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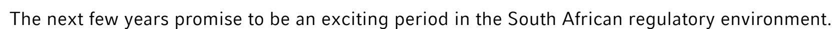
LifeTrends

somewhat different



The next few years promise to be an exciting period in the South African regulatory environment.

# 2016 legislation boom - are you ready?

## Protection of Personal Information Act (POPI)

POPI refers to South Africa's Protection of Personal Information Act which seeks to regulate the processing of personal information of individuals by companies. The purpose of POPI is to ensure that the use of personal information is for legitimate reasons, does not infringe upon a person's right to privacy and avoids the duplication of personal information. The Act particularly affects the insurance industry because the business of providing policy benefits to consumers relies heavily on underwriting based on personal information. Some of POPI's aims are to prevent data leakages and deter cyber criminals who view insurers as tempting targets from whom to steal personal information of individuals. POPI now also requires companies, including insurers, to inform their customers if their security systems have been breached and their personal information potentially compromised.

Compliance with POPI is mostly an IT-driven issue for insurance companies. Insurers may need to strengthen their existing security systems in order to prevent unauthorised persons gaining access to them. Whilst implied consent is granted by the customer during the underwriting process, insurers are urged to re-look at their application forms and call centre scripting to state explicitly that the information provided by the applicant will be used for underwriting purposes and obtain customer consent for this. The consent must extend to third parties such as binder-holders, outsourced service providers and reinsurers as they are likely to use this information.

Personal information generally means any information relating to an identifiable, living natural person or juristic person (companies, etc.) and includes, but is not limited to: [1]

- Contact details: e-mail, telephone number, address etc.
- Demographic information: age, gender, race, birth date, ethnicity etc.
- History: employment, financial, educational, criminal and medical history
- Biometric information: blood type etc.
- Opinions of and about the person
- Private correspondence etc.

Processing means anything done with the personal information, including collection, usage, storage, dissemination, modification or destruction (whether such processing is automated or not).

POPI affects intermediaries as they too will be required to obtain consent from their clients for any personal information being provided to an insurer and any other relevant third party. Legal action may be taken against intermediaries if contravention of POPI is proven by a client.

1 POPI Compliance, What is POPI all about, 25 August 2015, https://www.popi-compliance.co.za/start-here/

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POPI aims to protect companies and customers from the dangers associated with personal information falling into the wrong hands.

Insurers purchasing leads to conduct outbound selling of products are required to ensure that any personal information they purchase from third parties is fully compliant with POPI as unsolicited communication is no longer permitted. This essentially means that if insurers or third parties intend to sell personal information to suppliers, all customers on that database must have consented to their information being sold to suppliers for marketing purposes.

Compliance with POPI will ultimately drive up costs for insurers as they will have to take extra precautions with the channels from which information is obtained and how safely they store it. A mandatory requirement of the Act for insurers is the appointment of an Information Officer, who will be responsible for POPI compliance in the company.

Whilst the Act has been gazetted, it has not yet come into effect pending an official date of commencement from the Financial Services Board (FSB). It is comforting to note that many large industry players are already taking the necessary steps with their data containing personal information to ensure compliance with POPI. Insurers and intermediaries will have one year from the commencement date to ensure that they comply with its requirements.

Once the Act has come into effect, the FSB will appoint an official Regulator of POPI, responsible for the implementation and enforcement of the Act. Subsidiary regulations addressing specific insurance industry-related issues, such as the bypassing of certain POPI steps which may significantly lengthen the process of placing a policy on the books, may then be considered at a later stage.

## Retail Distribution Review (RDR)

The South African Financial Services Board has followed closely in the footsteps of the UK, USA and Australia by initiating the Retail Distribution Review (RDR). The RDR aims to regulate financial advisors and financial intermediaries, as defined in the Financial Advisory and Intermediaries Services Act (FAIS), 2002, to ensure insurance and investment distribution models are aligned to achieve and support the delivery of Treating Customer Fairly (TCF) outcomes - which include ensuring customers receive fair outcomes, prices and advice when purchasing financial products.

The proposals are grouped around the following key issues for greater transparency in the industry[2]:

| Proposals grouped around key issues | |
|---|---|
| Proposals relating to types of services provided by intermediaries | Services can be distinguished between services that are:<br>• Provided to the customer e.g. advice, financial planning, etc.<br>• Services that connect the product supplier and the customer e.g. sales execution, aggregated platforms, referrals, etc.<br>• Services to the product supplier e.g. binder functions, outsourcing of functions, etc.<br><br>Standards will be set for each of these service channels. |
| Proposals relating to relationships between product suppliers and intermediaries | Product suppliers will be fully responsible for the advice given to their customers, which will be defined as follows:<br>• Advisors will be defined as independent financial advisors (IFAs), multi-tied advisors or tied advisors.<br>• In order to be defined as an IFA or tied advisor, intermediaries will have to meet specified criteria.<br>• Multi-tied advisors: All those who do not fall into the former two categories. |
| Proposals relating to intermediary remuneration | These proposals will focus on addressing conflicts of interest, and ensuring that there is a distinct link between the services provided by the intermediary and the remuneration received. It is also important that there is a clear distinction between remuneration received upfront, and that received for ongoing services. |

Although the FSB recognises that the existing FAIS legislation seeks to regulate conflicts of interest, misconduct and the manner in which advice is given, they believe that further, more detailed interventions are needed to regulate potential inappropriate selling of products based on the outcomes of the review. The review aims to expand on the responsibilities for fair outcomes to customers to include financial advisors and intermediaries (at whom FAIS was directed) and also product suppliers and other participants in the supply chain.

The FSB's Retail Distribution Review 2014 indicated that distribution relationships and intermediary remuneration models are seen as the largest contributors to the poor outcomes of current selling practices.

The proposals aim to:

- Limit the remuneration intermediaries can earn;
- Address conflicts of interest, and
- Increase customers' understanding of the product and the quality of advice they receive.

RDR also aims to address the issue of the affordability of advice for low-income customers via "low advice" distribution models.

The proposals relating to intermediary remuneration have attracted a large amount of criticism from IFAs and tied advisors in the industry. This is due to the removal of upfront commission which is essentially the "bread and butter" of most intermediaries who are viewed as small businesses themselves. Most incur huge costs when generating new business leads, assessing their clients' needs and providing advice on suitable products. The upfront commission is a significant, if not the only, form of income to fund the process required for new product sales. Advisors will now have to charge specifically for the advice they give – this is a significant challenge as consumers are generally unwilling to pay for advice upfront. This cycle may negatively impact the advisor's overall profitability and may result in a mass exit of advisors from the industry, as was seen in the UK where the number of investment advisors dropped from 47,000 in 2010 to 32,000 in 2014[3].

2 Source: KPMG South Africa in Financial Services, "Retail Distribution Review – RDR", 21 May 2015, http://www.sablog.kpmg.co.za/2015/05/retail-distribution-review-rdr/

3 FA News, Retail Distribution Review: well-run practices have 'little to fear' , Sanlam Investments, 25 August 2015, http://www.fanews.co.za/article/abc-of-rdr-retail-distribution-review/1364

RDR in the UK focussed only on investment products whilst in South Africa, RDR regulation will be applied to the investment, risk and short-term insurance industries, making the potential number of intermediaries put out of business significantly larger than that observed in the UK.

The issue of financial sustainability has been on the lips of advisors for some time now since RDR was first mentioned, with many already adopting alternate methods of generating income and expanding into other lines of business. It is believed by the FSB that well-run practices do not need to panic. Practices should aim to build long-term funding models based on ongoing fees, negotiated with clients, which will exhibit a long-term value proposition to customers and the regulator. The RDR proposal paper was open for industry comment and is currently under further review.

## Solvency Assessment and Management (SAM)

Out of all the legislative changes due to come into effect, South African insurance companies have been predominantly occupied over the last few years with preparing their firms for the introduction and implementation of the SAM regulatory regime. The SAM project, adapted from the European Solvency II directive, began in early 2009 as a joint venture between the FSB and the South African insurance industry, with the primary purpose of appropriately aligning insurers' economic capital requirements via a market consistent approach. These economic capital requirements provide a realistic but indicative minimum level of spare capital a company should hold to sufficiently reduce the risk of insolvency and enhance financial soundness of the company. Previous methods of assessing capital requirements did not involve considering all the potential risks the company would be exposed to.

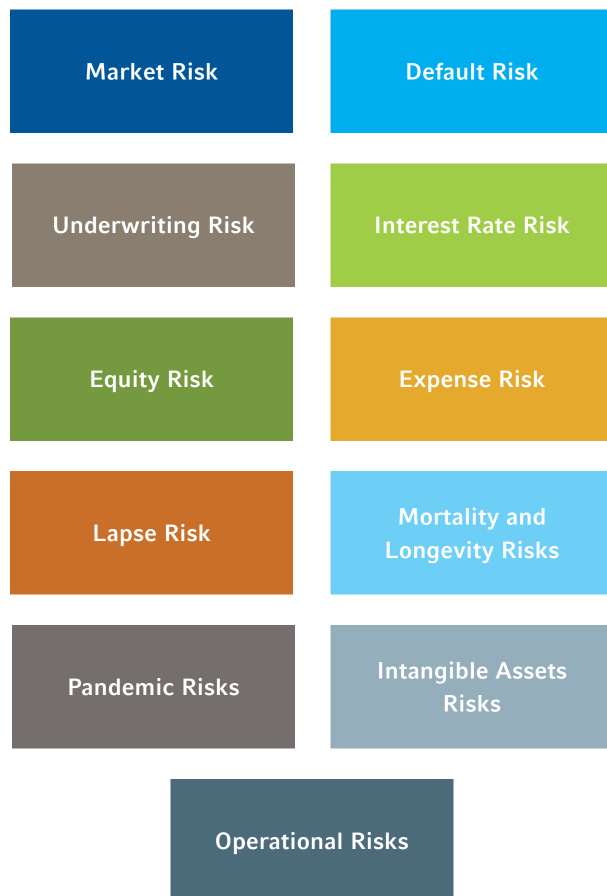
The SAM Framework implementation is based on a three-pillared approach which addresses solvency capital adequacy requirements, risk management and governance requirements, and reporting and disclosure requirements.

### Pillar I: Quantitative Requirements

Pillar I comprises the technical calculation of reserves, assets and required capital in order to determine the solvency of the company. These calculations essentially consider the available capital the company has versus the amount of capital they are required to hold, in case a risk event happens, in order to retain solvency. They aim to capture the various risk types inherent in an insurer's business. The capital requirements are divided into two categories: solvency capital requirements (SCR) and minimum capital requirements (MCR).

The SCR is a target level of capital that should be maintained after taking into account identified risk events. Stressing of risks is done in isolation for all identified risks and insurers will be required to inform the FSB in the event that they have insufficient funds to cover the SCR.

SCR consists of the following sub-risk modules, to name a few, which are stressed during the process of calculating the capital required:



The MCR represents the lowest level of required solvency capital. If the insurer's capital falls below the MCR, policyholders would be exposed to an insupportable level of risk and the insurer may be required to discontinue operation.

### Pillar II: Qualitative Requirements

Pillar II of SAM addresses risk management and governance under SAM principles in the company. Own Risk Solvency Assessment (ORSA) is a principle-based report that must be submitted by each insurer demonstrating how SAM is being used to manage risks and how SAM-oriented thinking is embedded into their business practices. The aim of ORSA is to encourage SAM requirements to be a part of the decision-making process and a part of the risk management framework of a company as well as sufficiently indicate the insurer's own risk appetite.

### Pillar III: Reporting and Disclosure Requirements

This pillar deals with reporting the results of Pillar I and Pillar II exercises through reporting templates with the goal of creating transparency and supporting regulatory objectives. Insurers are required to describe potential risks and how current risks are being effectively managed.

### The Road Ahead

The FSB has issued three quantitative and two qualitative impact studies that assess the impacts of the proposals developed and effectiveness of the reflection of risks. This was followed by the commencement of the parallel run during 2015 where companies are required to submit according to both the previous solvency reporting requirements and the new SAM reporting standards.

Although there have been questions around the complexity and tediousness of the process for companies to prepare for SAM, this regulation aims to improve overall business practices. The SAM Economic Impact study was also carried out considering the potential economic impacts of the implementation of SAM. The study found that SAM is expected to lead to better risk management, a more stable financial sector and will facilitate the access to insurance for lower income groups.

Whilst legislative timelines have been delayed to mid-2016 due to the pending passing of the Insurance Bill, the phased implementation approach will continue into the first half of 2016, with the requirement that all insurers must fully comply with SAM reporting requirements as at their 2016 financial year-end.

## The Insurance Bill

The Insurance Bill has been in development for the past five years and will provide a consolidated legal framework for the prudential supervision of insurance businesses in South Africa that is in line with international standards.

The Bill is also designed to replace those sections of the Long-Term Insurance Act and the Short-term Insurance Act that

The Insurance Bill will provide a globally aligned legal framework that closes the gap for local insurers that operate abroad.

deal with prudential supervision in particular.

The objectives of the Bill, stated in the Memorandum on the Objects of the Insurance Bill [4] include:

1. Enhancing access to insurance via the introduction of a micro-insurance regulatory framework;
2. Enhancement of the financial services sector and the protection of policyholders through: the introduction of the SAM regime (discussed above), a framework for group insurance supervision and enhancing reinsurance arrangements;
3. Alignment with international standards in accordance with South Africa's G20 commitments.

## Enhancing access to insurance

A regulated and well-operating micro-insurance market is vital to our South African market as it allows low-income households to gain access to insurance that is appropriate to their needs and financially affordable. This will have positive effects on economic growth and will reduce income inequalities.

The Bill gives effect to the National Treasury's Micro-insurance Policy by supporting the development of the micro-insurance industry through balancing lower regulatory requirements for providers and ensuring customer protection measures are in place.

## Enhancing financial soundness of insurers

The Memorandum of the Bill indicates that many insurance providers in the industry are currently operating within a group structure, however, previous legislation does not allow for group insurance supervision. Insurance groups benefit from the pooling and diversification of risk, intra-group financing and cohesive governance structures.

Although there are benefits, being part of a group also presents an array of risks to an insurer such as direct or indirect exposure to risks of other entities within the group and conflicts of interest. The Bill thus introduces a new group-wide supervision regime for insurers that allows protection for policyholders and beneficiaries against risks emerging from an insurance group.

Reinsurers play a crucial role in the global insurance industry as they improve the overall stability of the insurance markets. However, in order to achieve their goals, reinsurers must be able to meet their commitments to insurers when they occur. It is therefore significantly important to have a prudential framework which protects the financial position of insurers from potential non-performance by reinsurers, especially reinsurers operating outside of South Africa.

Previous laws may have inadvertently allowed some regulatory arbitrage, resulting in an unbalanced playing field for insurers. The Bill will facilitate a new reinsurance regulatory framework that allows wider recognition of reinsurance, through the use of classifications under branches and subsidiaries, and recognition of the risks involved in different reinsurance structures.

## Alignment with international standards

It is critical that local regulation is aligned with international regulatory standards since more and more insurers are operating globally but are regulated locally. South African regulators also regularly work closely with international regulators. This also improves the ease with which local insurers operate in other countries. The Insurance Bill aims to address gaps in and align the regulatory framework for insurance in South Africa to the International Association of Insurance Supervision's Insurance Core Principles.

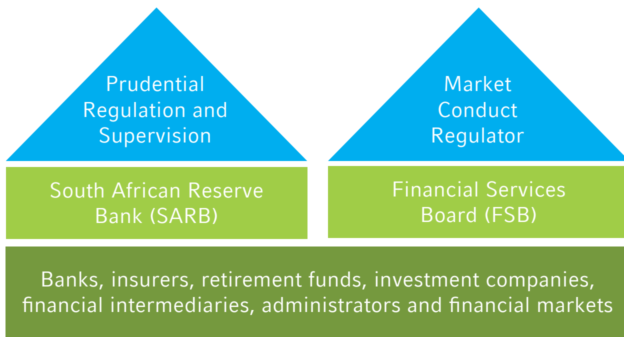
## Twin Peaks Legislation

The Insurance Bill will also facilitate a smooth transition into the Twin Peaks model of financial regulation (which originated in the UK).

In an attempt to address a perceived "non-compliance culture" in the financial industry (as indicated in the KPMG Twin Peaks publication[5]), the Twin Peaks model will see the formation of two regulators, namely the prudential regulator, forming part of the South African Reserve Bank (SARB) and the market conduct regulator, forming part of the restructured FSB.

4 http://www.treasury.gov.za/public%20comments/DraftInsuranceBill2015/Annexure%20B.pdf

5 https://www.kpmg.com/ZA/en/IssuesAndInsights/ArticlesPublications/Financial-Services/Documents/KPMG%20Twin%20peaks.pdf



Twin Peaks Model Diagram

The FSB's Twin Peaks Implementation Committee stated that prudential regulation and supervision will focus on maintaining and enhancing the safety and financial stability of companies in order to meet their obligations to customers. The market conduct regulator will focus on ensuring that consumers of financial products and services are protected against fraud, ill-informed advice and market abuse.

This will complement the prudential regulation and supervision by the SARB. Both the SARB and FSB will base their regulatory frameworks on the same set of principles with varying degrees of importance placed onto each principle.

It is likely that the Insurance Bill as well as the Twin Peaks legislation will incur additional costs to the insurer. However, these costs are believed to be offset by improvements to the insurance industry, resulting in a safer financial system and improved economy.

The envisaged date of implementation of the Insurance Bill is the 1st of January 2017, with industry players having already begun with the development of processes and systems to meet the requirements of the Bill.

Adequate preparation for and solid understanding of the regulatory changes will position insurers to meet the needs of both consumers and regulators.

## Conclusion

POPI, RDR, SAM and the Insurance Bill, amongst other regulatory changes, aim to improve our local regulation regime and bring it in line with international standards. Although these changes come with significant investments of time and money, it is important that the industry works in collaboration to support the regulators' intentions to protect public interests.

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