. Industry players advise that customers are indeed provided with both options, and in the majority of cases make an informed decision to purchase the optional cover as they do not perceive value in simply having their debt settled but still losing use of the asset.

Another example arises in the vehicle finance market, where credit providers typically require the customer to purchase fully comprehensive cover on the vehicle. In some models however, if the customer fails to provide evidence of comprehensive cover, the credit provider enters into a mandatory policy on the customer’s behalf (paid for by the customer) which provides only cover in respect of the outstanding debt in the event of total loss of the vehicle. Industry players argue that it is in the customer’s interests to secure comprehensive cover, as the “outstanding debt only” cover will mean that the customer still finds themselves without a vehicle after settlement of the debt.

provider also required short-time cover as one of the minimum cover requirements for the granting of the credit.

Consumers often do not exercise freedom of choice. In many instances, the opt-out rate, that is, the degree to which consumers opt for insurance cover from a different provider, is low. Reported opt-out rates as low as zero were observed.

Higher premiums and different pricing basis in CCI market compared to open market options. It would seem that premiums tend to be higher when a risk is insured under a CCI arrangement. An example would be an observed instance of credit life cover which is priced at around ten times the cost of commercially available single life funeral cover.

Credit life policies are usually actuarially priced on a "group underwriting" basis, where the mortality and morbidity risk associated with each individual life insured is not assessed, but where these risks are instead assessed in relation to the average risk profile of the type of customer group concerned. On the face of it, therefore, one would expect premium rates to be reasonably consistent with those applied to other types of "group underwritten" insurance products sold to similar customer groups. For example, one would expect risk rates for the death benefits on credit life policies marketed to lower income retail furniture customers to be comparable to those charged on funeral insurance group schemes marketed to customer groups with similar demographics and similar underwriting requirements.

Various arguments have, however, been raised as to why such a comparison is not valid. The retail furniture industry has, for example, pointed out that credit life insurance premiums in their market cannot be compared to funeral insurance premiums. They argue that this is because in the funeral market, the premium applied to the policy does not in fact reflect the amount paid by the consumer. The funeral parlours and administrators involved typically charge additional amounts over and above the actual insurance premium. On the other hand, a CCI policy does not recover such additional amounts from customers. Therefore, the CCI policy premium reflects the full cost of the insurance cover.

Where asset insurance premiums are concerned, insurers in the furniture retail sector point out that their premium levels cannot be compared to traditional personal lines premium levels as free-standing cover for individual household items simply does not exist - it is only provided in the CCI context. Furthermore, they explain that they do not use the underwriting practices applicable to traditional personal lines asset insurance. For example, they do not require risk mitigation measures such as burglar protection, fire protection, etc. Instead, they provide cover for any asset purchased on credit from their retail operations, without any actual insurance risk underwriting.

In effect, for both credit life and credit asset insurance cover, in many cases the credit scoring models of the credit provider are used as a proxy for assessing the insurance risk – on a "group underwritten" basis - for the customer group concerned. As a result, or so the argument goes, when the credit provider operates primarily in the low income market, the premiums charged for the CCI concerned will be relatively higher because of the riskier credit profile of the customer base.

Additional arguments that credit providers have provided to support the view that CCI premiums cannot be fairly compared to standalone open market insurance include the following:

- Standalone insurance policies have a fixed sum assured, whereas the sum assured for CCI varies according to the outstanding debt balance. Particularly in the case of insurance for revolving credit facilities, the sum assured is unpredictable.
- Unlike in the case of standalone insurance, the insurer offering CCI has little control over policy retention and lapse rates.

4. OUTCOMES OF THE CCI REVIEW

This section summarises the CCI Task Team's high level conclusions, based on the analysis and findings listed in Section 3, regarding the structure of the CCI market.

The Task Team recognises and acknowledges the benefits, to both consumers and credit providers, of appropriately designed and delivered CCI products. The review has however highlighted features of the structure and operation of the CCI market which suggest that competition in the market, or at least in various business models within the market, is not effective. These features reflect weaknesses in both the supply and demand sides of the CCI market:

- Supply side weaknesses arise from the structure of the CCI market and its overall value chain, including: the fact that CCI cover is mandatory; that product features limit substitutability between products; and that there is a highly interconnected value chain.
- On the demand side of the market, the review has revealed weaknesses in relation to: the fact that customers are "captive" to the CCI provided by the credit provider; the risk of information asymmetry arising from the compulsory, ancillary and usually bundled nature of CCI, coupled with the relatively low levels of financial capability and literacy of clients in many CCI business models; limited product comparability from the consumer's point of view; as well as the fact that customers may not find it practically possible to exercise their right to choose an insurance offering.

The combined effect is that the value proposition of CCI is called into question, with apparently high prices and inadequate benefit realisation. Below, the three main conclusions of the review are outlined regarding these market weaknesses.

4.1. Captive customers

The fact that credit providers are permitted to insist on CCI cover being purchased as a mandatory pre-requisite for granting credit, means that CCI customers are essentially "captive" clients. The bundled, ancillary nature of CCI (as discussed below) implies that consumers do not "shop" for CCI. Where consumers do shop around, this is typically with a view to identifying the lowest available overall credit repayment instalment. Usually, having selected a credit

offering, the customer then simply enters into the related CCI product offered by the credit provider.

4.2. No customer choice in practice

Despite the fact that the NCA requires customers to be given freedom of choice regarding the CCI product they enter into there is little evidence of this freedom of choice being exercised. Furthermore, the NCA allows credit providers to offer optional CCI cover, either in addition to or as an alternative to the mandatory CCI cover required as a condition for granting credit. Evidence suggests that, in certain business models, a substantial majority of customers opt for the more expensive optional offering. This raises questions as to how informed such a product selection actually is.

At least four factors contribute to the lack of choice in practice:

- *Information asymmetry*. In many CCI business models, the target market comprises unsophisticated customers, with low or relatively low levels of financial capability and literacy. Even in the case of middle to higher income target markets, the compulsory, ancillary and usually bundled nature of CCI entails an increased risk that customers may not appreciate the features and implications of CCI products they purchase. This increased risk of information asymmetry results in material bargaining power imbalances between consumers and product suppliers.
- *Advice bias*. The structure of many CCI business models is such that prospective customers have limited access to advice. The analysis in Section 3 suggests that inherent conflicts of interest in most distribution models mean that where a degree of advice is provided there is increased risk of advice bias in favour of the in-store CCI offering, as well as optional extras. In some models it appears that, even though sales staff members are not directly incentivised in relation to the CCI offering, they may be so incentivised in relation to the credit offering itself and/or in relation to extras such as extended warranties. In view of the bundled overall offering, this results in indirect incentives to sell the in-store CCI offering. This was confirmed by the mystery shopping exercise. The mystery shopping exercise also suggests a mismatch between the official compliance policies of providers with regard to disclosure and choice, and the on-the-ground behaviour of sales staff[26].
- *The ancillary, bundled nature of the product offering*. CCI is by definition an ancillary or secondary transaction, with the customer's primary aim being to secure credit. Where retail goods are purchased on credit, the insurance product is in fact a third level transaction. The consumer's primary aim in such cases is to obtain the asset or goods concerned, with credit extension being an ancillary transaction, and CCI in turn being ancillary to the credit extension. The analysis in Section 3 confirms that, as the cover provided by the CCI policy is dependent on the size of the outstanding debt and/or the value of the asset purchased on credit, there is in practice no market for "free standing"

[26] These findings confirm the Gumede determination of the FAIS Ombud listed in the Nienaber report, suggesting that customers are vulnerable to intimidation by sales staff and may be convinced to take additional cover that they do not need.

CCI products that are available for purchase separate from the credit transaction itself[27]. Instead, CCI is typically bundled together with the credit offering. Thus in practice, the interconnected value chain referred to in Section 3 contributes to a lack of competition in the CCI market.

- *Limited product comparability and substitutability*. The Task Team's investigation has revealed considerable variance between specific CCI benefits and product features offered by different providers. CCI policies typically provide cover for the same three main types of risk, namely death, disability and retrenchment. Within these cover types, however, insurers design their products to include specific features that differentiate their policies. Examples include cover for specific employment related events, over and above "retrenchment" as generally understood, such as "short time cover", etc.

  Although this product design innovation would be positive in a market where competitive forces operate effectively, various features of the CCI market discussed in Section 3 militate against competitive outcomes. Customers are often not in a position to benefit from product differentiation as they are not in a position to make informed purchasing decisions based on meaningful comparisons between CCI product offerings. Instead, the value and suitability of certain product features for customers is often unclear, raising doubt as to whether certain product designs – positioned as competitive differentiators - are indeed aimed at meeting the needs of the customer. Moreover, there is a concern that some differentiated product features actually serve to inhibit substitutability by effectively "locking customers in" to specific products. This lack of substitutability is exacerbated in business models where the credit provider is the legal owner of the CCI policy, and where the CCI cover is provided through a group scheme arrangement.

4.3. Questionable customer value

The CCI customer value proposition is only realised where the CCI is fairly and transparently priced and where the product features and business practices of the providers concerned ensure that the CCI product achieves its intended goals from the customer's perspective. Where the customer value proposition is compromised, CCI becomes a one-sided affair that in the first instance serves the interests of the credit provider. The outcomes of the review suggest that this is often the case, thus calling for a policy response. This is evidenced on two fronts:

- *Low claims ratios.* The analysis of reported data suggests that claims ratios are low and expenses relatively high in the CCI market. This suggests low levels of benefit realisation for consumers.

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[27] The Task Team is aware of models where insurers offer CCI, separate from the credit offering itself, as a replacement for an existing CCI policy (with another insurer) where they become aware of the existing policy and offer similar cover at a cheaper rate. This does however require arrangement with the credit provider to recognise the substituted cover. In the case of larger debts, such as mortgage protection insurance, it may (depending on the customer's other life insurance needs) be feasible for a customer to cede an existing life insurance policy to the credit provider for CCI purposes, but in these instances the policy would not initially have been purchased for CCI purposes.

- *Apparently high prices.* Evidence reviewed by the CCI Task Team suggests that CCI premium rates appear unreasonably high in some business models. The risk premium rates for credit life insurance are substantially higher on average than the rates applicable to free-standing insurance, and it is not clear that the extent of this pricing difference is fully justified by some of the admittedly unique features of the CCI market.

5. FOCUS AREAS

The review findings listed in Section 4 suggest that a policy response is required to address weaknesses in the CCI market. The following focus areas may be considered in determining the most appropriate response:

- ***Focus Area 1:*** **Regulating the pricing of credit and/or CCI:** This approach allows credit providers to continue to require CCI cover as a condition of granting credit, but within a framework where there is regulatory intervention in credit and/or CCI pricing. This approach already has a legal basis, following the amendments made to section 106 of the National Credit Act. Three further sub-options may be considered under this approach, namely:

    - **Regulating the CCI premium rate**. Prescribe a "band" of recommended reasonable risk premium rates for different CCI cover types, or placing a regulated cap on premium rates for different CCI cover types.
    - **Regulating the interest rate**. Introduce a maximum interest cap set at a lower level than the "unsecured loan" interest rate cap, for loans where the credit provider insists on mandatory CCI.
    - **Placing a regulated cap on the total cost of credit**, including interest, CCI premiums and other charges.

- ***Focus Area 2:*** **Regulating market conduct non-pricing practices:** The report recognises that in addition to the possibility of price limits, there is a need to also deal with market conduct failings through a range of potential regulatory measures. Sixteen regulatory options are discussed in this paper

- ***Focus Area 3:*** **Protecting consumers through insurance cover for credit providers:** It is recognised that for reasons related to both protecting the consumer, and lowering the risk to credit providers, an appropriate mechanism for insuring against credit risk is necessary, especially for relatively large credit transactions. This initial report notes the need to encourage or require credit providers to consider how to "self-insure" against loan default risks through purchasing insurance cover from insurers in their own names.

It is important to note that the above approaches may also be differentiated for different CCI sub-sectors. For example, it may be appropriate to retain the credit provider's right to insist on CCI cover for larger credit (and hence, larger sums insured) such as mortgage and motor-car loans, and unsecured loans above a certain threshold. Arguably, consumers in these transactions are somewhat less vulnerable to market conduct abuses than those applying for credit in respect of

small unsecured loans or relatively small retail purchases (such as furniture, white goods, clothing, cell phones, etc.).

The CCI market is not homogeneous

The review highlighted the fact that the CCI market is not a single, homogenous market and that different benefits and risks apply in different sub-sectors of the CCI market. Relevant sub-sectors include:

- Credit life insurance vs. credit asset insurance;
- CCI associated with free-standing credit as opposed to CCI associated with the purchase of specific assets on credit;
- CCI in relation to once-off credit transactions vs. revolving credit arrangements; and
- CCI in relation to different types of asset purchases, viz. furniture and white goods; clothing; immovable property; vehicle and asset finance; etc.

The policy options discussed below may be more appropriate to the market structures and practices in some sub-sectors than others. Comment is therefore invited from participants in these sub-sectors on the specific implications and relevance of the policy options for their sub-sectors.

None of the above focus areas are mutually exclusive, and could all be considered in parallel, or to complement one another. In the interim, while consultation is ongoing, NT and the FSB are already considering the extent to which certain of the regulatory measures described under focus area 2 could be used to mitigate risk to consumers in the shorter term. Below, each focus area is elaborated upon.

5.1. Focus area 1: Regulating the pricing of credit and/or CCI

Under this approach, CCI market weaknesses are addressed through regulatory intervention in credit and/or CCI pricing. A legal framework for CCI pricing intervention has been created through recent amendments to section 106 of the National Credit Amendment Act No. 19 of 2014 which empowers the Minister of Trade and Industry, in consultation with the Minister of Finance to prescribe the limit in respect of the cost of credit insurance that a credit provider may charge a consumer. Such pricing intervention could however be structured to relate not only to the premium rates of CCI policies, but could also relate to the relevant interest rate caps for the credit itself, or a combination of these:

- **CCI premium rate intervention**. There are two intervention options in relation to limiting CCI premiums:
    - Prescribing a "**band**" of recommended reasonable risk premium rates for different CCI cover types, while taking the CCI pricing considerations raised by industry players into account as necessary. Insurers will then be obliged to justify premium levels outside these bands to the regulator[28],

[28] See Annexure E for an overview of the comparable experience in the USA, where one reason for moving out of the bands may be a higher claims ratio.

not only on financial grounds, but also on TCF grounds. Credit providers should also be required to disclose to consumers whether or not their premium rates are within the recommended bands. This option should apply at least to mandatory cover, but could also apply to certain more common optional CCI cover types; or

- Placing a **regulated cap** on **premium rates** for different CCI cover types. Although this option has the benefit of certainty and simplicity, it does not recognise the different risk profiles applicable to different CCI models. It is also not consistent with the requirement in Section 106 of the NCA that the reasonableness of CCI premiums is to be determined having regard to the actual risk and liabilities involved in the credit agreement. If the cap is set too low, the risk arises that certain target markets considered high risk will effectively be "red-lined" as they are considered uneconomical and/or the cross-subsidisation between premium rates and interest rates will be exacerbated. If set too high, the cap potentially becomes meaningless as it does not materially change the status quo. The risk also arises that a fixed cap could become the default as it is seen as not being challengeable ("maximum becomes a de facto minimum").

  When considering intervention in relation to CCI premium pricing, regard will be had to previous CCI premium capping proposals made by the former Financial Sector Charter Council, following consultation with ASISA and SAIA[29].

- **Interest rate intervention**. One option would be to introduce a maximum interest cap set at a lower level than the "unsecured loan" interest rate cap, for loans where the credit provider insists on mandatory CCI.[30] Currently, the majority of loans secured by CCI policies – particularly in lower income segments – are classified as unsecured loans, where the credit provider may therefore demand the highest maximum interest rate in terms of the NCA. CCI only protects the credit provider against defaults triggered by "bad luck" insured events, and not against bad faith defaults or defaults arising from affordability problems not linked to an insured event. This is why the loans are classified as "unsecured". On the other hand, it is generally accepted that a meaningful number of defaults are indeed triggered by the "bad luck" insured events, and loans coupled with mandatory insurance cover are therefore less risky than those without such cover. This is, after all, the basis of credit providers' arguments in support of mandatory CCI cover. Accordingly, it could be argued that a lower interest rate – let us call it a "partially secured" rate – should apply to loans where the credit provider does not have full security

[29] The CCI caps proposed by the long-term industry for Financial Sector Charter policies are:

- Life Cover Only = Fixed Charge(R7.50) + (R3,80 per R1 000 of initial cover)
- Life and Physical impairment Cover = Fixed Charge (R7.50) + (R4,60 per R1 000 of initial cover)

While insurers are free to charge more than the caps, only products that comply with the caps can qualify for access points in order to earn Broad-based Black Economic Empowerment points.

[30] This type of CCI cover is sometimes referred to as "mandatory" CCI cover. Although credit providers are under no obligation to offer CCI cover to consumers, the NCA does permit them to insist on such cover as a pre-condition for granting credit – i.e. as a "mandatory" requirement imposed on the consumer, This mandatory cover is distinct from the additional, optional CCI cover which some credit provider offer to customers over and above the mandatory cover.

against all default reasons, but does have at least partial security (through CCI) against "bad luck" defaults.

Although further investigation would be needed to identify the level at which such a "partially secured" cap should be set, and whether it would require any review of the current "unsecured" cap, such an approach could mitigate the risk of credit providers "having their cake and eating it" by simply pushing up interest rates to the maximum unsecured loan cap in the event of a profit squeeze on CCI.[31]

- **Placing a regulated cap on the total cost of credit**, including interest, CCI premiums and other charges.

5.2. Focus area 2: Regulating market conduct non-pricing practices

Under this approach, some CCI market weaknesses are addressed through a range of market conduct regulatory measures designed to enhance the effectiveness of competition and improve customer outcomes in the CCI market. Many of the various possible regulatory measures under this approach will remain relevant regardless of whether the options discussed under focus areas 1 or 3 are adopted. Even if the approach discussed under focus area 3 (encouraging a shift to self-insuring against credit risk instead of requiring mandatory CCI) is adopted, many of these measures will remain relevant to any optional CCI cover that credit providers may continue to cover. If CCI pricing limits are introduced as discussed under focus area 1, a number of these regulatory measures will also remain relevant to improve customer outcomes over and above any pricing interventions.

The potential regulatory measures discussed under this focus area 2 could also be adopted as transitional measures in moving towards either of the other sets of approaches, and are being considered as such by NT and the FSB.

Sixteen potential regulatory measures are put forth, each relating either to (i) a specific aspect of market conduct raised by the review findings as set out in Section 4, or (ii) an aspect of the current regulatory framework which potentially impedes the efficient operation of the CCI market or the efficacy of supervisory oversight of business practices.

Below, these measures are set out in conjunction with observations regarding the way in which each intends to address certain market or regulatory concerns. These observations are informed by the overall TCF framework. The expected TCF outcomes require the CCI market to achieve appropriate product design, distribution and servicing to enable customers' reasonable benefit expectations to

[31] A number of commentators have pointed out that, if regulatory intervention in the CCI market results in CCI provision becoming less profitable, the likely response from interconnected credit provider groups will simply be to increase interest rates (where not already at the maximum) or other charges in relation to the credit offering itself, to compensate for reduced profits from CCI. The net result will mean that the customer is no better off as a result of the regulatory reforms in the CCI space, unless the regulatory intervention concerned limits opportunities for this type of arbitrage.

be met and to ensure that no unreasonable barriers are created to comparing, exiting, claiming or switching cover.

5.2.1. Measure 1: Addressing the value and suitability of CCI product features

Observations: The findings suggest that the value and suitability of certain specific CCI product features is unclear. Insurers argue that the product differentiators witnessed in the market are valuable consumer benefits designed to meet specific identified needs, which enable them to compete by differentiating their offering from that of competitors. This assertion is however called into question in business models that do not allow customers to select which of these features are appropriate for them, but simply offer a "one-size-fits-all" product containing all the features concerned. This is exacerbated where the product features are included in mandatory products. In such cases, there is a concern that the product features are not designed with the target customer in mind, but are in fact designed to inhibit the consumer's freedom of choice in selecting an insurance provider. For example, the credit provider can insist on a particular type of product feature that is in fact only available from their associated insurer. This also significantly inhibits product substitutability, from a supply-side perspective.

In addition, even in the case of more generic product features, there is a risk that the cover concerned will not be suitable to the circumstances of the customer concerned. For example, where retrenchment cover is a standard feature of a product, there is no evidence that insurers have controls in place to ensure that they do not offer the policy concerned to self-employed or unemployed customers (such as social grant beneficiaries) – with the risk of some customers paying for a benefit they will never be able to claim[32]. Again, this risk is exacerbated in the case of mandatory cover.

As a result, the TCF requirement that products should be designed to meet the needs of identified customer groups and targeted accordingly (TCF Outcome 2) is significantly compromised.

Potential regulatory response: Require insurers to offer more flexible cover, for both mandatory insurance and optional insurance, by offering a "menu" of CCI cover features that policyholders are able to opt out of if the cover is not applicable to them, without compromising their access to credit.

5.2.2. Measure 2: Clarifying the distinction between mandatory and optional cover [33]

Observations: The apparent high take-up of optional cover raises the concern that credit providers "push" the sale of optional products without ensuring that the

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[32] In the United Kingdom, sales of retrenchment cover as a standard feature of Payment Protection Insurance (their equivalent of CCI) to self-employed or unemployed customers was one of the areas of mis-selling that triggered substantial regulatory fines for UK lenders.

[33] This measure will ultimately not be necessary if Policy approach 1 is adopted, but could be adopted as an interim measure.

customer's options are presented in a manner that enables informed choice. Examples listed in Section 3 include: "replacement of asset" cover provided by furniture retailers, or comprehensive vehicle cover, rather than cover just on the outstanding credit. In cases reviewed, information provided to the customer does not make it clear that the comprehensive cover is in fact optional and that only the "outstanding debt" cover (which is typically cheaper, but with more limited benefits) is mandatory.

Potential regulatory response: Disclosures provided by credit providers must make it clear to customers which cover types are mandatory and which are optional, and clearly highlight the costs, advantages and disadvantages of such options, to enable customers to make an informed choice.

5.2.3. Measure 3: Prescribing a degree of product standardisation for CCI cover types

Observations: Because CCI is an ancillary product and customers typically do not "shop around" for CCI cover, it is questionable whether differentiated CCI product features serve a meaningful competitive purpose. Conversely, an appropriate degree of product standardisation – particularly in relation to mandatory CCI products[34] – could improve such competition that does exist by increasing product comparability.

Potential regulatory response: Prescribe the types of product features or cover types that may be insisted on for mandatory cover. Any other "differentiators" or additional cover types (such as cover for relatively uncommon employment related events) should only be permitted to be offered as optional cover. This measure would need to apply in addition to improved disclosure of the distinction between mandatory and optional cover.

It should also be borne in mind that a substantial number of CCI product types are likely to fall within the future micro-insurance framework being developed by NT and the FSB. The micro-insurance policy proposals recognise that prescribing simple standard product parameters is an appropriate mechanism to enhance both consumer protection and financial inclusion in that market segment, and allows for a concomitant relaxation of advice related regulation. This policy measure for CCI products would therefore be consistent with the broader policy approach for micro-insurance.

5.2.4. Measure 4: Requiring consistent disclosure standards

Observations: Although various legislative provisions impose extensive disclosure obligations, the way in which disclosure material is designed and presented to customers, the timing of the disclosures and the communication methods used differ from provider to provider. In addition, providers often adopt a compliance-based approach to disclosure, sometimes at the expense of considering the

[34] Note that this measure would not be fully relevant, other than as an interim measure, in the absence of mandatory cover . However, consideration should also be given to adopting this approach to certain classes of optional cover, particularly for lower income consumers.

customer's information needs, resulting in a "quantity over quality" disclosure model. Credit providers operating in unsophisticated consumer markets have provided examples of disclosure documentation "packs" running into dozens of pages, which are clearly not suitable to the information needs of their customers. This undermines the customer's ability to make informed decisions, compare CCI products in order to exercise freedom of choice, and appreciate the benefits, costs and risks covered by CCI offerings.

Potential regulatory response: Two potential regulatory measures can be considered in response to this market concern:

1. Introduce a simple, standardised Key Information Document ("KID") template for CCI, under the current TCF disclosure work stream, which all insurers will be required to produce and maintain for each type of CCI policy, and which all credit providers and/or CCI distributors, as the case may be, will be required to provide to customers at point of sale, prior to conclusion of a CCI transaction. The KID must ensure clear differentiation between the cost of insurance and the "normal" loan repayment, but also clearly demonstrate the total all-in cost.
2. Generally review and enhance disclosure rules around freedom of choice, including in particular disclosures relating to mandatory and optional cover, where applicable.

5.2.5. Measure 5: Aligning prescribed disclosure standards

Observations: Relevant legislated disclosure provisions are contained in the NCA, the FAIS Act and the Policyholder Protection Rules under the LTIA and STIA (where applicable). In some cases, there are inconsistencies and overlaps between the various prescribed disclosure obligations. Typically, the disclosure obligations are generic, applying to various types of products and/or providers, and not targeted to the needs of particular consumer groups.

Potential regulatory response: Review and rationalise existing legislative and regulatory disclosure obligations for consistency and completeness. The review would also include consideration of whether existing disclosure rules require customisation in view of the reasonable information needs of unsophisticated CCI customers.

5.2.6. Measure 6: Improving ongoing disclosure

Observations: CCI is typically a once-off purchase, usually purchased directly through the credit provider simultaneously with the primary credit transaction. Disclosure models therefore tend to focus on providing information up-front, at point of sale, with minimal focus on providing ongoing information in the course of the insurance product life cycle, other than if and when a claim arises. Typically, the only ongoing information the customer receives is a line on their monthly credit statement reflecting the insurance premium. This compounds the lack of consumer awareness of CCI cover and compromises the customer's ability to assess ongoing suitability of the product as their needs and circumstances may change.

Potential regulatory response: Review the disclosure rules relating to provision of ongoing information, to ensure CCI customers are provided with appropriate and meaningful information regarding their cover at regular intervals during the life of a CCI policy and/or on the happening of specific contractual events.

5.2.7. Measure 7: Reviewing conflicts of interest in distribution models

Observations: A feature of the highly inter-connected CCI value chain is that the entities distributing CCI policies are typically either the credit providers themselves, members of the same group as the credit provider and/or the insurer, or close affiliates of the insurer and/or credit provider. These distributors are often remunerated in the form of insurance commissions under the LTIA or STIA, in addition to their other financial interests in the transaction/s concerned arising from being part of the group or through contractual relationships such as profit share arrangements. Although there are a number of different business models with different types of inter-relationships between the different legal entities involved, most CCI distribution models entail clear risk of conflicts of interest.

Potential regulatory response: Five potential regulatory measures (and combinations thereof) can be considered in response to this market concern:

1. The FSB has commenced a holistic review of distribution practices in respect of financial services products, including the respective legal responsibilities and relationships between different types of financial advisers, other intermediaries and product suppliers, as well as intermediary remuneration practices. In addition to traditional direct and intermediated distribution models, the review will focus on models using group schemes, cell captives, "cell captive like structures" and ownership relationships between manufacturers and distributors. This review will explicitly include a review of these distribution models in the context of the CCI market.
2. Ensure that insurance binder and outsourcing frameworks are appropriately applied to CCI value chains. Regulations have been promulgated governing binder arrangements entered into between insurers and intermediaries rendering certain core insurance functions on an insurer's behalf. In addition, the Registrar of Insurance has issued a Directive governing the outsourcing of insurance functions that are over and above those functions constituting binder functions. Both sets of provisions aim to reduce conflicts of interest inherent in the outsourcing activities concerned and to ensure that remuneration to outsourced service providers is reasonably commensurate with the cost of the services concerned. Another principle of these provisions is that an entity should not be remunerated more than once for the same or very similar services. The services rendered by credit providers and their associates in relation to the distribution of CCI will in a number of cases fall within the scope of the binder regulations or outsourcing directive, as the case may be, and should therefore be carried out in accordance with those provisions. Where this is the case, the entity concerned should be remunerated in a manner commensurate with the actual cost of the binder or outsourced functions rendered.

3. Disallow payment of commission in respect of CCI in cases where the intermediary is also the policy owner, or an associate of the policy owner. This would apply in models where the CCI policy is issued in name of the credit provider (usually, but not always, a “group scheme” policy) and also distributed by the credit provider or an entity within the credit provider’s group. Such a situation leads to legal absurdity as the same entity can be the policyholder as well as the intermediary and in effect earn commission for selling a policy to itself.
4. Remove the current LTIA maximum commission cap of 22.5% for credit schemes “with administrative work”. This will mean that the maximum commission cap for all credit schemes (CCI policies structured as group policies, as opposed to individual policies) is 7.5% - in other words the current “without administrative work” level[35]. The introduction of the binder regulations and outsourcing framework has rendered the “with administrative work” commission category obsolete. To the extent that additional remuneration over and above the 7.5% commission cap can be justified for administrative work done for the insurer, this should be done within the binder regulations framework or the outsourcing directive, as applicable. Such an arrangement would be carefully scrutinised by the FSB to ensure that it does not result in the entity concerned being paid twice for the same work.

   This measure could be combined with the broader review of the regulatory framework for so-called “voluntary group schemes”, being undertaken by the FSB.
5. Prohibit all volume based sales incentives, over and above any other remuneration-related measure that may be introduced, for the sale of mandatory CCI. This prohibition should apply not only at the level of individual sales agents (who in many models are currently in any event not remunerated based on sales volumes) but also at the level of the distribution entities concerned and their management. In addition, investigate incentives for other so-called “value add” benefits, such as extended warranties, “club” memberships, etc.

5.2.8. Measure 8: Improving access to advice for CCI consumers

Observations: Industry players argue that there is little need for structured advice processes in relation to CCI, as the products concerned are in their view simple and straightforward, and the need they are designed to meet is self-evident – the cover is required in order to secure the requested credit. They also argue that there is no need for a specific affordability assessment in relation to the CCI product, as this is included in the affordability assessment carried out as part of the credit application process. Their view therefore is that providing factual information about the CCI offering provides sufficient consumer protection to ensure a suitable sale.

It is doubtful whether these arguments against the need for advice fully appreciate the significant information asymmetry that exists between service

[35] See Annexure 1 to Part 3 of the Regulations under the LTIA

providers and most customers – particularly in vulnerable and unsophisticated sectors. However, even if it is accepted that adequate disclosure provides sufficient consumer protection, the risk remains that the business model often does not practically allow the customer a reasonable opportunity to review and reflect on the information they have been provided with before transacting. In most cases, the customer will be anxious to conclude the primary credit transaction (or asset purchase) as soon as possible, with the risk that they do not apply their minds sufficiently to the CCI offering.

Potential regulatory response: Three regulatory measures could be considered:

1. Require separate, clearly distinguishable application forms for the application for credit and the application for CCI, with an obligation to clearly communicate to the customer that these are separate transactions. This option would apply in addition to applicable options relating to enhanced disclosure.
2. Introduce a compulsory "two step" process for the sale of CCI, where the insurance product may not be sold simultaneously with the provision of credit, but needs to be purchased through a separate transaction. Depending on the distribution model, this could entail either a "come back another day" model, a "go to another desk" model, or an "our insurance agent will call you" model. For telesales, the CCI transaction would need to take place through a separate call from the primary telephonic transaction. This option would require careful consideration of the potential inconvenience and direct and indirect cost to consumers in some models.
3. Disallow payment of commission for CCI where no advice is provided – in other words, make the provision of advice, including a basic needs analysis and affordability assessment, a prerequisite for commission. Such advice would also be subject to compliance with the relevant FAIS provisions, albeit appropriately customised to the needs of the customer base concerned. Alternatively, reduce the maximum commission payable for non-advised sales. Current commission regulations do not differentiate between remuneration for advice and for intermediary services, but commission caps are typically based on the assumption that advice is part of the service rendered by an intermediary. Although the FSB's pending distribution review is likely to result in changes to this approach, in the interim it is arguably inappropriate that maximum current commission levels should be applicable to distribution models that explicitly exclude the provision of advice.

5.2.9. Measure 9: Addressing low claims ratios in respect of CCI

Observations: With the exception of mortgage protection insurance, claims ratios in respect of CCI policies appear unreasonably low, on average, when compared to claims ratios for other life insurance and personal lines asset insurance markets respectively. Credit providers and insurers that form part of the same group have been at pains to point out that they are in no way incentivised to avoid paying claims. These groups argue that, on the contrary, they are incentivised to pay as many CCI claims as possible, as this enables them to reduce their bad debt ratios, which is the primary indicator used by investors and the market to assess the group's market performance and sustainability. Accordingly, although high claim rejection rates could boost profitability of the insurance arm taken in

isolation, at group level this is seen as less advantageous than paying CCI claims to limit credit exposure.

It is less clear whether the incentive to pay rather than reject claims applies equally to insurers that are not closely affiliated to the credit provider, and therefore do not have the same imperative to focus on group level interests over and above the profitability of the insurance business.

Potential regulatory response: Two potential regulatory measures can be considered with regard to claims ratios:

1. Prescribe a "band" of recommended reasonable claim ratios for different CCI cover types. Insurers should then be obliged to justify levels outside these bands to the regulator, not only on financial grounds but also on TCF grounds. Credit providers should also be required to disclose to consumers whether or not their claims ratios are within the recommended bands. This approach could be considered in conjunction with the option of prescribing a "band" of reasonable CCI premium rates as discussed under focus area 1, for example by using claims ratios as a factor in determining whether premiums are reasonable[36].
2. Require periodic public disclosure of claims ratios and/or claims rejection statistics of all comparable insurers. Publication should be facilitated through either industry associations or the regulator, and formatted in such a way as to ensure comparability of claims ratios or rejection rates of different insurers.

5.2.10. Measure 10: Addressing practical challenges leading to under-claiming

Observations: Some insurers have pointed out that, although they make every effort to pay CCI claims, the nature of their customer base in some cases presents practical challenges to paying claims, or in some cases to even becoming aware of claimable events. These practical challenges are in proportion to the relative sophistication of the customer base and the value of the credit concerned. Greater challenges are experienced in, for example, the retail furniture and small unsecured loans CCI sub-sectors than in relation to CCI for mortgages and vehicle financing arrangements.

Different practical challenges have been raised in respect of different cover types:

- In relation to credit life death claims, due to the nature of the cover, the deceased customer's beneficiaries have little incentive to claim (particularly in the case of mandatory cover which settles the outstanding debt only) and are often not aware of the cover. Some practical difficulties are also experienced in relation to reconciling reported deaths with data from the Department of Home Affairs.

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[36] In this regard, refer to the approach in the USA as set out in Annexure E.

- Where disability cover is concerned, evidence of disability that will satisfy the insurer's claims underwriters is often difficult to obtain from public health facilities and employers.
- In the case of cover for retrenchment, evidence of retrenchment is dependent on proper labour law procedures having been followed by the employer, which is often not the case, particularly for smaller employers. Insurers argue that this is exacerbated by a too narrow definition of "retrenchment" in the insurer's licensing conditions as set by the regulator.

The effect of these challenges is that, in the markets most affected, under-claiming occurs. This in turn contributes to the low claim ratios in these sub-sectors.

Potential regulatory response: Two regulatory measures can be considered to address under-claiming:

1. Specify and simplify the scope of certain cover types, with a view to simplifying the evidence required to prove a claim. In particular, review the regulatory definition of "retrenchment" and specify the types of employment related events to be insured against. This option is linked to the proposal under measure 3 above relating to standardisation of certain CCI cover types and product features.
2. Reduce claims barriers by requiring relevant third parties to co-operate in the claims process and by developing or improving access to relevant databases. For example, appropriate databases could be developed where employers record retrenchments and occupational disability events, or appropriate enhancements could be considered to state databases held by the Unemployment Insurance Fund, Department of Home Affairs, etc. Confidentiality considerations would need to be adequately taken into account.

5.2.11. Measure 11: Clarifying rights and responsibilities of insurers and credit providers in respect of claims

Unlike traditional insurance models, where the claim is initiated by the customer or the customer's estate or beneficiaries, the CCI claim is typically initiated by the credit provider. Also unlike traditional insurance, the claim is paid to the credit provider, as opposed to the individual customer or beneficiary. As a result, the respective rights and responsibilities of the parties are less clear.

Potential regulatory response: Review the respective legislated responsibilities of insurer and credit provider in respect of claims handling processes as part of a currently planned broader FSB review of insurance claims handling practices. Relevant aspects of the CCI claims process to be reviewed would include:

- Determining whether the insurer offering CCI should be responsible for ascertaining the outstanding loan balance before payment of a claim and ensuring that any excess over the outstanding debt is paid to the customer or beneficiaries.

- Placing an explicit obligation on the credit provider to carry out an investigation into a possible insurance claim within a specific time after default on debt repayments.
- Developing appropriate rules, with due regard to cost implications, requiring insurers to obtain adequate risk related information at sales stage as opposed to claims stage, to reduce the risk of customers facing unfair barriers at claims stage.
- Requiring specific regulatory reporting on CCI related complaints and redress.
- Confirming that any binder or outsourcing arrangements between insurers and credit providers (or their associates) clearly address the respective responsibilities of all parties in the claims process, while ensuring that final accountability for fair insurance claims practices is borne by the insurer offering CCI.

5.2.12. Measure 12: Addressing the complex contractual and regulatory relationships stemming from the highly interconnected CCI value chain

Observations: Typically, multiple components of the bundled offering are offered by entities either within the same group or otherwise affiliated with one another. These interconnected entities in turn often carry out multiple types of regulated financial services activities. In the resultant interconnected CCI value chain the respective contributions of different parts of the value chain to the overall cost of credit, to the customer value proposition, and to the earnings and profits of the financial services groups concerned are difficult to assess. Industry players admit that the profits of the CCI arms of their businesses often heavily subsidise their less profitable credit granting operations. They also argue that it is unfair to analyse the profit margins of their CCI operations in isolation, as this creates a distorted impression, and that profits should only be assessed by looking at the aggregate profits of the entire value chain on a holistic "sum of the parts" basis. This opacity and cross-subsidisation raises the following concerns:

- It hampers a proper assessment of both prudential and market conduct or consumer risks that the business models may present;
- It reduces the incentive for credit providers to carry out responsible credit risk assessment of consumers, as the costs of poorly performing loans can be compensated for by insurance profits elsewhere in the business;
- It entails substantial conflicts of interest.

Although the approach discussed under focus area 3 (encouraging a shift to self-insuring against credit risk instead of requiring mandatory CCI) would significantly mitigate these concerns, optional cover can still pose some of these risks.

<u>*Potential regulatory response*</u>: Three potential regulatory measures can be considered in response to these concerns:

1. Apply a sufficiently intrusive conglomerate supervision approach to both the prudential and market conduct supervision of financial services groups offering both credit and CCI. Top level board and executive management

structures of these groups would be required to ensure that both the financial and conduct/consumer risks of the business model are identified, reported and managed as part of an enterprise-wide risk management framework. Enhanced regulatory reporting of intra-group relationships would be prescribed to ensure improved supervisory insight into the profitability and costs of the separate components of the value chain as well as the overall "sum of the parts". From a market conduct perspective, TCF principles would also be expected to be applied at an enterprise-wide level, with the group as a whole required to demonstrate that the entire bundled product offering (comprising credit, insurance and any other "value added" benefits) delivers TCF outcomes. The regulatory and supervisory frameworks concerned would be structured to ensure any necessary inter-regulatory co-ordination necessary to achieve this. The intensity of supervision would be proportional to the nature, scale and complexity of the prudential and conduct risks identified in the business model concerned, with highly interconnected structures requiring more intensive scrutiny than arms' length structures.

2. Unbundle the insurance and credit offerings by requiring credit providers to explicitly offer a “panel” of at least three CCI cover providers, with clear disclosure of the differences between the options to enable an informed decision. The selected insurer would be obliged to notify the credit provider if the policy falls into arrears or lapses. Sub-options within this policy option include:
    - Exclude the insurance products offered by a member of the credit provider’s own group from the panel;
    - Allow the panel to include a product from an insurer in the credit provider’s own group, but require this relationship and the potential conflict it entails to be explicitly disclosed;
    - Apply this approach only in respect of mandatory cover;
    - Apply this approach in respect of both mandatory and optional cover;
    - Require credit providers to apply a formal tender process in selecting insurers for inclusion in the panel concerned.

3. Prohibit the credit provider from being the outright owner of the CCI policy, including in the case of group schemes. Instead insist on a “collateral cession” model, where the policy is always issued with the credit customer as policy owner, with a collateral cession in favour of the credit provider. The nature and extent of the rights which this cession confers would be codified, as opposed to operating under common law, and appropriate legislative provisions would be introduced (and current NCA provisions reviewed) to limit and/or prescribe certain provisions of the cession agreements concerned. In particular, legislation should entrench the policy owner (credit customer’s) rights with regard to freedom of choice to switch insurers, intermediaries, and effect other appropriate changes despite the existence of the cession – such rights being appropriately balanced against the legitimate interests of the cessionary.

5.2.13. Measure 13: Creating a unified regulatory framework in relation to CCI

Observations: In the current legislative framework, the FSB is the primary regulator of insurers and insurance business, as well as financial intermediaries. The NCA however introduces elements of dual regulation in respect of CCI. Although the NCR clearly has a key interest in the operation of the CCI market in view of CCI's integral role in overall credit provision, the current framework poses a risk of duplication and gaps in supervision by the two regulators (see Section 5.2.15).

Potential regulatory response: Two options are relevant:

1. Review and rationalise the relevant provisions of the NCA, LTIA and STIA to clarify that CCI is subject to the primary supervision of the FSB (Registrar of Insurance), coupled with appropriate information sharing and liaison obligations between the FSB and the NCR. As an interim step, current quarterly reporting to the NCR by insurers offering CCI should be replaced with equivalent reporting obligations to the FSB. The FSB's Insurance department is currently in the process of revising quarterly insurance reporting obligations for all insurers, and the new requirements will address a number of market conduct related statistical matters that are currently reported to the NCR in the case of insurers offering CCI. The FSB will in turn share such data as the NCR has an interest in with the NCR. This will eliminate current dual reporting and improve data consistency.
2. Require entities providing advice to consumers in relation to credit to be subject to appropriate elements of the FAIS Act. Currently, advice and intermediary services in relation to CCI are subject to FAIS, but advice in relation to credit is not. In view of the bundled nature of the credit and CCI offering, this gives rise to anomalies. Consideration should also be given to applying relevant aspects of the FAIS framework to debt counsellors.

5.2.14. Measure 14: Aligning responses with the future micro-insurance framework

Observations: The pending micro-insurance policy framework contemplates a new regulatory model for both long-term risk insurance and short-term asset insurance in the lower income market. The micro-insurance framework is likely to lend itself to a number of current credit life and credit asset insurance business models. CCI insurers in these markets are likely to benefit from the simplified regulatory requirements proposed in this framework, while affected consumers are likely to benefit from the customised consumer protection measures it entails.

Potential regulatory response: Ensure that the evolving micro-insurance framework appropriately and explicitly caters for the CCI market, taking into account the observations contained in this document. Conversely, the implementation of any policy options contained in this document should take into account the evolving micro-insurance framework.

5.2.15. Measure 15: Ensuring focused supervision of CCI

Observations: The current LTIA and STIA do not recognise CCI as a specific class of insurance business. As a result, supervisory frameworks and reporting formats are not designed to ensure specific supervisory scrutiny of the CCI market. Data on CCI has not been fully distinguishable from data on traditional standalone insurance, particularly where the insurer concerned offers both types of products. This hampers pro-active monitoring of trends and risks in the CCI market, requiring *ad hoc* thematic work to be undertaken when concerns arise – such as the information requests and research underpinning this document. It also hampers the development of appropriately tailored governance and market conduct requirements for CCI insurers.

Potential regulatory response: Two options can be explored for addressing this shortcoming:

1. Amend the relevant statutes and/or applicable subordinate legislation to recognise CCI as a specific class of business for licensing and all other regulatory and supervisory purposes. This measure is currently under consideration by the FSB.
2. Whether or not measure 1 above is implemented, continue with work already in progress at the FSB to structure the insurance supervisory framework to recognise CCI as a business model in its own right. Work currently underway seeks to ensure that:
   - Specific prudential and market conduct reporting requirements are being introduced in respect of CCI business, distinguishable from traditional insurance data. Reportable indicators that apply to all insurers (such as claims, sales, distribution, retention, customer demographic and complaints data) are being structured to distinguish between different product types, including CCI. New reportable indicators for CCI in particular could be expanded to include data on the number of customers who elect mandatory as opposed to optional cover, the number of customers who exercise freedom of choice in relation to CCI providers, etc.
   - Where the data concerned is held by the credit provider as opposed to the insurer, measures will be introduced to ensure that the insurer has access to the data for reporting purposes, or that appropriate reporting obligations apply to the credit provider too.
   - Risk-based supervisory approaches are designed to take account of specific financial and conduct risks to which insurers and CCI customers are exposed.
   - The FSB issues guidance material and directives, as and when required, focussed specifically on CCI business practices.

5.2.16. Measure 16: Avoiding regulatory arbitrage with respect to CCI

Observations: The current regulatory framework allows short-term insurers to provide cover, in the form of “accident and health” policies, that is similar in effect

to, and competes with, the credit life cover provided by long-term insurers. Because of other differences between long-term and short-term regulatory frameworks, this gives rise to regulatory arbitrage opportunities. The arbitrage opportunity is described as follows in the Nienaber report: "Whereas the LTIA differentiates between types of policies and types of work done for that policy, namely allowing charging an introduction fee of 7.5% and admin fee of 15% for a "credit scheme", the STIA has no corresponding provision. In this instance the STIA allows for the charging of a composite fee of 12.5% for motor policies and 20% for any other policy. It's this difference in rating regimes that creates arbitrage potential."

Potential regulatory response: Ensure a clear differentiation between long-term and short-term insurance offerings by restricting short-term insurers to offering only credit asset insurance and removing "credit life" type offerings (i.e. cover for disability, illness, retrenchment, etc.) from the short-term insurance framework. When the micro-insurance framework, which allows for both long-term and short-term business to be written on the same insurance licence, is implemented in due course, appropriate product standards can be developed for a "hybrid" product.

5.3. Focus Area 3: Protecting consumers through insurance cover for credit providers

Observations: The current legislative framework allows credit providers to insist on CCI cover as a pre-condition to granting credit.[37] Though consumers must by law be allowed to choose a preferred insurance provider, evidence as outlined in this report suggests that this choice cannot easily be exercised in practice due to the inherent characteristics of the CCI market. As discussed in Section 2 obstacles to exercising freedom of choice arise from:

- a captive market – a consumer buying for example a television on credit from a retailer is not going to shop around for a better insurance deal as their focus is on acquiring the asset and the insurance is a secondary purchase;
- practical constraints – particularly in the case of retail goods purchases and small unsecured loan applications, the "point of sale" nature of the credit transaction makes it highly impractical for the consumer to enter into a separate insurance transaction with an unrelated insurer. This is exacerbated in cases where the credit provider requires the mandatory CCI cover to contain certain specific product features that are typically not included in free-standing insurance policies (for e.g. retrenchment cover)
- conflicts of interest – the credit provider (whose interests are protected together with those of the customer) and other entities in the CCI value chain are frequently aligned to the insurer; and
- information asymmetry and lack of product understanding- in many CCI business models, the target market comprises unsophisticated customers, with low or relatively low levels of financial capability and literacy. Even in the

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[37] This type of CCI cover is sometimes referred to as "mandatory" CCI cover. Although credit providers are under no obligation to offer CCI cover to consumers, the NCA does permit them to insist on such cover as a pre-condition for granting credit – i.e. as a "mandatory" requirement imposed on the consumer, This mandatory cover is distinct from the additional, optional CCI cover which some credit provider offer to customers over and above the mandatory cover.

case of middle to higher income target markets, the compulsory, ancillary and usually bundled nature of CCI entails an increased risk that customers may not appreciate the features and implications of CCI products they purchase. This increased risk of information asymmetry results in material bargaining power imbalances between consumers and product suppliers.

The above characteristics result in consumers being vulnerable to exploitation by being sold CCI products which do not meet their needs. This is evidenced by the high premiums and low claims ratios in many models, which seem to imply a lack of value for money for consumers.

Potential regulatory response: Encourage or require credit providers to "self-insure" against "bad luck"[38] loan default risks through purchasing insurance cover from insurers in their own names (i.e. where the credit provider is both policyholder and beneficiary and the debtor is no party to the CCI policy).

This approach may not be appropriate for all CCI sub-sectors. For example, it may be appropriate to retain the credit provider's right to insist on CCI cover for larger debts (and hence, larger sums insured) such as mortgage loans, relatively substantial vehicle and asset finance transactions and unsecured loans above appropriate values. Arguably, consumers in these transactions are somewhat less vulnerable to market conduct abuses than those applying for credit in respect of small unsecured loans or relatively small retail purchases (such as furniture, white goods, clothing, cell phones, etc.).[39]

This approach seeks to preserve the positive features of the current model while at the same time strengthening customer protection by potentially addressing a number of the market weaknesses summarised in this report. More particularly:

- where the credit provider effects its own insurance, this will maintain the current protection of both credit provider and consumer against so-called "bad luck" defaults, while reducing the complexity of the CCI value chain;

- it will obviate the need to undergo the complex exercise of determining what constitutes a "reasonable" CCI premium for mandatory cover, having regard to the actual risk and liabilities involved in the broad range of credit agreements for which mandatory CCI cover may currently be imposed;

- it will mitigate the risks to consumers arising from poor disclosure, practical challenges in claims processing and the operational compliance burden (such as FAIS compliance obligations) of the current model; and

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[38] This refers to defaults arising from the types of unforeseen events typically insured under CCI policies, such as death, disability, incapacity or retrenchment in the case of credit life insurance, and loss, accidental damage or theft of goods in the case of credit asset insurance.

[39] Evidence obtained by the CCI Task team also suggests that the market weaknesses discussed in this document are less prevalent in the mortgage and larger asset finance markets than in other CCI sub-sectors.

- it will reduce the opacity and cross-subsidisation currently surrounding the profit and cost contributions of the different components of the value chain , thereby facilitating greater transparency of the total cost of credit.

If credit providers are no longer permitted to refuse credit unless the customer pays for CCI cover, this will improve incentives for credit providers to conduct effective affordability assessments. This is because they will no longer be in a position to subsidise potential losses arising from poor credit practices with profits earned from mandatory CCI cover. It will require credit providers to price the cost of the insurance into the interest rates and repayment terms they set. Some credit providers have argued that this will not be feasible within current interest rate caps, particularly in low-income markets where lending risks are high. An advantage would be that the interest rate will more accurately and transparently reflect the total cost of credit, rather than the current fragmented and cross-subsidised cost model.

6. CONCLUSION AND NEXT STEPS

This initial report drew on reported data, qualitative information submitted by insurers, as well as a mystery shopping and consumer interview exercise to investigate the state of the CCI market in SA. It found that, although CCI has a strong value proposition, various supply and demand-side weaknesses inhibit the market from providing effective, competitive consumer outcomes. Though consumers have a theoretical choice of cover and provider, products are in practice not substitutable or comparable, few open market options exist and the interconnected value chain challenges consumers' ability to shop around. Claims ratios, pricing and disclosure practices are indicative of limited customer value.

In response, three focus areas are put forward for comment:

- ***Focus area 1:*** **Regulating the pricing of CCI:** This approach allows credit providers to continue to require CCI cover as a condition of granting credit, but within a framework where there is regulatory intervention in credit and/or CCI pricing. This approach already has a legal basis, following the amendments made to section 106 of the National Credit Act. Three further sub-options are considered under this approach, namely:
    - **Regulating the CCI premium rate**. Prescribe a "band" of recommended reasonable risk premium rates for different CCI cover types, or place a regulated cap on premium rates for different CCI cover types.
    - **Regulating the interest rate**. Introduce a maximum interest cap set at a lower level than the "unsecured loan" interest rate cap, for loans where the credit provider insists on mandatory CCI.
    - **Placing a regulated cap on the total cost of credit**, including interest, CCI premiums and other charges.
- ***Focus area 2:*** **Regulating market conduct non-pricing practices:** The report recognises that in addition to the possibility of price limits, there is a need to also deal with market conduct failings through sixteen potential regulatory measures which are set out in this report.

- ***Focus area 3:* Protecting consumers through insurance for credit providers:** It is recognised that for reasons related to both protecting the consumer, and to lower the risk to credit providers, an appropriate mechanism for insuring against credit risk is necessary, especially for relatively large credit transactions. The initial report notes the need to encourage or require credit providers to consider how to "self-insure" against loan default risks through purchasing insurance cover from insurers in their own names.

None of the above focus areas are mutually exclusive, and could all be considered in parallel, or to complement one another. In the interim, while consultation is ongoing, NT and the FSB are already considering the extent to which certain of the measures described under focus area 2 could be used to mitigate risk to consumers in the shorter term. For each, the report sets out detailed observations as well as sub-measures and options where applicable.

Next steps

Public comment is invited on the findings of the review as well as, particularly, the various potential policy approaches and measures outlined.

Public comments are invited up to 30 September 2014. The initial report and accompanying documents are available on the NT (www.treasury.gov.za) and FSB (www.fsb.co.za). Comments on the report are invited from all interested stakeholders. Written comments should be sent to Ms. Reshma Sheoraj at **cci@treasury.gov.za** or faxed to 012 315 5206. Comments should follow the format of the comment template provided in Annexure F.

To improve the quality of public consultations, workshops will be convened with key or interested stakeholders

ANNEXURE A: NCR Information request 2011

www.treasury.gov.za

ANNEXURE B: FSB Information Request 3/2011

www.treasury.gov.za

ANNEXURE C: FinMark: Credit life insurance in South Africa: the customer's perspective

www.treasury.gov.za

ANNEXURE D: Nienaber Panel of Enquiry Report

www.treasury.gov.za

The panel findings and recommendations can be grouped according to three themes:

- Market conduct
- Intermediary remuneration
- Cell captives, underwriting managers and profit sharing arrangements

In the five years since the enquiry report was published, the FSB has undertaken a number of policy initiatives that are directly relevant to the recommendations of the panel. Below, the panel findings and recommendations for each theme is summarised along with the subsequent regulatory developments.

Market conduct

Findings

With regard to market conduct, the panel found that the STIA, LTIA, the FAIS Act, the FAIS General Code of Conduct, the Policyholder Protection Rules ("PPR") and in particular the NCA have provisions in place that cover, amongst other things, the crucial issue of disclosure. However, regulation alone is not necessarily sufficient to ensure corresponding action on the ground. General instances of poor market conduct include the lack of proper disclosure (of costs and charges, of sensitive terms and conditions), pre-sale mis-selling by intermediaries, lack of awareness by consumers that they have signed up for CCI, CCI policies being foisted on consumers, failure by intermediaries to explain the limitations and exclusions of cover, problems surrounding extended warranties, conflicts of interest, time bars and the like[40]. The panel found that evidence of actual market misconduct on the part of insurers was mostly general and anecdotal and that individual insurers strive, by and large, to comply with market conduct regulation. However, they are not always able to achieve the goal in practice.

Recommendation

The panel recommended proper disclosure to consumers, including the fact that insurance is included as part of the credit "package", who the insurer is and what the insurance premium is.

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[40] Specific examples include the "free choice rule" and the *Gumede* determination of the FAIS Ombud regarding lack of proper disclosureWhere the free choice rule is concerned, customers have a choice of insurance provider on paper, but not in practice. In the Gumede determination, it was found that the claimant was not adequately informed of various add-ons to the credit contract, including CCI, and that a salesperson asked the complainant to sign a series of documents without proper explanation, some with blank spaces, contrary to the provisions in FAIS and the General Code, as well as contrary to directives from the respondent's head office.

Regulatory response

TCF. The most notable regulatory initiative speaking to this panel recommendation is the TCF framework. The FSB continues with the development and implementation of its TCF programme initiated in 2010. The TCF programme is an outcomes-based framework that seeks to ensure that fair treatment of customers is embedded within the culture of regulated firms. The TCF work stream relating to the development of Key Information Documents and other disclosure improvements, in particular, will support aspects of this recommendation.

Current review. In addition to – and in support of – the TCF framework, the current review is aimed at specifically addressing market conduct and disclosure with regard to CCI.

PPR. Another relevant development in terms of market conduct relates to the rejection of claims and time-barring under the Policyholder protection rules**.** A variation of Rule 16 of the PPR (Long-Term Insurance) 2004 made under Section 62 of the LTIA and Rule 7.4 of the PPR (Short-Term Insurance) 2004 made under Section 55 of the STIA, which relates to communication with policyholders following the rejection of claims by insurers was published in Government Gazette of 17 December 2010 and came into operation on 1 January 2011.

Intermediary remuneration

Findings

Regarding intermediary remuneration the panel concluded that:

- The provisions of the STIA and the LTIA and the regulations issued relating to intermediary remuneration are complex and unclear. This has given rise to some interpretative confusion in the industry, as well as to commission arbitrage between the LTIA and the STIA.
- There is a lack of clarity and consistency in the manner in which individual insurers understand and apply the commission regulations. The principal uncertainties relate to the payment of remuneration by insurers to third parties for the outsourcing of intermediary services and to payments additionally made pursuant to Section 48(2) of the STIA, which pertains to remuneration and binder agreements of intermediaries.
- The FSB Interpretative Note[41] did not provide the requisite clarity and may have added to the uncertainty as to what was and what was not permitted payment.

[41] The Interpretative Note was released in December 1998, entitled: "Limitation on remuneration for services rendered by an Intermediary." It intended to provide for servicing fees to be paid for work done on a policy by non-intermediaries, thereby lying outside the scope of the defined intermediary and the commission regulations. In effect it created an incentive for intermediaries and other participants to use these outsourcing arrangements to circumvent commission limits.

- Some contraventions of the relevant commission regulations did occur, but in most cases insurers' conduct was sanctioned, based on an interpretation of the Interpretative Note issued by the FSB that was widely held in the industry.

Recommendations

- The panel recommended that the provisions of the LTIA, the STIA and their regulations relating to intermediary remuneration should be reviewed and revised where appropriate to ensure clarity.
- The panel was divided regarding whether there should be any regulation on intermediary remuneration with respect to CCI: "The one view is that market forces should determine the proper level of intermediary remuneration between competitors and that commission regulation is anti-competitive and simply creates opportunities for commission regulation manipulation and contravention. The other view is that, subject to what is decided about commission regulation at the lower income end of the market, the time for complete deregulation has not yet arrived and that deregulation may lead to an increase in premiums, at least in the short term, to the ultimate detriment of consumers. Moreover in the absence of any regulation of the introduction fee, there is no benchmark against which improper incentives can be measured."
- The panel did not find premium regulation to be a viable option and was divided as to whether regulation on the introduction fee should be scrapped or retained.
- Some panel members recommended that regulations under both Acts should be reviewed to align the levels of the commission to the nature of the product, regardless of the licence under which an intermediary operated when the introduction was effected
- The panel found that improper incentives should be condemned.
- The panel recommended that in line with the proposals in NT's Micro-insurance Discussion Document, all CCI products with a benefit level below the waterline determined for micro-insurance be fully deregulated.

Regulatory response

Retail Distribution Review. The FSB initiated a project in November 2011 to review the definition of intermediary services in SA's current insurance laws and to reform related remuneration structures in order to promote appropriate, affordable and fair advice to policyholders and to support a sustainable business model for financial advice. The project is being broadened into a full cross-sector RDR, against the background of the broader TCF framework. The project is also being approached from the context of the enhanced future market conduct regulation mandate of the FSB in the "Twin Peaks" regulatory framework. A discussion report in this regard will be published in 2014.

FAIS and Insurance Laws amendments. The issue of improper incentives is dealt with through changes to both the FAIS requirements and insurance regulation, namely:

- Amendments to the General Code of Conduct for Authorised Financial Services Providers and Representatives as published in Board Notice No. 80 of 2003 (as amended from time to time) to address conflicts of interest;
- Binder regulations that spell out who may be a binder holder and the allowable remuneration for performing binder functions; and
- Proposed guidance on the definition of intermediary services in the STIA and LTIA.

Current review. The current review, particularly the regulatory options proposed in relation to Measure 8, Section 5.2.8, is also relevant to the panel findings and recommendations regarding intermediary remuneration.

Cell captives, underwriting managers and profit sharing arrangements

Findings

The enquiry included a specific investigation into the operation of cell captives, UMAs and profit sharing arrangements in the CCI field. Specific questions raised and main findings for each include:

- *Do these arrangements yield conflicts of interests for the respective parties to the detriment of consumers?* The panel noted the conflict of interest for business sourced between cell owner and intermediary and the unintended consequence that premiums may as a result be inflated. The customer is not aware who the underwriter is and of the cost involved because of the fact that the business is placed in a cell structure. Cell captive insurers are prohibited from offering cells to independent intermediaries, but the definition of independent intermediary is too wide. With regard to UMAs, the panel also observed that potential conflicts exist in the relationship between the UMA and the intermediary.
- *Can these structures be exploited to circumvent intermediary remuneration restrictions?* The panel found that cell structures may be set up to circumvent commission regulations. It also needs to be clarified when commission versus fees are to be paid to UMAs
- *Do cell captives, UMAs and profit share arrangements lead to inflated premiums or some other harmful outcome for consumers?* The panel determined that any profit sharing arrangements involving intermediaries are illegal. The profit sharing element in a cell can also lead to a possible conflict of interest. In the case of UMAs, profit sharing arrangements in the binder agreements scheme can lead to unfair repudiation of claims, thereby creating a conflict of interest.

Recommendations

Though the panel did not make any specific recommendations with regard to cell captives, UMAs and profit-sharing arrangements in CCI, the findings outlined above suggest a review of such arrangements.

Regulatory response

The three most notable regulatory developments in this regard are:

*Binder regulations***.** The enhancement of the legislative framework relating to binder agreements commenced with the enactment of the Insurance Laws Amendment Act No. 27 of 2008. The latter Act amended the existing provisions of the STIA and introduced provisions in the LTIA relating to binder agreements. These legislative amendments were followed by the publication of binder regulations in 2011. The following broad principles informed the regulations:

- Accountability of the insurer: The insurer is responsible for complying with the Act, irrespective of the fact that the insurer outsources some of its functions to a third party.
- Responsible outsourcing: Where an insurer outsources "binder functions" to a third party, the insurer must ensure that the contractual arrangements, and the oversight and management of the contractual arrangements, facilitate (not impede) the insurer's compliance with the Act and the fair treatment of policyholders.
- Policyholder protection: Policyholder interests and the fair treatment of policyholders may not be prejudiced by the outsourcing of binder functions by an insurer.
- Conflicts of interest: Any potential conflicts of interest that may arise where a non-mandated intermediary is a binder holder must be avoided.

*Outsourcing directive***.** Directive 159.A.i (LT & ST) outlines requirements that insurers need to meet when outsourcing any aspect of their long-term or short-term insurance business. Specifically, insurers entering into arrangements with intermediaries to render services and functions to the insurer (other than intermediary services) are required to ensure that such agreements comply with the requirements of Directive 159.A.i. An insurer must when outsourcing any function or activity avoid, and where this is not possible mitigate, any conflicts of interest between the insurance business of the insurer, the interests of policyholders or the business of the other person that performs the outsourcing.

3rd party cell captives review. In agreement with the panel's findings, the NT/FSB identified the regulation of cell captive insurers as an area that needs further attention and released a discussion report for public comment on 11 June 2013. A moratorium was also placed on new cell structures. In particular, the FSB is concerned about the potential conflicts of interest that may be introduced, thus influencing the advice given to consumers, possibly to their detriment. The FSB continues to be of the view that the profit sharing arrangements that are inherent in cell structures can introduce a conflict of interest if cells are offered to independent intermediaries, and hence such practice should continue to be prohibited. A grey area that exists is the granting of a cell to intermediaries where they are part of an “affinity scheme”. The prohibition or management of conflicts of interest under affinity schemes is a key focus of the regulatory guidance being developed by the FSB.

ANNEXURE E: Comparative international examples – regulatory treatment of CCI

The Nienaber Panel selected the UK, Australia and the United States (US) for a benchmark review of CCI regulation and misconduct. Below is a summary of findings of the three jurisdictions, as well as some additional lessons emerging from recent developments in Italy and Chile:

Lessons from the UK

In the UK intermediary remuneration is unregulated. Payment Protection Insurance ("PPI") became a public issue in 2005 when a designated consumer body known as Citizens Advice submitted a super-complaint to the Office of Fair Trading ("OFT") about PPI. Three main areas of concern were highlighted: -

- Consumers pay excessive prices for PPI;
- The protection consumers buy is partial, with evidence of high pressure and unfair sales tactics; and
- The administration of PPI claims can be slow and unfair, and can leave consumers facing additional charges or serious debt enforcement action.

The Financial Services Authority ("FSA"), as part of its Treating Customers Fairly initiative, conducted its own investigation to improve sales standards in the PPI market. In February 2007 the OFT, liaising closely with the FSA, launched an investigation into the supply of all PPI services on the grounds that features of the market were preventing, restricting or distorting competition and thereby harming consumers. Findings emerging from the enquiry suggest that the cost of PPI is in some instances higher than the interest paid on loans, that distributors' credit products are relatively price insensitive when they consider buying PPI, and that distributors face relatively little substantive competition when supplying PPI. To address these issues, the Insurance Conduct of Business Sourcebook sets out a differentiated regulatory regime that imposes stricter selling standards on "protection products" than on general insurance.

On 14 October 2010, the Competition Commission announced it had decided to go ahead with the point of sale ban for all types of PPI, except retail PPI[42]. In 2011, after a court ruling, the CC published its final order to introduce competition into the PPI market. The package included (but excluding retail PPI):

- a prohibition on selling PPI at the point of sale of the credit until after seven days after the credit sale or, if later, seven days after the supply of a personal PPI quote ('point of sale prohibition');

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[42] Retail PPI covers a percentage of the outstanding balance owing on a customer's retail finance account/loan. The type of retail finance sold in conjunction with the PPI defines the type of PPI policy. There are two types of retail finance:
'Personal loan' retail finance, which is a personal loan provided by or on behalf of the retailer granting credit to the consumer to purchase a specific good (or goods, usually of high value) sold by the retailer of that good.

'Credit account' retail finance, which is a running account credit facility provided by the retailer to the consumer to purchase goods from the retailer. The consumer typically buys goods at different times, such that their credit balance rises and falls over time

- an obligation to provide a personal PPI quote, setting out the cost of PPI along with details of the cover provided;
- an obligation to provide information in marketing material about the cost of PPI and 'key messages', for example making it clear that PPI is optional and available from other providers;
- an obligation to provide information to the OFT and the Consumer Financial Education Body for monitoring and publication;
- an obligation to provide information about claims ratios to any person on request;
- a prohibition on the selling of single-premium PPI policies;
- an obligation to provide an annual review setting out the cost of PPI and including a reminder of the consumer's right to cancel; and
- compliance reporting requirements, including commission of independent 'mystery shopping' exercises by the largest providers

In summary, key lessons from the UK include: (i) the need to recognise the distinct nature of CCI; and (ii) the value of a multi-pronged response to ensure consumer choice and proper market conduct, including (iii) monitoring of market practices.

Lessons from Australia

In Australia, CCI is the most profitable product line for insurance companies, but presents many of the same problems as in SA. As a rule, CCI is offered when a consumer takes out a loan, the premium being included in the borrowed amount. The product usually covers three types of risks: death, sickness or accident, or unemployment. The Australian model differs from that of the UK in that intermediary commissions on CCI are capped at 20% of the premium. Otherwise, CCI offered in Australia shares many of the market-related problems identified for the UK.

The Australian experience offers lessons to SA with regard to intermediary remuneration and the avoidance of conflicts of interest, as well as with regard to market conduct provisions:

Intermediary Remuneration

The Australian Securities and Investments Commission (ASIC) conducted a review to assess brokers' compliance with their legal obligations, particularly in relation to managing conflicts of interest and disclosing remuneration. ASIC's review also aimed to identify the types of remuneration arrangements that exist between brokers and general insurers in Australia. The main types of remuneration paid by insurers to brokers consisted of:

- Commissions—including flat rate commission based on premium, contingent remuneration, override commission (extra commission payable on top of the normal rate paid by participating insurers) and extra commission for conducting business electronically etc.;
- Fee for service—often referred to as administration fees, including fees for performing functions such as claims handling, marketing or risk management services; and

- Non-monetary remuneration—including entertainment, gifts, sponsorship, access to IT and other resources.

Although CCI intermediary commissions are capped there are still concerns over a broker's market conduct and conflicts of interest. Conflicts of interest may arise when brokers receive contingent remuneration in two capacities, as agent of the intending insured; and/or as agent of the insurer, e.g. in a binder arrangement. The report finds that disclosure of the composition of the commissions may be necessary for managing potential conflicts of interest, especially if the commission rate includes an override component or other incentives for the broker to refer business to particular insurers. ASIC could not ascertain from the information obtained whether *fee for service type* remuneration received by some brokers reflected the economic value of the service to the insurer. It found that more than half of the brokers reviewed had contingent remuneration arrangements in place and that most of those brokers placed a significant proportion of their business with insurers that paid extra commissions based on the volume of business placed with them.

Market conduct review

In 1998, the Australian Competition and Consumer Commission conducted a review into misconduct issues in the field of CCI. The report emphasised the importance of consumer awareness in the wider context of consumer education. Problems identified with particular resonance for SA included:

- The price and cost of CCI products;
- Competition at the point of sale;
- Training of agents;
- Provision of information to consumers;
- Third line forcing;
- Content and coverage of policies;
- Inappropriate sales;
- Lack of free choice;
- Disclosure issues; and
- Misselling.

In 2011 a report was released that examined the sales practices of Authorised Deposit-taking Institutions (ADIs) that sell CCI in conjunction with home loans, personal loans and credit cards. The review found several issues relating to sales practices and tools used by ADIs:

- Consumers were not always aware of their CCI purchase or that CCI is optional;
- The price and contract term of the CCI product was not always clearly disclosed;
- Consumers may not have been aware that they may have been ineligible to claim on all components of the CCI;
- Consumers may not have given consent to the CCI purchase; and
- Sales staff pressured/ harassed consumers in purchasing CCI.

To address the concerns, ASIC made the following recommendations:

- When CCI is sold over the phone, distributors should have formal scripts in place for the sales staff;
- Distributors should obtain adequate evidence that a consumer has consented to purchase CCI;
- If a CCI premium is fully funded by the underlying loan, consumers should be informed verbally, as well as in the loan contract, that they will pay interest on their CCI premium;
- When CCI is sold with a credit product, staff should quote repayments of the underlying loan separate to the CCI premium;
- Consumers should be informed how their premiums will be structured;
- Consumers should be informed about the duration of the policy where the CCI policy is not linked to the duration of the underlying credit product;
- Distributors should provide product disclosure statements to consumers at the appropriate time, usually before the consumer takes out the CCI;
- Consumers should be provided with ongoing information about their CCI policy, including a contract number to call if they have queries or need make a claim;
- Distributors should review their training programs to ensure that they are provided to staff on an ongoing basis; and
- Distributors should have documented monitoring systems in place that comprise a range of systems to detect non-compliant sales of CCI.

In summary, the Australian experience highlights: (i) the merits of a thorough review of market practices to inform any policy response; (ii) the importance of disclosure and standardisation of such disclosure with regard to both remuneration and the presence and terms of CCI; as well as (iii) the role of monitoring in ensuring effective outcomes.

Lessons from the USA

In the UK, intermediary remuneration is unregulated, whilst in Australia commission is regulated at 20% of the premium. In the USA, the *premium rate* is regulated. The following considerations regarding premium and commission regulation, respectively, are relevant for SA:

Premium regulation. All of the states regulate the premium rate on CCI. Most publish a "*prima facie* rate", which is a "safe harbour" rate for insurers. The *prima facie* rate is presumed to be reasonable without any further proof required of the insurer. An insurer may use any rate up to the *prima facie* rate. To use a higher rate the insurer must file for a "deviation" and demonstrate that the rate they want to use satisfies the reasonableness standard, which is calculated according to a minimum loss ratio test. A few states require insurers to annually file and adjust the premium rate schedules to reflect the prospective attainment of the loss ratio standard predicated on recent loss experience (usually three years). The regulation spells out a minimum level of benefits that must be provided to enable the insurer to use the prima facie rate. If the insurer wants to restrict these benefits, it must file for approval of a lower actuarial equivalent premium rate. If an insurer wants to expand the benefits, it may file for approval of a higher actuarially equivalent premium rate.

Commission regulation. Premium regulation partly removes the rationale for regulating the commission payable as a means of protecting the consumer

against exploitation. Nevertheless, fourteen states currently have limitations on commission or compensation for intermediaries. Emerging lessons include that, while commission as a percentage of premium is easy to define and limit; "compensation" is not. Experience has shown that competitors often seek to find a way around any limitations in order to gain marketing advantage.

In summary, the USA experience illustrates that premium regulation could be an option, provided that any price regulation is carefully designed so as not to distort the market, and that it is combined with effective monitoring of market practices, with claims as benchmark. It also shows that avoidance of commission caps is a common problem across countries

Lessons from Italy[43]

As of July 2012, the Italian regulator, ISVAP, regulates the sale of life insurance contracts linked to consumer credit contracts. Regulation 40 of 2012 holds that, before issuing any consumer credit contract that requires the consumer to take out a life insurance policy, banks and other financial intermediaries must provide the consumer with at least two quotations from two different insurance providers *not* linked to the bank or financial intermediary providing the consumer credit contract.

Furthermore, the regulation sets out minimum requirements for consumer credit-linked life insurance so as to enable the customer to make an informed choice. Notably, the consumer has the right to choose any alternative policy available on the market and is allowed ten working days following receipt of the quotation from the bank/financial service provider to buy such alternative cover. Insurers must also provide a free online service where consumers can find and compare policies, as well as access the detailed terms and conditions of policies. The details of such websites are to be provided to the regulator for monitoring purposes.

The regulation subjected insurers to a tight compliance deadline. In the span of four months, between the publication of the regulation and its taking effect, they had to redraft their policies in line with the required minimum terms and conditions, and design and implement the disclosure website. There were given a few more months' to design a free online quotation service. Within the same timeframe, banks and financial intermediaries had to set up agreements with at least two insurers each, and put in place procedures to provide consumers with quotations and all relevant documentation required by the regulation.

In summary, the Italian case provides an innovative example of potential strategies for ensuring consumer choice, but also highlights the potential compliance burden impacts of such an approach.

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[43] Source: International Law Office, Law Now newsletter, May 2012. Contributed by CMS Legal Services, a **European Economic Interest Grouping that coordinates an organisation of independent member firms.**

Lessons from Chile[44]

Chile presents an interesting experience specifically with regard to mortgage insurance:

Law 20.552 of 2011, effective from July 2012, contains new rules for banks and other financial institutions in the case of collective/group scheme mortgage insurance. The main purpose of the law is to prevent a mark-up in insurance premiums through payments or commissions associated with the procurement or management of such insurance, as well as to increase competition among insurers by requiring an open bidding process.

The law specifically applies to instances where the party contracting the insurance is the mortgage credit provider, which then enters into a collective insurance contract with the insurer on behalf of its debtors. The law holds that such contracts must be based on an open bidding process, of which all local insurers must be informed, and subject to a number of provisions. Debtors may also individually contract mortgage loan insurance, provided that the insurance cover complies with the minimum requirements established by law and equates to that provided under the collective contract.

In summary, though the Chilean case applies specifically to mortgage insurance, it presents an interesting case for consideration in the South African context regarding policy options when the credit provider is the policy holder on behalf of its debtors.

[44] Source: International Law Office, contributed by Sahurie and Asociados. See: http://www.internationallawoffice.com/Directory/Sahurie-Asociados/Santiago.

ANNEXURE F: Comment template

Comment submitted by:	
Person	
Organisation	
Email address	
Telephone number	
General/summary comments	

Detailed/section-specific comments		
Section	**Content reference**	**Comment**
2	Background to the review	
2.1	Review rationale	
2.3	Nienaber Panel findings and regulatory responses (including Annexure D)	
2.4	International lessons (including Annexure E)	
3	SA CCI landscape	
3.3	Data analysis findings	
3.4	Mystery shopping findings	
3.5	Qualitative review findings	
4	Review outcomes	
4.1	Customer choice	
4.2	Customer value	
5	Focus Areas	
5.1	Focus area 1: Regulating the pricing of credit and/or CCI pricing	
5.2	Focus area 2: Regulating market conduct non-	

Detailed/section-specific comments		
Section	**Content reference**	**Comment**
	pricing practcies:	
5.2.1	Addressing value and suitability of CCI product features	
5.2.2	Clarifying distinction between mandatory and optional cover	
5.2.3	Prescribing degree of CCI product standardisation	
5.2.4	Requiring consistent disclosure standards	
5.2.5	Aligning prescribed disclosure standards	
5.2.6	Improving ongoing disclosure	
5.2.7	Reviewing conflicts of interest in distribution models	
5.2.8	Improving access to advice	
5.2.9	Addressing low claims ratios	
5.2.10	Addressing practical challenges leading to under-claiming	
5.2.11	Clarifying rights and responsibilities in respect of claims	
5.2.12	Addressing complex contractual and regulatory relationships stemming from interconnected value chain	
5.2.13	Creating a unified regulatory framework	

Detailed/section-specific comments		
Section	**Content reference**	**Comment**
5.2.14	Aligning responses with the future micro-insurance framework	
5.2.15	Ensuring focused supervision	
5.2.16	Avoiding regulatory arbitrage	
5.3	Focus area 3:Protetcing consumers through insurance cover for credit providers	
6	Conclusion	