The role of policy, regulation and supervision in

Making insurance markets work for the poor

The case of South Africa • October 2008

By Christine Hougaard, Hennie Bester and Doubell Chamberlain. Based on the country report by Hennie Bester, Doubell Chamberlain, Christine Hougaard, Anja Smith, Simon Hendri and Tim Hobden (Genesis Analytics)

micro insurance network

This document is focus note 6 in a series of 12 produced as part of a five country study on the role of policy, regulation and supervision in making microinsurance work for the poor. See page 7 for further details.

Introduction

Access to insurance may be an important strategy for reducing poverty. Financial markets, and particularly insurance services, can help poor people manage critical risks such as death in the family, illness, or loss of income or property. Despite the growing importance and expansion of microinsurance services geared to low-income people, microinsurance penetration remains limited, leaving the vast majority of poor people without adequate protection.

This focus note explores the state of microinsurance in South Africa and the factors that influenced the development of this market specifically considering the impact of policy, regulation and supervision. The individual country reports and summary findings can be accessed at www.cenfri.org.

Table of Contents

1 South Africa economic and financial sector context[1]

Economic context. South Africa is a middle income country with a population of around 47m, of which 59% live in urban areas. The country has recently experienced modest economic growth, averaging around 4% since 2000. Underlying this, however, is a history of inequality[2] and poverty[3], which, in terms of access to financial markets, has created a distinct divide between the intensively served high-income end of the market and the low-income market, the latter largely excluded from the formal sector. The informal markets that have developed in this void, together with the various policy and regulatory forces impacting on the market in the post-apartheid era, have shaped the dynamics of the South African microinsurance market in a way that provides valuable insights for other jurisdictions.

The formal financial sector is sophisticated and well regulated. South Africa has a well developed, sophisticated financial sector. The five biggest banks account for up to 90% of total bank sector assets[4]. Usage of financial services has risen to 60%[5] of adults. The payment system infrastructure is strong, with in excess of 15,600 ATMs (Automatic Teller Machines) and a multitude of POS (Point of Sale) devices spread across the country in 2006[6]. With a premium to GDP ratio of among the highest in the world (16%[7]), the insurance sector is well developed. There are 75 commercial long-term (life) and 97 short-term (non-life) insurers. No composite insurers are allowed.

Traditional high-income focus. The industry has traditionally served mostly the high-income end of the market, and only recently started to focus on ways in which to innovate (in terms of products and especially distribution) to better serve the low-income market. In the traditional formal vacuum, a robust informal market of risk-pooling via mutual burial societies has developed. It is estimated that there are up to 100,000 such societies serving more than 4 million individuals, almost exclusively for funeral insurance. In addition, funeral service providers often self-insure even though they are not licensed for insurance purposes.

2 Salient features of the micro-insurance market

Figure 1 captures the key characteristics of the microinsurance market in South Africa:

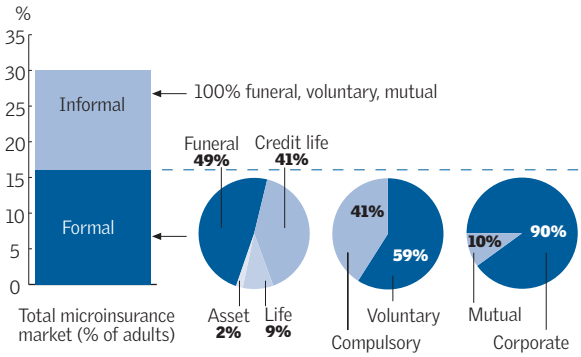

Figure 1. Composition of the South African microinsurance market

Source: FinScope (2006); National Credit Regulator consultations and authors' estimates (for credit life).

The diagram indicates:

Usage. Microinsurance usage in South Africa is estimated at 30% of adults – the highest among the sample countries. Formal insurance accounts for just more than half the market, with the rest being informal risk-pooling via burial societies as well as self-underwriting by funeral parlours not authorised as insurers.

1 Unless otherwise specified, all information and data in this focus note stem from: Bester et al (Genesis Analytics), 2007. Unpublished South African country study: IAIS/MIN JWGMI study on the role of regulation in the development of microinsurance markets. It represents the latest available information at the time of writing of the country report.
2 Inequality remains high, with the Gini coefficient estimated at 57.8 by the UNDP's Human Development Report of 2007/08. (UNDP, 2008. Human Development Report 2007/08. Available at: http://hdr.undp.org/statistics/ (accessed March 2008))
3 About 36% of the South African population of around 47m lives on less than $2 per day and 18% on less than $1 per day (World Bank, 2007. World Development Indicators. Poverty statistics and other data extracted from: http://ire-search.worldbank.org/PovcalNet/jsp/CChoiceControl.jsp?WDI_Year=2007 (accessed March 2008)).
4 Calculated from South African Reserve Bank data, 2008. Available at: http://www.reservebank.co.za/internet/Live%20SDDSAppl.nsf/sddsdata?openagent#5/
5 FinMark Trust, 2006. FinScope South Africa survey, 2006.
6 PriceWaterhouseCoopers, 2007. Pan-Africa Banking Survey 2007. Available at: http://www.pwc.com/extweb/pwcpublications.nsf/docid/CED744E8355691B980257296004A1E88
7 Swiss Re, 2007. World Insurance in 2006.

Players. There are 75 commercial long-term (life) and 97 short-term (non-life) insurers. No composite insurers are allowed. The formal market is dominated by corporate insurers. Though the two largest insurers originally developed as mutuals, they demutualised to become public companies towards the end of the 1990s. Today, there is only one mutual insurer[8]. In addition, there are a number of burial societies providing funeral insurance formally (as friendly societies), within a limited-benefit space provided for them under the insurance legislation. On the informal side it is estimated that there are between 80,000 and 100,000 mutual burial societies serving between 4 and 8 million individuals[9], as well as between 3,000 and 5,000 funeral parlours providing funeral cover – of which we estimate 50% to do so formally, i.e. with underwriting by registered insurers, and 50% informally. All in all, almost two thirds of the demand for funeral insurance is met informally.

Products. Lately, formal insurers have started to move down-market, focusing on innovations for more appropriate products. This is partly due to industry associations' efforts to create product standards for the purpose of complying with the Financial Sector Charter (see regulatory discussion below). The criteria for these standards include fair charges, easy access and decent terms (so-called CAT standards). As a result, various products are now available that provide cover at as little as $3-7 per month and that are characterised by simple and flexible terms.

The South African microinsurance market is distinguished from most of the international experience in that voluntary insurance accounts for the majority of the microinsurance market. Compulsory credit life insurance accounts for only about 22% of the total microinsurance market. This figure moves up to 41% when only focusing on the formal market[10]. The increasing prominence of credit life insurance is largely the result of the development of the micro-credit market in South Africa. Funeral insurance however still clearly dominates (at 72% of the total microinsurance market and 93% of the voluntary market). The cultural necessity for a dignified (and thus costly) funeral drives the demand for funeral insurance.

Non-life and non-funeral life insurance have achieved limited take-up among the poor, despite recent innovations and the introduction of housing, cell phone, personal accident and other types of insurance targeted at the low-income market. Focus group insights indicate this to be a function of affordability and a lack of awareness of the value proposition offered by such products. The only asset-based insurance product starting to achieve some voluntary take-up is cell phone insurance. This reflects the rapid adoption of mobile telephony and the very important role played by the cell phone as personal and business communication tool in the lives of the poor – a phenomenon strongly supported by the focus groups.

Distribution. In all successful microinsurance products, intermediation innovations have played an important role. These include the use of the cell phone as communication and sales tool, as well as joint ventures with retailer chains and even with low-income groups such as church networks or sports clubs as distribution channels. Innovation in microinsurance distribution has been made possible by the availability of a large, well developed retail network in South Africa, as well as a sophisticated payment system. Due to the restrictive market conduct regulation, all these products are sold in a passive, "off the shelf" way, with no or limited advice and verbal disclosure of product terms. Rather, insurance policy contracts are filled out using a "tick-of-the-box" approach that requires minimal insurer or sales person engagement. This is a feature that only characterises models aimed at the lower-income market. High-income individuals tend to be served via the traditional broker/agent model. Low-income market products are also sold on a group basis and with contract periods of no more than one year (with the norm being one-month contracts renewable with the payment of each premium). All of this has assisted in bringing down the risk, both from an underwriting and a market conduct point of view, of insurance products sold to the low-income market and the implicit emergence of a "microinsurance" category of products. A regulatory review process has been launched with the intent to formalise the definition of microinsurance in order to tailor regulation to its specific risk characteristics.

8 Mutual insurers are not allowed unless a special act of parliament is passed to provide for them.

9 Of these burial societies, only 180 are registered friendly societies. Under the Friendly Societies Act, only friendly societies with a turnover of more than R100,000 (about $1,300) need to submit annual financial statements and adhere to the requirements of the act. Only 74 out of the 180 registered friendly societies resort in this category.

10 Note that this is a conservative estimate and that the share of credit life insurance may therefore be higher.

3 The insurance policy, regulation and supervision landscape

Insurance in South Africa is primarily regulated by the Long-Term Insurance Act (52 of 1998) and the Short-term Insurance Act (53 of 1998), governing respectively the life and non-life insurance industries. The Financial Services Board (FSB) is the statutory body in charge of supervision. Health insurance (in the form of indemnity benefits covering medical expenses) is regulated separately under the Medical Schemes Act (131 of 1998) and does not fall under the supervision of the FSB. In addition, certain elements of the Friendly Societies Act (25 of 1956) and the Co-operatives Act (14 of 2005) are of relevance. Market conduct is regulated primarily through the Financial Advisory and Intermediary Services (FAIS) Act (37 of 2002). Below, the main aspects of the regulatory scheme are discussed.

Institutional and prudential regulation. Only public companies with insurance as their main business are allowed to register as insurers under either the long-term or short-term act. No company may have more than one insurance license and no composite licenses are possible. Registered friendly societies may provide insurance without registering under the insurance acts, provided that their policy benefits do not exceed R7,500 (about $930). Under the Co-operatives Act, registered financial cooperatives may provide insurance but must register under the long or short-term act to do so. In effect this implies that they must convert to a public company, undermining the intent of the Act to facilitate the delivery of financial services by cooperatives. Prudential regulation requires minimum upfront capital of approximately $1.3m for life and $0.7m for non-life insurers.

Product regulation. Upon registration, each insurer is authorised to provide a number of classes of policies as defined under each act. No product pre-approval is required, though insurers are required to report separately to the FSB on each class of policies they provide. In the case of the Long-term Act, it is possible to register as an "assistance business" (funeral insurance) provider only, with assistance business policies defined as policies not exceeding R18,000 (about $2,350) in value. Though no prudential or institutional concessions are made for assistance business-only insurers, assistance business is granted special regulatory treatment in a number of instances: it is the only class of product for which no commission caps are imposed and its intermediaries are temporarily exempted from the education requirements under the FAIS Act. Insurers are required to give assistance policyholders the option of a monetary benefit, even in cases where the terms of the policy contract specifies that payment will be in kind (i.e. the provision of a funeral). Assistance business is the only product subject to this requirement.

Market conduct regulation. Market conduct regulation is primarily contained in the FAIS Act. It sets the conditions for the intermediation of insurance (and other financial services) to the public in order to enhance consumer protection. Amongst others, it requires all intermediaries providing advice or intermediary services to be authorised to do so by the supervisor. Intermediary services are defined as actions requiring the person to exercise judgment that leads the client to enter into a transaction. Advice encompasses intermediary services, but also includes the recommendation of a product choice. Authorisation entails various education, experience, fit and proper, reporting and other requirements[11].

FAIS does not require advice to be provided on all transactions, but *where furnishing advice*, the FSP is obliged to conduct an analysis of the client's financial needs, identify the products that will be appropriate to his/her needs and take reasonable steps to ensure that the client understands the advice and makes an informed decision. Furthermore, records of client interactions and advice should be kept for a minimum of five years. In terms of a guidance note issued by the FSB, financial products may be sold by *non-authorised* intermediaries as long as they do not provide advice or intermediary services, that is, as long as they do so in a passive, clerical way that does not require the exercise of judgment. This has opened the space for "tick-of-the-box", advice-less sales models, which in turn have found application in the various innovative models currently on the market.

In addition to FAIS, commission levels payable to intermediaries are capped under the regulations to

11 Including: the need to appoint a compliance officer; the need to maintain externally audited accounting records; an annual levy; the duty to supply factually correct information to the client and to confirm this in writing upon request; and the duty to disclose the nature and extent of any remuneration.

the Long-term and Short-term Acts (with the exception of assistance business, as indicated above).

Financial inclusion policy and regulation. Since democratisation in 1994, South Africa has been characterised by a drive towards black economic empowerment. As part of this process industry, labour and other stakeholders within the financial sector in 2003 negotiated and signed the Financial Sector Charter as a commitment by the formal industry to implement black economic empowerment that includes the extension of financial access to the low-income market. The charter also commits government to provide a facilitative regulatory framework for the achievement of the charter targets and goals. The access targets for insurance require that 6% of the low-income[12] population have effective access to short-term and 23% to long-term insurance by 2014. This equates to 1.2m short-term and 4.5m long-term policyholders (FinScope, 2006). "Effective access" is defined in terms of the distance to the nearest service point, the range of products and services available, their appropriateness to the needs of the low-income market, and whether they are affordably priced and structured and described to customers in a simple and easy to understand manner. In addition, industry is committed to spending 0.2% of post-tax profits on consumer education.

Other regulation of note includes the implementation in 2007 of the National Credit Act of 2005. This has implications for the credit life insurance industry in that it reiterates the client's right to choose the provider of insurance, should the credit provider compel them to take out credit life cover, as well as for transparent sales and pricing of credit life insurance.

Current reconsideration of insurance legislation as it pertains to microinsurance. Concerns about potential consumer abuse in the low-income market, combined with government's commitment under the Charter to remove regulatory barriers to market development, have prompted the National Treasury (the policy-making body for the financial sector) to reconsider the insurance regulatory framework in South Africa. The aim is to create a microinsurance regulatory space to (i) bring down regulatory unit costs in order to facilitate outreach into the lower income market by formal insurers and (ii) provide formalisation and graduation options for the informal market.

Risk-based microinsurance space proposed. The chosen route for creating such a dedicated microinsurance framework has been to tailor regulation to the risk associated with microinsurance provision. This is in line with the risk-based approach to regulation and supervision and ensures that no regulatory concessions are passed that will lead to unsound insurance practices. The first step in creating such a framework is to define microinsurance as a product category for regulatory purposes. This microinsurance definition must be crafted so as to limit the product space to those products exhibiting lower risk characteristics. Once such a definition has been established, regulation can be tailored to the microinsurance product category. For dedicated microinsurance providers this will imply a dedicated microinsurance license to facilitate entry and competition, independent of institutional form, as well as a tailored prudential and market conduct regime. Proposals for such a framework are contained in a Discussion Paper released by National Treasury for public comment during 2008[13].

4 Impact of policy, regulation and supervision on the market

Regulation has shaped the microinsurance market in a number of ways.

Financial inclusion policy drives low-income market expansion and triggers innovation. The access targets contained in the Financial Sector Charter have been the main driving force in formal sector expansion over the past few years. In this quest, it has proven essential to bring

12 Defined as the LSM (Living Standards Measure) 1-5 population. The LSM measure uses location (urban vs. rural), ownership of household assets and access to services to group individuals into one of ten potential LSM categories. The average income across LSM1-5 is about $300 per household, or $100 per individual per month. The average individual income in LSM 5 amounts to about $140 per month (FinScope, 2006).

13 National Treasury, 2008. Discussion Paper: the future of microinsurance regulation. Report prepared by Genesis Analytics. Available at: www.treasury.gov.za (accessed April 2008)

down transaction costs. The intermediation innovation described above has emerged as the most viable avenue for achieving lower transaction costs and larger scale reach.

At the same time FAIS Act increases intermediation costs. The greater drive towards consumer protection embodied in the FAIS Act increases the per transaction cost of intermediating financial services, creating a disincentive to serve lower-income (and hence lower revenue-per-premium) clients. This is especially true where advice is provided as part of the sales process. However, since the regulation allows financial products to be sold by non-authorised intermediaries as long as they do not provide advice or intermediary services, this has opened the space for "tick-of-the-box", advice-less sales models that in turn have found application in the various innovative models currently on the market. The result of (i) the need for low-income market expansion under the Charter, (ii) the increased transaction costs under FAIS and (iii) the space for advice-less sales, is a split of the market into a high-income end served with detailed financial advice, versus a low-income market served through advice-less selling techniques. The implication is that the low-income market receives no advice in the insurance products that they buy.

Regulation inhibits the formalisation of the large number of informal providers. Current institutional regulation inhibits the formalisation of mutual groups by requiring registered insurers to be public companies. Given the important role of burial societies in the funeral insurance market, this undermines formal microinsurance development. Furthermore, existing prudential regulation, set at uniform levels for respectively the life and non-life categories, is not commensurate to the risks inherent in microinsurance products.

Strict demarcation undermines the development of short-term microinsurance. Demarcation between short-term (non-life) and long-term (life) insurance implies that short-term insurers are not able to offer funeral insurance, which is classified as a long-term insurance product. In practice, however, the product characteristics of funeral insurance as provided in South Africa correspond to that of short-term insurance rather than long-term insurance, as these products tend to be written on a one-month or one-year at most renewable contract basis. Given the dominance of funeral microinsurance, an inability to provide funeral insurance is a serious disadvantage to low-income market expansion.

5 Key insights and lessons from South Africa

High voluntary microinsurance uptake. South Africa is unique among countries where some form of microinsurance exists in that a large voluntary market for micro-insurance exists in the form of funeral insurance. Social risk-pooling mechanisms (burial societies) and funeral parlours account for the majority of the total demand. However, the highly sophisticated formal insurance market is also increasingly expanding down-market, partly as a result of Financial Sector Charter commitments.

Microinsurance driven by demand for underlying service rather than insurance per se. Microinsurance in South Africa has primarily grown on the back of demand for the underlying funeral service, rather than via compulsory credit life insurance. The cultural significance of a dignified burial in African society is therefore the primary driver of the uptake of funeral insurance. Communities have organised themselves informally through burial societies and funeral parlours to mitigate the risk of covering the substantial and usually unexpected cost of a funeral. Although this informal market is prone to abuse (usually from the funeral parlour side) it does provide much needed risk mitigation for low income families. As formal providers have increasingly catered for this market, the risk mitigation options available to low income families have increased and so has their uptake of formal funeral insurance products. Now the market faces the challenge of also selling other life products as well as non-life insurance to their funeral insurance clients. Since these products require active selling, market extension has up to now been inhibited by the onerous market conduct regulation (FAIS Act). The new microinsurance regulatory framework aims to reduce the cost of selling and also allow previously informal providers to formalise.

Primacy of distribution. Effective market provision of microinsurance requires the distribution of

products with low value premiums. Low cost distribution is therefore critical to success. Although the cost of distribution can be substantially increased by regulation (as discussed above) it can also be substantially reduced by innovations in the use of distribution channels. South African insurance providers have been successful in using distribution channels beyond the traditional agent/broker model. These include the use of large retailer networks, pre-paid airtime networks as well as aggregated groups of clients such as large church organisations.

Lack of awareness remains a key obstacle: Beyond funeral insurance the general awareness amongst low income persons of the value of insurance for other risks they face, remains low. Simply providing suitable products will therefore not necessarily lead to substantial uptake of such products – they will have to be sold to clients. The South African experience shows that this is best done when the products are bundled with insurance for which there is a demand (such as funeral) or sold when the client buys a non-insurance product or service.

Proposed new microinsurance regime takes on board lessons. The current proposed regulatory reform (initiated by the South African National Treasury to correct market imperfections) is encouraging in that it suggests an active engagement of the regulatory authorities to address the challenges highlighted by the case study. It also forms part of a broader policy to empower the previously disadvantaged citizens of the country. Should the proposal for regulatory reform be accepted and enacted, it will provide a valuable case study on the impact of regulatory change on the development of a microinsurance market. ■

The focus note series

Focus note 1: What is microinsurance and why does it matter? The rationale for microinsurance from a regulator's perspective.

Focus note 2: The role of policy, regulation and supervision in making insurance markets work for the poor: Executive summary and emerging guidelines.

Focus note 3: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of Colombia.

Focus note 4: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of India.

Focus note 5: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of the Philippines.

Focus note 6: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of South Africa.

Focus note 7: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of Uganda.

Focus note 8: Risk it or insure it? Understanding the microinsurance purchase decision.

Focus note 9: Ensuring mutual benefit: The role and regulation of member-owned insurers.

Focus note 10: Informal insurance: a regulator's perspective.

Focus note 11: The impact of policy, regulation and supervision on the development of microinsurance markets.

Focus note 12: Making a market for microinsurance: the success and failure of different channels of delivery.

Federal Ministry for Economic Cooperation and Development

About this document

To support the development of microinsurance markets, a project was launched under the auspices of the IAIS-MIN JWGMI[I] aimed at mapping the experience of five developing countries – Colombia, India, the Philippines, South Africa and Uganda – where microinsurance markets have evolved in varying degrees.

The objective was to assess how much regulation has affected the evolution of these markets and gain insights which can guide policy-makers, regulators and supervisors looking to support the development of microinsurance in their jurisdiction.

To disseminate the findings of this project, a number of focus notes have been written to highlight themes that emerged from it. This document is the sixth focus note in a series of 12 – six thematic focus notes and six notes summarising each country study.

The project was majority-funded by the Canadian IDRC[II] (www.idrc.ca) and the Bill and Melinda Gates Foundation (www.gatesfoundation.org), with funding and technical support from the South African-based FinMark Trust[III] (www.finmarktrust.org.za) and the German GTZ[IV] (www.gtz.de) and BMZ[V] (www.bmz.de). FinMark Trust was contracted to oversee the project on behalf of the funders. With representatives of the IAIS, the ILO, the Microinsurance Centre and the International Cooperative and Mutual Insurance Federation (ICMIF), the funders are also represented on an advisory committee overseeing the study.

I International Association of Insurance Supervisors (IAIS) and Microinsurance Network (MIN) Joint Working Group on Microinsurance
II International Development Research Centre
III Funded by the UK Department for International Development (DFID).
IV Deutsche Gesellschaft für Technische Zusammenarbeit GmbH.
V Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung - Federal Ministry of Economic Cooperation and Development

These focus notes and other material related to the project can be downloaded at www.cenfri.org.
For more information, please contact the project coordinator, Doubell Chamberlain: Doubell@cenfri.org

Centre for Financial Regulation and Inclusion,
University of Stellenbosch Business School Campus,
Carl Cronje Drive, Bellville, Cape Town, 7530, South Africa;
+27 21 918 4390; www.cenfri.org

www.microinsurancenetwork.org