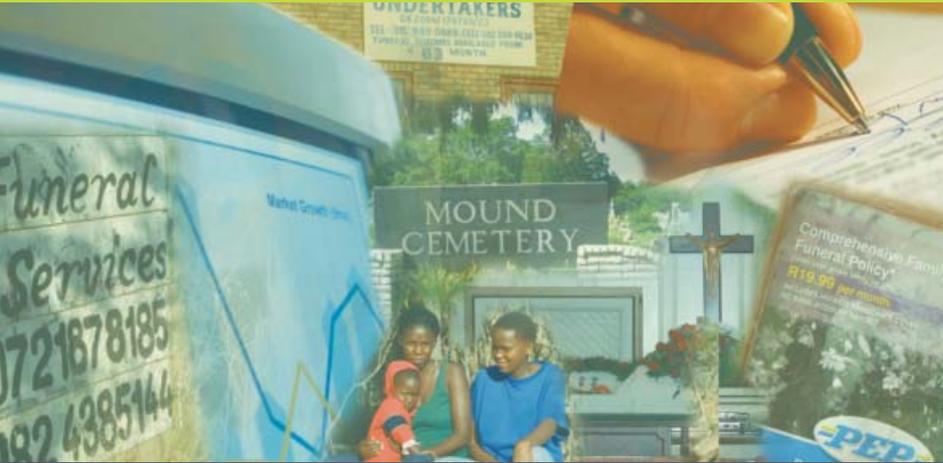


The nature of informality in the South African funeral services market – implications for policymakers and regulators



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I. Introduction¹

This focus note highlights the policy and regulatory implications of a larger study on informality in the funeral service provider industry in South Africa (“Nature of Informality in the South African Funeral Services Market” available from www.cenfri.org) carried out with the aid of the Canadian International Research Development Centre (IDRC).

Why this note?

Funeral service providers – also called funeral parlours or undertakers – are a prominent part of many South African communities. In order to secure a market for their services, funeral service providers typically offer a number of financial services to both individuals and burial societies, including, pre-payment for funerals (savings), credit and funeral insurance. By covering South Africans against the risk and cost of a funeral, which can financially cripple low-income families, they fulfil an important social protection role. However, in doing so, many do not comply with insurance regulation. This includes prudential insurance regulation concerned with the financial soundness of insurers and market conduct regulation, which focuses on their conduct vis-à-vis clients. Over the years, this has raised concern among regulators. One of the objectives of the proposed new microinsurance regulatory regime in South Africa is to formalise funeral insurance provision in the funeral service provider industry (see Box 1).

Box 1. The role of consumer abuse concerns in the development of the South African microinsurance regulatory framework

In 2003 and again in 2005, the South African Parliamentary Committee on Finance heard evidence of abusive practices in the funeral insurance market in South Africa by funeral insurance providers. Such abusive practices include (Gibson, 2011):

- so-called “suitcase undertakers” who take insurance monies from clients, then disappear without honouring the promise of a claim
- provision of a funeral service, with benefits defined in terms of the aggregate funeral services, to which a Rand value is attached, without the option of a cash payment as required by law; this makes it difficult for the consumer to know and compare the true value of offerings amongst the various potential providers; and

¹ Note: this document is written primarily for a policymaking and regulator audience already familiar with insurance and microinsurance. Readers less familiar with this context can consult Bester et al (2008) and IAIS (2012) for a complete overview.

- practices whereby product terms and conditions are not adequately disclosed to clients as part of the sales process, with no reporting to the supervisor; failure to keep requisite records of sales transactions and internal processes, and the use of unregistered sales personnel that do not meet fit and proper requirements.

Following the hearings, parliament requested the National Treasury as financial sector policymaker and the Financial Services Board (FSB) as insurance regulator to investigate these abuses in order to propose regulatory reform that would better protect vulnerable consumers, especially those in the lower-income segment. In 2006, National Treasury decided to broaden the scope of the regulatory process beyond funeral insurance to create a framework for microinsurance at large that would (i) create a formalisation path for informal funeral insurance, but also (ii) facilitate outreach by the commercial insurance sector into the lower-income market. In this way, consumer protection concerns in the funeral service provider industry directly triggered the development of a microinsurance regulatory regime in South Africa.

But is such informality indeed undermining consumer protection? How does insurance provision in the funeral service provider industry work in practice and what would be the implications on the industry, should they be required to formalise? What insights can regulators take into account when finalising the microinsurance regulatory framework and the approach to formalisation?

These are the core questions that this note seeks to answer. The study it is based on is the first systematic study that explores the nature and dynamics of the South African informal insurance market as it relates to funeral service providers. Thus its goal is to provide empirical evidence that can provide valuable input into the regulatory discussions.

Methodology

The study that informs this note examined the nature and practices of funeral service providers that also provide or sell funeral insurance informally. It is based on a combination of quantitative and qualitative methodologies:

- Following exploratory interviews, a quantitative survey questionnaire was designed and rolled out among a sample of 72 funeral service providers in four areas in South Africa: Cape Town in the Western Cape province (13 providers, comprising 18% of the sample), Durban in KwaZulu-Natal (20 providers, 28% of the sample), Thohoyandou in Limpopo (20 providers, 28% of the sample) and Butterworth, King Williams Town and Willowvale in the Eastern Cape (19 providers, 26% of the sample).
- This was followed by so-called “deep dive” studies; in-detail examinations of the financial and other business information, of four funeral service providers in the larger survey sample; and
- Available studies on informal insurance were reviewed and, where relevant, municipalities and other stakeholders in the community were interviewed to build an understanding of the funeral service provider landscape.

What is informality?

‘Informality’ in relation to funeral service providers is the key theme of this note. International literature² defines three types of economic informality:

1. **Business informality:** business informality refers to the nature of the business or entity providing the service and

whether it is registered/complies with relevant corporate legislation. The study that informs this note explored business informality with regards to two specific dimensions:

- **Corporate form:** funeral service providers may be sole proprietors or form partnerships, neither of which is required to be registered. They can also incorporate as limited liability companies which do require registration and compliance with the Companies Act, 71 of 2008. The previous Close Corporation or “CC” regime which enabled registration as a separate legal entity with lighter regulation than a company, was abolished by the 2008 Companies Act, although CCs in existence can continue to operate as such; and

- **Tax:** Anyone who receives taxable income as defined in the South African tax regime is required to register as a taxpayer and pay tax. Individual taxpayers with an annual income of less than R63,556 (\$8,200)³ (2012/2013 tax year) are exempt from paying income tax. All other individual tax payers pay tax according to a graduated tax rate⁴. Where the corporate form of the enterprise is a limited liability company, tax registration is automatic upon company registration⁵. In addition to income tax, a person (natural or legal) that makes taxable supplies in excess of R1 million per annum (\$130,000) is required to register as a value added tax (VAT) vendor⁶. However, funeral insurance is exempt from VAT.

2. **Employment informality:** Employment informality relates to the nature of the relationship a business has with its employees. Typically, employment informality means that an entity does not have formal contracts with some or all of its employees and does not adhere to all or some of the country’s labour legislation. In South Africa, this includes the Labour Relations Act of 1995 and its amendments, the Basic Conditions of Employment Act 1997, as amended, the Employment Equity Act of 1998 and various other codes and provisions. It can also mean non-compliance with minimum wages that have been set in certain economic sectors.

3. **Informality of the type of economic activity in question.** This is the *functional* definition of informality and implies that an organisation, which may or may not be formal from a business and employment point of view, conducts an activity without being regulated to do so. This may either be because of the absence of regulation (due to an exemption of certain activities or gaps in the particular regulatory context), or in contravention of existing regulation (which would make the activity illegal). In the case of funeral service providers in South Africa, informality of the activity may relate to their status as *funeral service* providers or to their status as *insurance* providers or intermediaries:

a. **Funeral service provision:** Funeral service providers are required to comply with the Funeral Service Providers’ Premises Regulation issued under the National Health Act. Compliance with certain local government authority health regulations is also required. The Births and Deaths Registrations Act 1992 deals with the provision of licences regarding receiving death notices, issue of burial notices and completion of the death registry.

b. **Insurance and financial service intermediation:**

- **Insurance:** The Long-term Insurance Act of 1998 governs the provision (also called underwriting) of all long-term insurance in South Africa, the definition of which includes funeral insurance. Thus all funeral insurance providers are required to obtain a licence under the Long-Term Insurance Act and to meet the prudential and reporting requirements contained therein, or to obtain underwriting from a licensed insurer.

- **Intermediation:** Under the Financial Advisory and Intermediary Services (FAIS) Act of 2002 and the Code of Conduct and various other provisions issued under it, all providers of financial advice or intermediary services are required to register with the FSB as financial service providers (FSPs) and to meet all the compliance requirements under the framework. FAIS obligations include upfront registration and annual licence fees, appointment of a compliance officer (unless the FSP is a sole proprietorship), the submission of annual compliance reports and financial statements and a number of fit and proper requirements imposed

3 Throughout this document, unless direct USD references are quoted, an average year to date exchange rate of R 7.75 per USD on 1 June 2012 (as obtained from www.oanda.com) is applied to convert South African Rand (R) amounts to USA Dollars (\$).

4 starting at 18% of every Rand earned above R63,556 (\$8,200) with a maximum rate of 40%

5 Companies pay tax at the rate of 28%. A tax regime introduced for SMMEs of any corporate form from 1 March 2009 enables businesses with an annual turnover of less than R1 million (\$130,000) to pay Turnover Tax, a simplified tax system that incorporates income tax, capital gains tax and VAT

6 VAT is an indirect consumption tax levied at the rate of 14% on most goods and services.

on key individuals and representatives of the FSP. Alternatively, providers of financial advice or intermediary services can become representatives of the insurer that underwrites it, which will be a registered FSP, so that the FSP retains the FAIS obligations. An FSP is held responsible for the conduct of all its representatives. Thus it takes on significant liability when it registers funeral service providers as representatives and many insurers may opt not to do so.

The focus of this note is specifically on **insurance informality (compliance with insurance and/or intermediation regulation)** as an example of the third category of informality, namely functional informality. Note that insurance or intermediation informality also exists among burial societies in South Africa. Burial societies are informal associations of people that pool savings for purposes of providing funeral cover to members. Most burial societies either fall under an exemption to the Long-term Insurance Act for friendly societies or do not guarantee their benefits and hence are not regarded as providing insurance. This note does not deal with friendly or burial societies, but specifically considers **for-profit funeral service providers** in South Africa that do not comply with the insurance and/or FAIS regulatory frameworks. While many of the funeral service providers interviewed for this study also displayed characteristics that relate to the other two categories of informality (business or employment), all references to informal providers or informality in the rest of the document refer to this specific application.

Structure

This note is arranged as follows:

- Section 2 outlines the funeral insurance landscape in South Africa, looking at the importance of funeral insurance in the microinsurance market, before pausing to consider the landscape and typology of funeral service providers as informal insurers;
- Section 3 unpacks the proposed South African microinsurance regulatory framework as backdrop to the analysis in the rest of the document;
- Section 4 asks what the consumer protection implications are of informal insurance provision and intermediation by funeral service providers;
- Section 5, in turn, considers the regulatory implications for funeral service providers, should the insurance formalisation proposed by the South African government be enforced; and
- Section 6 concludes on what these findings signal to regulators as they finalise the regulatory framework.



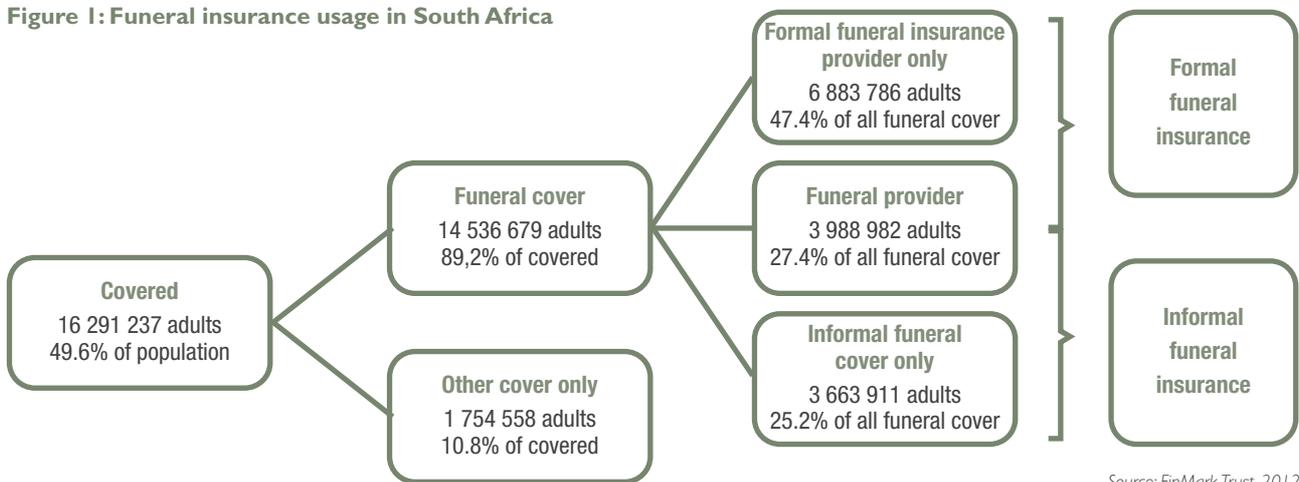
2. The funeral insurance landscape in SA

Before considering the implications of informality in funeral insurance, it is important to understand the demand for funeral insurance as well as the nature of the funeral service provider landscape in South Africa.

Importance of funeral insurance

Biggest driver of insurance usage. According to 2010 FinScope⁷ survey data, almost half (49.7%) of South African adults have some form of risk cover, of which funeral cover accounts for the largest proportion (89.2%). This equates to more than 16 million South Africans covered by funeral insurance. Of all those with funeral cover, 27.4% or 4 million adults are covered through a funeral service provider and 25.2% (3.6 million adults) have cover through burial societies. Though survey data does not capture whether insurance through a funeral service provider is formal or informal, based on previous research⁸ it is estimated that a significant proportion of funeral parlours provide funeral insurance on an informal basis. Figure 1 provides a breakdown of current usage:

Figure 1: Funeral insurance usage in South Africa



Source: FinMark Trust, 2012

Drivers of demand. Earlier qualitative research (Bester, Chamberlain et al, 2005) shows that the demand for funeral cover is driven by the need for a dignified funeral under traditional custom, as well as the everyday reality of death. The cost of a funeral can detrimentally affect a low-income family without cover and consequently people in this market segment use a variety of methods and a number of financial instruments to cope with funeral costs, including burial societies, funeral insurance from a number of sources such as insurers, banks and funeral parlours, and other formal and informal means.

Target market largely economically vulnerable. As to the consumers of informal insurance, the picture emerges of a relatively vulnerable group: 54% those with cover from a funeral service provider are female, 83% are African, only 30% have full-time employment in the formal sector, 20% are unemployed (compared to only 10% among those with cover from a formal insurer) and 26% are social grant recipients. These figures become even higher for users of burial societies only. Likewise, user income as well as highest level of education attained decrease as we move from users of formal funeral insurance providers to users of insurance from funeral services providers, to users of burial society cover only.

7 A nationally representative demand-side survey of financial inclusion conducted by FinMark Trust. See www.finscope.co.za.
 8 Bester, H.J., Chamberlain, D., et al, 2005 (See bibliography)

Funeral service offering

Funeral package options rarely state cash value. A distinguishing feature of funeral insurance (relative to other insurance) is that it provides an in-kind funeral benefit in the form of a funeral service. It is typical for informal funeral service providers to offer one or more funeral service packages that consumers can choose from at different premium levels. Those providers in the sample rarely attach a monetary amount to the service provided or offer clients the option of a cash pay-out in lieu of the funeral service. Most, however, do provide so-called cash funeral packages to walk-in (that is, non-insurance) clients.

Wide range of funeral package options. Though the research shows that cash funerals are provided at a substantial cost premium to insurance packages, considering the price of such cash funerals nevertheless gives some indication of the range of funeral services offered and the biggest drivers of price. The service offerings ranged widely, with the most basic cash package, priced at around R2,500 (just more than \$300⁹), typically including:

- storage and treatment of the body;
- hearse for transport of the coffin to the grave;
- coffin;
- lowering device for the lowering of the coffin into the grave;
- flowers/coffin spray;
- tents for shade for mourners at the graveside;
- chairs for mourners at the funeral; and
- black and white pamphlets.

On the other end of the spectrum, extravagant packages are offered for as much as R70,000 (about \$8,650). Such packages typically contain all the elements of a basic funeral package, plus a casket instead of a coffin, tombstone, family cars, buses for transport of the mourners to the graveside, catering after the funeral, a radio announcement of the funeral, a choir in the church, colour pamphlets and a toilet for mourners at the graveside.

The main determinant of cost is the quality of the hearse and tombstone and whether customers prefer a coffin or a casket (caskets are more extravagant than coffins and are available in a variety of designs). Some respondents indicated that they do not have fixed funeral packages: each funeral is tailored according to the client's specific needs and the price is determined accordingly



Funeral service provider typology

According to Bester, Chamberlain et al (2005), there were an estimated 3,000 to 5,000 funeral parlours in the country at the time. Though no updated data is available, there are thousands of funeral service providers operating in South Africa, many of whom offer insurance cover. This is by no means a homogeneous landscape:

Table 1. Size distribution of funeral service providers in the survey sample

Category	Number of funeral insurance policy holders	Number of providers in category	% of sample
Micro	0 – 150	18	25%
Small	151 – 1,000	29	40.3%
Medium	1,001 – 3,000	7	9.7%
Large	>3,000	11	15.3%

Source: Smith et al (2012)

Size typology. The size of the 72 funeral service providers surveyed, measured according to the self-reported number of funeral insurance clients that they have, varies substantially. They can be grouped into four categories:

Funeral service offering typology. The sample was selected so that all funeral providers sell funeral insurance in addition to their basic funeral service offering. With regards to funeral services (as opposed to insurance), the study finds that it is common practice for funeral service providers to conduct business outsourcing. This leads to a long and disaggregated value chain. Funeral service providers range in terms of the funeral services that they offer, which can include body removal, transportation, storage and treatment of the body, as well as the various elements of the funeral service itself (for example the coffin or casket, grave services, catering and equipment). They offer all or a combination of the aforementioned services, outsourcing those aspects that they are unable to offer directly (due to not owning the necessary equipment or assets) to another provider. It is important to emphasise that, regardless of what outsourcing arrangement is in place, the client will be offered the full range of services required for the funeral.

Three categories of funeral service providers emerge from the study:

- **Project managers or funeral directors: 12 providers, comprising 17% of the sample.** At the lowest end of the value chain there are project managers or funeral directors who outsource all funeral service components except for the provision of an insurance policy to another funeral service provider. They provide or “stage” the funeral by contracting in services from various different providers, from body transport to body refrigeration and preparation of the body for burial.
- **Transporters: 22 providers, 30% of the sample.** The next “big step up” the value chain is when a funeral director acquires its own vehicles for body transportation (body removal and transport to the grave), because this requires significant capital expenditure. Some transporters will treat the bodies in preparation for burial, others will outsource this function¹⁰.
- **Full servicers: 38 providers, 53% of the sample.** The highest level in the value chain is when a funeral undertaker owns all the necessary facilities and assets required to provide the full funeral service. This includes refrigeration facilities for the treatment and storage of the bodies as well as vehicles for body transport.

¹⁰ The treatment of bodies does not necessarily imply a big leap in terms of capital expenditure and can rather be viewed as a preference in terms of the structuring of the value chain. A funeral director who outsources the refrigeration of the body (renting space at the mortuary of another undertaker) would either outsource the treatment of the body to the funeral service providers who provided the mortuary, or if the undertaker wishes to do the treatment, would use the mortuary's treatment area and do the body treatment in preparation for burial themselves. Alternatively, the undertaker would do the treatment in illegal facilities.

Full servicers tend to have more expensive insurance offering. The table below summarises the insurance offering provided across the types of providers identified above:

Table 2. Spread of insurance offerings among provider types

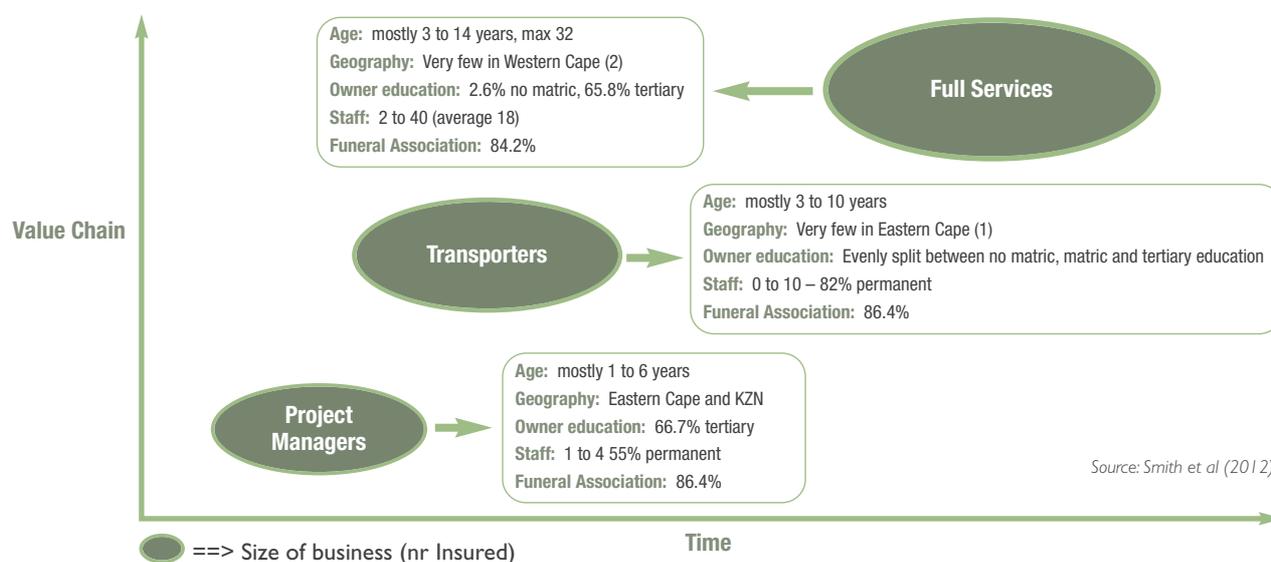
	Project managers	Transporters	Full servicers
Average monthly funeral insurance premium	R79.80 (USD 10.30)	R82.60 (USD 10.66)	R96.70 (USD 12.48)
Average inferred monetary value of funeral packages¹¹	R8,454.50 (USD 1090.90)	R8,084.30 (USD 1043.14)	R8,896.20 (USD 1147.90)
Offer cash pay-out option?	3 of 12	10 of 22	16 of 38

Source: Smith et al (2012)

Full servicers tend to charge the highest premiums and offer funeral packages with the highest average inferred monetary value. There does not seem to be a clear trend, though: on average, project managers tend to charge a lower premium for a higher benefit package than transporters. A significantly lower percentage of project managers offer a cash pay-out option than transporters and full servicers.

Correlation between provider type, size and age. The study found that, as funeral service providers progress up the value chain, they tend to have more insurance clients and that, the larger the business is in terms of number of clients, the longer it tends to have been in existence. Furthermore, full servicers' owners tend to have a higher education level than those in the other categories. The relationship of these factors is illustrated in the following graphic:

Figure 1: Funeral insurance usage in South Africa



11 As no cash equivalent is stated for the funeral packages offered, the average inferred monetary value was calculated according to the average cash price of the most popular funeral service package provided across the type of providers.

Industry trends

Insurance used to build funeral client base. The fact that a cash benefit is mostly not offered as an alternative to an in-kind funeral service benefit (as required by insurance legislation), and that a monetary benefit is rarely attached to the funeral services provided, are both explicit strategies employed by funeral insurance providers to tie clients to them, thereby ensuring a client base for their funeral services. Under such a scenario, the client has little or no control over whether the actual value or quality of the service is directly related to the premium paid. Furthermore, the fact that no monetary benefit equivalent to the value of the service is provided makes it difficult for consumers to compare packages between providers.

Pervasive informality. Of the 72 funeral service providers surveyed, only seven were formal in that their insurance offering is underwritten by a licensed insurer and they are compliant with the FAIS framework. Of those providers that are informal, 60 were not underwritten by a licensed insurer and not FAIS compliant, while a further five were underwritten, but not FAIS compliant.

Informality not necessarily a permanent state. An interesting finding is that many funeral service providers surveyed drift in and out of insurance formality and that informality may simply be an initial phase of business development. The positive relationship found between business age, size, value chain category and formality seems to indicate that there is a greater chance of formality as businesses evolve over time and move up the value chain.

Cut-throat competition leads to unsound practices. Competition in the industry is perceived to be tight – the result of many funeral service providers operating in close proximity. In one province, it was alleged that the industry is also under threat from the minibus taxi industry which is said to “control” some of the transport routes. As will be analysed in Section 4, strong competition means that new entrants essentially engage in a “start-up lottery” where they try various strategies to ensure their chance of survival. This leads to various underhanded business practices detected in the study, including corpses being held for ransom by competitor funeral service providers or corrupt behaviour among hospital clerks with regard to the distribution of bodies to different funeral service providers. In addition, many use their insurance business as a means to ensure cash flow in the start-up phase and their survival strategies include questionable insurance practices such as not imposing waiting periods or age limits so as to attract clients, or pay-out of dubious claims.



3. Regulatory context

The discussion above highlighted a number of industry practices that may be relevant from a regulatory perspective. Sections 4 and 5 will consider the consumer protection and regulatory implications of funeral insurance informality in more detail. As basis for that discussion, we first outline the regulatory context for microinsurance in South Africa.

In 2008, National Treasury issued a Discussion Paper on a proposed regulatory framework for microinsurance. Amongst others, the discussion paper proposed creating a distinct formalisation path, commensurate with the level of risk of microinsurance products, for microinsurance providers. The proposal was formalised when National Treasury issued a Policy Document on the Microinsurance Regulatory Framework in 2011. In 2012, working groups were created between representatives of National Treasury, the FSB, industry and other stakeholders to translate the broad policy proposals outlined in the regulatory framework into more detailed legislation. This process is on-going.

Formalisation core to framework objectives. Informality in the funeral services industry is relevant to all the core objectives set out in the policy framework, namely:

1. **Extend access** to a variety of good-value formal insurance products appropriate to the needs of low-income households, thereby supporting financial inclusion (funeral providers currently enhance access to the products because of their geographic proximity to low-income users);
2. **Facilitate formalised insurance** provision by currently informal providers;
3. **Lower barriers to entry** to the microinsurance market, further supporting poverty alleviation through economic growth and job creation;
4. **Enhance consumer protection** within this market segment through appropriate prudential and business conduct regulation, improved enforcement of regulatory transgressions and consumer education interventions; and
5. **Facilitate effective supervision and enforcement.**

Number of proposals relevant to funeral service providers. The proposals in the microinsurance policy document that are of most direct relevance to funeral service providers that currently provide insurance informally include (National Treasury, 2011):

- **A microinsurance licence.** The framework allows for the creation of a dedicated microinsurance licence limited to the provision of microinsurance products as defined, and with proportionate regulatory requirements. All entities that currently provide insurance without a licence will be required to register as a microinsurer; obtain underwriting from a registered insurance company (that is, become formal insurance intermediaries) or terminate their insurance activities.
- **Separation of business.** For the sake of sound prudential management and to minimise the level of actuarial scrutiny required of microinsurance, registered microinsurers may only conduct insurance business. Other business operations, such as the provision of funeral services or credit, will not be permitted within the same legal entity (although management and governance structures may be shared).
- **Monetary benefit option.** If an in-kind benefit such as a funeral service is provided, a monetary pay-out must be offered in the alternative which must be equal to the stated value of the in-kind benefit and disclosed upfront.
- **Waiting periods.** Waiting periods of a maximum of six months will be permitted for persons up to the age of 65 except for accidental death or disability policies, which do not require waiting periods to counter adverse selection. No waiting periods are permitted when policyholders switch insurers provided cover remains uninterrupted.

- **Prudential & corporate governance requirements.** Commensurate with the simplified product offering implied by a licence limited to microinsurance, microinsurers will require R3 million upfront capital (compared to the current R5 million and R10 million required for short- and long-term insurers respectively), and will enjoy simpler capital reserving, reporting and corporate governance requirements. Instead of requiring a statutory actuary as is the case for full insurers, all premiums and pricing changes must be signed off by an actuary.
- **Intermediary requirements.** The FAIS Act requires anyone that provides advice or intermediary services be registered as a financial services provider with the FSB and comply with the provisions of the FAIS framework. Sellers of microinsurance products will enjoy appropriately streamlined FAIS requirements, as is currently the case for sellers of funeral policies. Where an intermediary collects premiums on behalf of an insurer, certain minimum requirements such as maintenance of separate bank accounts and communication from insurer to insured regarding receipt of premium, are required.
- **Consumer complaints.** Every microinsurer will be required to maintain a client care system.
- **More effective supervision and enforcement.** The FSB will develop and implement a holistic implementation strategy for the microinsurance regime that will cut across the microinsurance and FAIS regulatory frameworks. It will include a broad-ranging enforcement campaign aimed at facilitating formalisation and protecting consumers. The counterpoint will be proactive support to prospective microinsurers in building the necessary capacity to formalise and to undertake the registration process¹².
- **Transition phase.** Market participants will be given a three year transition period to comply with the new regime. Provided that a suitable business plan accompanies a licence application, the prospective microinsurer will be allowed to build up its capital over the three year transition period (subject to a minimum of R1.5 million on application). Market consolidation is expected as entities such as funeral parlours, that do not have the upfront capital or the capacity to become microinsurers, may aggregate into larger corporate or co-operative entities to facilitate better compliance¹³.

Various insurance formalisation options. In summary, it is envisaged that all funeral service providers that currently operate outside of insurance legislation will be required first to nominally register, then to follow one of the following formalisation routes (National Treasury, 2011):

- Obtain underwriting from a licenced insurer (i.e. become an intermediary of that insurance company);
- Enter into a cell captive, joint venture or partnering arrangement with a licenced insurer¹⁴;
- Obtain their own microinsurance licence and split their insurance business from their funeral service business into a separate legal entity, be it a company or a co-operative; and
- Consolidate with other entities to form a microinsurer, as a company or a co-operative.

12 Intergovernmental coordination will further support enforcement, for example working with the health regulators to get funeral parlours into the regulatory net, and the tax revenue service to detect operators trying to conduct their business out of sight of tax and other regulatory authorities.

13 Transition arrangements for regulatory compliance will be harmonised to any transitional tax treatment granted. This means that entities that formalise from both a regulatory and tax perspective will be considered more favourably, while those that fail to do so will face a coordinated South African Revenue Service-FSB probe with no leniency granted for non-compliance on either the regulatory or tax fronts.

14 A cell captive is an insurance vehicle created by an insurance company (referred to as the "cell provider" or "promoter") whereby its insurance license is extended for use by another organisation (referred to as the "cell owner") for the insurance of the organisation's own assets (in which case it is referred to as a "1st party cell") or the assets and/or lives of its customers or members (in which case it is referred to as a "3rd party cell") (Peard & Witten, 2010).

The difference between these scenarios and that of the underwriting scenario is that there is usually some profit-sharing arrangement and that the funeral service provider would be more directly involved in product design. It will be more than a mere intermediary.

Intermediation formalisation options. Under all of the scenarios above, those funeral service providers who currently operate in contravention of the intermediation (FAIS) regulatory framework will need to either register as a financial service provider in their own right, with all the compliance implications that it entails, or become a representative of a registered financial service provider, typically an insurance company.

Based on the understanding of the funeral insurance landscape and regulatory context sketched above, Section 4 examines the implications for consumer protection of the current insurance practices and the nature of informality amongst funeral service providers, while Section 5 considers the impacts of the proposed regime on funeral service providers, given their current modus operandi.

4. Consumer protection implications of informal funeral insurance

One of the main drivers of the proposed microinsurance regulatory regime discussed in Section 3 is the protection of the consumer through prudential requirements and market conduct regulations. This will ensure that consumers are sold an appropriate and affordable insurance product to proportionately meet their identified risk needs (Gibson, 2011) by sound providers that will be sure to honour the promise of future claims. Is this the case for the informal insurance offering of funeral service providers?

Business management practices. The in-depth financial and business data obtained from four funeral service providers as part of the deep dive investigations enable a detailed analysis of their insurance risk management practices. The table provides summary statistics on the four deep dive participants:

Table 3: Key data points for the deep dive participants

Funeral insurance provider	A	B	C	D
Province	KZN	Limpopo	KZN	Limpopo
Value Chain Category	Full servicer	Transporter	Project manager	Full servicer
Number of insurance clients	510	446	52	N/A
Number of lives covered	4,434	5,130	251	N/A
Total insurance premiums received (year ending Feb 2012)	R910,140 (USD 117,437)	R226,110 (USD 29,175)	R64,640 (USD 8,341)	N/A

Source: Smith et al (2012)

Though the findings cannot be generalised to the industry at large, they are nevertheless indicative of likely broader industry trends. They raise a number of warning signals from an insurance risk management perspective:

- **Governance generally limited to oversight by owner-manager.** Given that funeral insurance is a credence good whereby the consumer is asked to pay premiums in exchange for a benefit promised at some uncertain date in future, clients are particularly vulnerable to the provider not keeping its promise. This emphasises the need for good governance. Of the four providers in the sample, three are owner-managed with no board or separate management.
- **Questions about reliability of financial statements.** Two providers have only rudimentary accounting systems (capturing payments and expenses in a book) and do not prepare any annual or periodic financial statements. As a result, they have almost no information on what their financial position is at any point in time and tend to conduct their business on the balance available in their bank account. One of the two providers that do prepare financial statements uses an administrative employee who has no training in accounting to do so, bringing into question the reliability and quality of the financial statements. Only one provider's financial statements can be considered reliable, as they are outsourced to a qualified accountant.
- **No detailed data on covered lives.** The level of insurance client data collected and recorded is important because it allows an insurer to know exactly who it is insuring and to price their product accordingly. Among those studied, client data is limited and, where it is available, it is not used to inform risk management or pricing. In the extreme, one respondent only collects the identification documents of its main members and the names and surnames of the additional lives covered (as many as 13 per main policyholder) under the policy. This practice will encourage adverse selection and implies that it is impossible for the provider to assess and manage the risk of their portfolio.
- **Paper-based administration systems prevent monitoring.** All four providers have paper-based systems for recording client information. This makes it difficult to monitor or analyse the member profile on an on-going basis even where the data is available, or to evaluate and settle claims and monitor premium payments. Such paper-based systems also do not facilitate good data management practices such as retaining back-ups in case of fire or another disaster which may destroy paper-based documents.
- **No insurable interest required.** A typical feature of funeral policies is to restrict insurance cover to those lives in which the policyholder has an insurable interest (e.g. immediate family and dependents). This is not only to protect the insured individuals but also to avoid adverse selection. All four deep dive cases permit the main members the freedom to insure individuals who are not immediate family members. This increases the risk substantially, as there is no control over who is added to the policy. The situation is exacerbated if, as is often the case, providers do not record and monitor who is covered.
- **Replacement of nominated beneficiaries.** Two providers allow the policyholder to replace someone who has passed away with a new person. This effectively means that the policy will cover far more people than the stated maximum and should, at a minimum, be factored into pricing. Neither of the two takes this into account for pricing purposes. The one applies a waiting period on new lives added, but the other does not.
- **Pricing not informed by understanding of health risks.** None of the providers apply any explicit health underwriting. This means that they do not take into account the health status of their policyholders and insured lives to arrive at a price that takes into account the health status of the insured lives. Formal insurers usually apply a number of measures to assist in managing and understanding the health risk profile of the overall pool, including filtering health risks through waiting periods to avoid adverse selection or applying differentiated pricing for higher health risks (e.g. pricing based on age as age is correlated with health profile). In all cases, the risk profile and claims experience of the group is closely monitored and pricing adjusted accordingly or other management measures taken to avoid further deterioration of the risk pool. Such management practices were not found in the study sample.

- **Short or no waiting periods.** In the absence of health underwriting, the use of waiting periods is a key measure to manage adverse selection. Two of the four providers studied impose no waiting period and one only progressed to a waiting period system following a suicide claim within three months of the policyholder commencing the policy. This reflects the trend for such providers to introduce risk management measures after the fact without a clear risk management framework or strategy. Most simply copy these measures from competitors (whether formal or informal) without considering the differences in risk pools between themselves and their competitors. As no health underwriting is applied, sickly individuals are more likely to insure themselves with service providers who have no waiting periods.
- **Limited age underwriting and minimal restrictions on maximum age of entry.** A key and simple element of underwriting is managing the age of the risk pool, which includes managing the age of entry, managing the overall age profile of the insured group and pricing according to age. Two of the four providers price for the higher risk of having elderly scheme members in their client pools through charging them a higher premium. A third does not apply age restrictions or pricing, but does not allow individuals older than 60 to be the main member on a policy in an attempt to ensure that there are some younger lives on the policy. However, as up to 10 lives may be covered on one policy by this provider, it is possible that 9 out of 10 covered lives could be older than 60. The last provider does not take age into consideration at all when pricing. Accordingly, it faces a risk of adverse selection as it is likely to attract older members.

An important factor that influences an insurance fund's risk profile is the change in age distribution over time. Mature insurance funds are often in a situation where new entrants do not offset the impact of the ageing of existing members. The fund's claims experience will then tend to increase each year as the fund grows older and will cause losses if premiums are not proactively increased. Only one of the four providers had data available to allow them to monitor age profiles over time.

- **Inadequate or over-pricing.** Data was available to analyse the adequacy of the premiums charged by two of the four providers: even before taking into account operational or overhead costs, it is apparent that the premium charged by the one provider is too low for the level of risk it is covering. This is due to the fact that it has significantly under-estimated the increase in premium required to cover older lives. The other provider's family premium is very high relative to the risk it is covering, which in turn raises concerns about the level of value that this particular policy is offering to clients.
- **Unsustainable claims experiences.** Quantitative analysis of the risk experience of the providers show that three of the four have adverse claims experiences relative to the size of their risk pool (measured as number of claims per main member), which may undermine their viability.
- **Questionable sustainability of insurance funds on standalone basis.** If the insurance revenue is separated from the funeral service revenue, two of the deep dive insurance funds are very close to the break-even point over the most recent financial year. This is under the assumption that funeral services are provided at cost (i.e. no profit mark-up on funeral services provided as part of the insurance pay-out in calculating transfers out of the fund) and that the funeral service provider, not the insurance fund, carries all overhead costs of the insurance business. If these two funds were to offer any type of cash value¹⁵ alternative to the in-kind service, these funds would become financially unsustainable. Alternatively, premiums will have to increase to offset the increased cost.
- **Funeral service business substantially more profitable than risk funds.** When the funeral service (as opposed to insurance) businesses are assessed on a standalone basis, it is clear that they are more profitable than the insurance businesses of these providers. The high profitability of the funeral service fund is likely explained by significant mark-ups on the cost price of cash funerals purchased by walk-in, non-insurance clients (with a 128% mark-up over cost, including fixed costs, for one provider and 259% for another), as well as additional tombstone sales and upgrades on services for insured funerals¹⁶.

15 This is the stated or advertised value of the funeral being provided as benefit of the insurance product. This usually exceeds the cost of delivering the service by a substantial margin. If funeral providers were to formalise, regulation would require them to give clients the option of a cash benefit and not compel them to take the service.

16 When an "upgrade" occurs, the client pays an additional cash amount to, for example, receive a better coffin or transport than covered by the policy.

This begs the question why the funeral service providers sell insurance at all when they generate more revenue and profit from cash funerals than from their insurance business. The most likely reason is that insurance provides a captive client base for their funeral services. In addition, the cash flow generated by premium income is used as an inexpensive financing mechanism to cover day-to-day expenses. If it is the latter reason, serious questions arise around the risk this presents to their insurance clients. When premiums are used to cover day-to-day costs, there is a real possibility of insufficient cash flow to provide the funeral services when multiple deaths arise.

High risk behaviour approximates start-up lottery. Of particular concern is the fact that poor risk management as outlined above may, in some cases, be deliberate. The interactions with the deep dive providers and the funeral service providers surveyed in the larger sample suggest that they are mostly not able to quantify the risks in their insurance risk pools. While they may notionally know that risks need to be managed, they deliberately decide to take risks for short-term gain. Examples include avoiding waiting periods to gain clients and hoping that the risk of adverse selection does not materialise. Some use premium income to fund other business activities or capital expenditures at the risk of needing the money to pay claims. This is exacerbated in cases where they do not know who they are underwriting. Furthermore, providers have no real way of judging the risk of additional lives added to the policy. Where there is no restriction on who can be added and no additional charge for additional lives added, there is every incentive for the policyholder to fill the maximum number of lives allowed on their policy (in fact, they may have the incentive to add the sick and dying as they may benefit from claiming on their death).

These findings are confirmed by a solvency scenario exercise conducted on the full survey sample of 72 funeral providers: much of the sample is simply not solvent from an insurance perspective. The majority of the theoretically insolvent providers are micro or small insurance funds with fewer than a thousand clients, as well as relatively new businesses in operation for five years or less. This confirms the concept of a “start-up lottery” whereby small funeral service providers take on more risk than they are able to carry in the early years in order to fund business expansion from insurance premiums.

Start-up lottery creates consumer protection concerns. Such risky behaviour is at the cost of the client: clients pay premiums in the expectation of receiving a funeral service when one of the covered lives on the policy passes away. When their premiums are used to fund business start-up costs, it leaves them exposed to the risk that the insurance fund will go bankrupt if the number of claims is more than anticipated, implying that their claims cannot be honoured. From a market conduct perspective, consumers have no formal recourse against informal providers and the intermediation regulatory requirements regarding disclosure, conduct during the sales process and fit and proper sales staff are for the large part not met, placing the consumer at risk of purchasing a product s/he does not understand or need.



5. Formalisation implications

Informal insurance practices confirm need for formalisation. Given the aforementioned practices of informal funeral service providers and intermediaries, the necessity to protect consumers of funeral insurance, who are often the most vulnerable members of South African society, is self-evident. Government proposes to achieve this via formalisation of these providers' insurance business. As discussed in Section 3, the 2011 National Treasury Microinsurance Policy Document outlines a number of options for funeral services providers to formalise their insurance business, namely: (i) obtain a microinsurance licence; (ii) obtain underwriting from a registered insurer and become an intermediary; (iii) partner with a registered insurer; (iv) or join with other providers to obtain a microinsurance licence. But what will be the implications for the funeral service provider industry, should they be forced to formalise their insurance business?

Formalisation will require business as usual to change. The following table summarises the proposed microinsurance regulatory requirements vis-à-vis current practices for the areas most likely to require funeral service providers to change their insurance business model – as well as the likely implications for funeral providers¹⁷:

Table 4. Comparison between proposed regulatory requirements and current practices

Regulatory proposals	Current practices	Likely business implications of formalisation
Separation of insurance and other businessm	No separation	Business model depends on cross-subsidisation between funeral services and insurance business. Separation may mean that whole business goes under, especially for younger businesses, since there will be no lock-in effect on clients, no cross-subsidisation of the insurance to funeral business.
Mandatory monetary benefit option equal to the stated value of the in-kind benefit	No monetary benefit option for most	Likely that most insurance funds in sample would become insolvent if this were required. Alternatively, premiums will have to increase to offset increased cost, raising questions about client value.
No requirement for minimum waiting period , just restriction on maximum and specification of instances where no waiting period is allowed	No standard practice, but many have no or insufficient waiting period	Waiting period waiver used as competitive tool by many. Thus unlikely to adopt waiting periods under microinsurance regulatory regime – unsustainable business practices will continue.
Capital adequacy ¹⁸ & reserving requirements ¹⁹	Generally no capital set aside for contingencies.	Most, especially in start-up phase, will be unable to put up required capital, implying that own microinsurance licence will not be feasible formalisation option.
Actuarial sign-off on pricing of new products and all subsequent price changes	Pricing not informed by risk considerations. Aggressive pricing practices used as part of “start-up lottery”.	Being forced to reform pricing practices will increase sustainability of funds, but may see some, especially new, providers lose “start-up lottery”. Along with cost implication of obtaining actuarial input, this may disincentivise take-up of the own microinsurance licence option.

17 We do not include aspects of the microinsurance definition, such as the proposed benefit cap or the need for short contract terms or sum assured policies, as these are not expected to deviate from current business practices in the industry.

18 5% of the net written premium over the previous 12 months, subject to a minimum absolute amount of R3 million. Microinsurers will be permitted to build capital up to the minimum required level over a 3-year period starting from the enactment date of the proposed microinsurance regulation, subject to a minimum of R1.5m.

19 According to formulae to cover unearned premium reserve, outstanding claims reserve, incurred but not reported reserve and unexpired risk premium.

Regulatory proposals	Current practices	Likely business implications of formalisation
Minimum corporate governance standards to be applied ²⁰	Governance largely owner-manager driven	Need for corporate governance will require fundamental change in way business is run and may disincentivise own microinsurance licence.
Accounting and reporting requirements (annual audited and quarterly unaudited statements to be submitted to FSB)	Limited, largely paper-based accounting	Imposition of such requirements will strengthen business management practices, but likely to have significant cost implications for smaller, younger providers, causing many to exit (if requirement is imposed) or to avoid own licence option.
Maintaining a client complaints system	No formal recourse	Cost and operational implications
Tax and business registration compliance required for microinsurance licence, with tax amnesty considerations and plans for business support to those opting to formalise	Many not formally registered or tax compliant	Broader formalisation requirements likely to serve as disincentive to obtain own microinsurance license – unless successful tax amnesty and business support as part of microinsurance implementation strategy.
Intermediation requirements:	Only 7 out of sample of 72 are FAIS compliant	Compliance cost and operational impact of FAIS compliance will depend on whether the provider registers as an FSP in its own right or whether the underwriting insurer (for any of the scenarios other than own microinsurance licence) allows it to become its representative. If the latter, impact is likely to be relatively low. If the former, impact will have to be calculated on a case by case basis, depending on number of key individuals and representatives and size of business. Impact is likely to be substantial and may disincentivise formalisation.
FAIS registration as financial service provider, including meeting application requirements, paying registration fee		
Ongoing requirements, including appointing a compliance officer, submitting of annual financial statements, paying annual levies,		
All key individuals and representatives to meet fit and proper requirements, including experience requirements, qualification requirements, regulatory exams and continuous professional development requirements		
Complying with a FAIS Code of Conduct to be developed for microinsurance, including tailored requirements regarding conducting of suitability analysis and record of advice		

Source: main study

20 including need for board and fit and proper board and management

It is clear from Table 4 that, despite the proposed microinsurance regulatory requirements being simpler/lower than those for “full” long-term or short-term insurers, formalisation will entail a significant change in the way that currently-informal providers do business, will require a large capital outlay and will have significant operational cost implications.

Microinsurance licence not a viable option for most. Many of the impacts indicated in the table will be likely to disincentivise formalisation or, at the least, the option of applying for an own microinsurance license. It is furthermore important to note that, though the proposed microinsurance regulatory framework does not impose any minimum risk pool requirements, almost 90% of the sample would not be able to become microinsurers if one were to consider the size of their risk pools. A risk pool needs to have at least 4,500 policyholders to be considered viable from a risk perspective²¹. Only 7.5% of informal funeral service providers surveyed indicated that they have 4,500 policyholders or more. The majority of informal funeral service providers have only 1,000 policyholders and the sample average is 1,274 policyholders. Thus a large proportion of informal funeral service providers are at risk of having too few policyholders to ensure that the difference in risk experience between the actual number of deaths and the expected number of deaths is manageable.

This indicates that the majority of informal funeral service providers would be unable to become microinsurers and may rather have to seek underwriting from a licensed insurer. Thus many of the prudential requirements set out in the table above (such as actuarial sign-off on pricing, capital requirements and governance requirements) will not apply. However, under either one of the other formalisation scenarios (underwriting, partnering or consolidation) they would still have to separate their funeral service and insurance business by paying over the collected premiums to a licensed insurer; thereby foregoing funds that they currently use for business start-up and expansion up the value chain over time. Furthermore, they would have to offer clients the option of a monetary benefit and would need to become FAIS compliant under all scenarios, with all the corresponding implications.



21 A risk pool needs to have at least 4,500 policyholders to achieve 95% certainty that the actual number of deaths does not exceed the expected number of deaths by more than 7.5%. This is based on an assumption of 100 deaths per 1,000 policyholders/main members. Although the risk tolerance margin can be set at different levels, here we have used a risk tolerance of no more than 7.5% of the expected number of deaths as this is the additional mortality margin prescribed by the South African Actuarial Society in the calculation of financial reserves (under the Financial Soundness Valuation Methodology).

6. Conclusion

The main finding of the study is that most funeral parlours in our sample would not be able to comply with the proposed regulation without either substantial assistance and support or partnering/merging with other entities.

What do these findings mean for policymakers and regulators? No regulatory framework is without compliance implications. In the case of the proposed microinsurance framework, a process of extensive stakeholder consultation was followed to develop the parameters for the framework and every effort was made to design each aspect so as to balance compliance implications with the consumer protection and financial inclusion benefits thereof. Nevertheless, the findings of the current study indicate a dilemma for the regulator where informal funeral insurance providers are concerned:

- **Imperative for formalisation to protect consumers.** On the one hand, the current risk management practices and the nature of informality strongly confirm the need for formalisation of insurance provision and intermediation by funeral service providers to ensure the protection of vulnerable consumers.
- **Regulatory response likely to disincentivise formalisation or force players out of the market.** On the other hand, it is clear that these businesses use their insurance income to fund the start-up, expansion and potentially even formalisation of their larger business (including the funeral service component) over time. The proposed microinsurance regulatory regime aims to incentivise formalisation by defining microinsurance to pose a lower level of risk than other classes of insurance and then setting regulatory requirements proportionately vis-à-vis a “full” long-term or short-term insurance licence. Despite the “carrot” of lower regulatory requirements, the likely impact of compliance on the modus operandi of funeral service providers as set out in Table 4 means that most will have every incentive to avoid formalisation. If the implication is that they continue to operate informally, the purpose of the regulatory framework will be defeated.
- Thus the enforcement “stick” will be a prerequisite to formalisation. However, should informal funeral insurance providers be forced to formalise, the study finds that many of them will be unable to survive on their funeral service income alone. Unless they find alternative financing mechanisms, many will face bankruptcy. Enforcement of formalisation may therefore lead to a smaller and potentially less competitive industry. This is clearly not desirable, given the fact that this is a largely black-owned micro, small and medium enterprise industry that employs a number of people and provides access to insurance services in many areas that may not be otherwise served. It may furthermore be that, while informal funeral service providers are providing services at a price and in a manner that is not altogether consumer friendly, they are nevertheless honouring claims by providing a funeral service, meaning that it will not be desirable for them to close down. Therefore there is a need to balance consumer protection considerations against the likely consequences of enforcement.
- **Findings confirm need for enforcement in tandem with formalisation support.** The 2011 Policy Document states that government will assist informal providers to formalise by being lenient in respect of previous non-compliance with tax legislation and by providing assistance to those willing to formalise, but cautions that a zero tolerance policy will be applied to those who continue to operate illegally. The findings of this study confirm that both of these elements (an effective enforcement strategy on the one hand, as well as business support to those who are being formalised on the other hand) will be essential to the success of the framework. The challenge will lie in effectively implementing both of these elements.

Four recommendations in this regard stem from the study findings:

1. **Effective enforcement calls for industry education.** Many of the providers in the sample know what the FSB is, but do not understand the FAIS framework or its requirements. While greater awareness of regulatory requirements will not automatically lead to compliance, this finding suggests that compliance will not be achieved without awareness. Thus “industry education” is just as important as consumer education and needs to be part-and-parcel of any enforcement strategy.
2. **Business support to include financing strategies.** Government will not only have to provide general business support; it will also have to facilitate access to finance so as to allow providers to purchase the necessary assets to migrate to a full service provider without having to rely on the funds generated by informal insurance in the process.



3. **Option of partnerships or merging.** The option to merge/partner should be considered as a mechanism to ensure business survival and aid compliance, along with the role that associations might play. The enforcement approach adopted should accommodate this option.
4. **Regulatory impact assessment.** The results of our study confirm the current risks in the industry as well as the anticipated regulatory impact of proposed legislation. While there is a need for a detailed cost-benefit analysis of the proposed microinsurance regime on funeral service providers - from both a market conduct and a prudential point of view, given the current stage of development of new legislation, it is important that the details of regulation that are currently being finalised reflect and take into consideration the likely impacts and recommendations that our study highlights.

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