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Brokering change in the low-income market
The threats and opportunities to the intermediation of microinsurance in South Africa

Prepared for FinMark Trust and the Ford Foundation

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EXECUTIVE SUMMARY

South Africa is faced with the challenge of extending insurance products to low-income individuals. The insurance sector recently started to act upon this realisation by re-examining the insurance needs of low-income households. This change in focus was triggered by a number of factors, including the access targets set in the Financial Sector Charter (FSC), non-insurer players' entry into the low-income space for insurance and an increasingly contested high-income market. Although product development for this market can prove challenging, finding appropriate and efficient distribution mechanisms in serving the low-income market seems equally challenging.

This study was commissioned with the goal of identifying and reviewing the threats to and opportunities for the intermediation of insurance to low-income (LSM 1-5) households in South Africa. The terms of reference of the study included a specific focus on the broker as an intermediary category and an assessment of the broker's ability to successfully sell insurance products to the low-income market.

The first section will briefly look at some of the fundamentals that are important for the discussion to follow. Following on from a summary of the findings we will note the market and regulatory trends shaping microinsurance intermediation. From this we will identify three drivers of successful intermediation of microinsurance and finally answer the question "can the broker re-invent themselves to serve the lower-income market"?

FUNDAMENTALS

In this section we will briefly discuss what intermediation means, describe the intermediary framework that was developed in this study and note the segmentation of the low-income market into groups with similar distribution characteristics.

Understanding intermediation. Distribution is not only limited to sales activities, but encompasses a variety of administrative and intermediation activities necessary to deliver the product to the customer. These activities include marketing, sales, premium collection, policy and client management, policy administration and claims payment. In addition, these distribution activities may be conducted by various

entities and the roles of specific entities may vary from case to case. The major components of the distribution channel are identified as the risk carrier, administration, intermediation and a technology platform.

Intermediary framework. In order to assess the differential impacts of market and regulatory forces on different intermediaries, the first part of the study developed a framework within which to map various types of intermediaries. Taking into account each category's distinctive features, five categories of intermediaries were identified:

- Brokers;
- Captive agents;
- Independent multi-function intermediaries;
- Captive multi-function intermediaries; and
- Organised low-income groups.

Segmenting the low-income market. On the demand-side, the study considered the characteristics of the low-income market. The adult LSM 1-5 population is not a homogenous group (consisting of 19m individuals) and was, for the purpose of assessing distribution potential, divided into groups with consistent distribution characteristics. Two key factors, 'consistency and source of income' and 'availability of formal point of access for insurers' (e.g. workplace), were used to categorise the adult LSM 1-5 population into four groups. These groups varied from those that, from a distribution point of view, are:

- easy to reach;
- easy to reach, but where incomes are inconsistent and, as a result, product adaptations will be required;
- not easy to reach, but where incomes are consistent; and
- hard to reach.

These groups were then described in terms of a number of characteristics relevant to distribution. With this information the study was able to evaluate the distribution potential of the four groups and provide an overview of the size of unserved markets within reach of existing formal and informal client touch points.

SUMMARY OF FINDINGS

This section will include the major findings of the report, as well as, some of the threats and opportunities to microinsurance intermediation.

Opportunity: The review finds that a large number of unserved clients are within reach of existing formal and informal client touch points. In LSM 1-5 there are the following groups of people who do not have formal insurance:

- 4.2m people who have bank accounts;
- 3.3m people who have a pre-paid cell phone;
- 1.4m people who have store cards/accounts; and
- 2.2m people who are members of burial societies.

As a result, for a large proportion of LSM 1-5, premium collection is not the main constraint to reaching the uninsured as they are already accessing other formal and informal networks that could serve as potential payment collection systems. The significant numbers of people accessible through existing client touch points shows that the FSC targets are well within 'distribution' reach.

Growing focus on the provision of microinsurance. In addition, both formal insurers and other organisations are actively targeting the low-income market. This is not only driven by the Financial Sector Charter (which only applies to formal insurers), but by perceived opportunities for profit in this market. It is thus an increasingly competitive environment and multiple delivery models are emerging. This leads to growing pressure on insurers to produce better value propositions and gain ownership of customer groups.

New cost-effective distribution models are emerging, but have yet to show results. Traditional (and particularly advice-based) intermediation models have not been able to extend significantly into LSM 1-5 (even before FAIS) and have been limited to the banked and employed. Furthermore the cost modelling conducted as part of this review suggests a limited role for the advice-based sales model of brokers in LSM 1-5.

A number of new intermediary models are, however, emerging that are able to reach LSM 1-5. These models are able to collect cash premiums, rely on passive, tick-of-the-box selling and, therefore, do not provide advice. Importantly, these

distribution channels extend beyond banked and employed clients and are, therefore, able to serve a large proportion of LSM 1-5.

The emergence of the tick-box approach points towards the commoditisation of insurance. This means that the insurance product is no longer sold within a relationship, especially a relationship with a broker. It is sold as a commodity, i.e. a standardised product. In addition, there is a move to multiple contact points to deal with the distribution of the same product – personal contact, cell phone, contact centre, retail or other point of contact. This trend to client-centric rather than broker-channelled communication has been facilitated by low-income consumers coming "on grid", especially via cell phone uptake. The ability to communicate directly and immediately via a very popular medium (SMS) has increased the viability of non-debit order premium collection. Experience shows that significantly better payment performance can be achieved by sending SMS reminders, which can be generated at very low cost.

However, despite all of these improvements and innovations, little penetration has been achieved beyond funeral insurance and it is not clear whether these new intermediary models will achieve take-up as they are faced with a number of limitations. Most critical is the concern over the level of disclosure provided in the sales process and the fact that these models employ a passive sales methodology expecting clients to approach the distribution points for insurance rather than the other way around. The entry of these new models could have a double impact. It is pushing market makers (brokers/agents) out of the market, but due to a passive sales methodology is not replacing the market making function previously fulfilled by brokers/agents. In addition, the lack of even disclosure in some models runs the risk of mis-selling and, as a result, a potential regulatory backlash. If the models currently providing no advice are allowed to continue operating in this manner, it could have negative repercussions for the market as a whole, especially for those models currently providing policy disclosure, but no advice.

Major risk for market players to generalise observable trends in funeral insurance to hold for non-funeral insurance products. There is an innate culturally-driven demand for funeral insurance in South Africa, particularly amongst the low-income market, where it is by far the largest category of insurance being used. Unlike other types of insurance, funeral insurance is, therefore, bought not sold. Products such as credit life insurance have achieved penetration based on compulsion and by being bundled with other products. It is unlikely to have achieved the same

penetration if it has been sold on a voluntary basis. Funeral and non-funeral products, therefore, require very different intermediation approaches to succeed in the low-income market. Whereas the former can rely on some form of passive selling, the latter requires active selling.

Regulation has placed the cost of advice beyond that which can be afforded in the low-income market. Even before the introduction of FAIS, traditional advice-based intermediation models had not been able to extend significantly into LSM 1-5. Given the cost of conducting advice-based intermediation, there has been little commercial incentive for advice-driven intermediaries to pursue this market and the introduction of FAIS combined with the debate on commission restructuring is likely to remove the little incentive there was. Cost modelling conducted as part of this review suggests that it is unlikely that advice-based sales model of brokers will be able to profitably serve any significant proportion of LSM 1-5.

Does active selling mean the same as providing advice? We argue that it does not. In fact, the regulatory review suggests that guidelines issued by the regulator implicitly also differentiate between “selling” and providing advice. However, given the lack of clarity on this distinction (due to conflicting regulatory signals from the FSB and FAIS Ombud), the market has effectively bifurcated into active, advice-based selling or completely passive, advice-less selling. The result is, therefore, that the only active selling models operational in the market are, therefore, ruled out by increased regulatory cost of providing advice.

This leads to a conundrum: To go beyond funeral insurance in the low-income market requires active selling (e.g. proactive human interaction). Yet regulation, by combining active selling with advice, is making active selling more expensive and beyond the reach of the low-income market. Unless some agreement can be reached on a definition of “active sales”, which does not equate to providing advice, this study concludes that it is unlikely that any take-up beyond funeral insurance will be achieved in the low-income market. And while non-advice is pushing advice out of the low-income, it is not clear that the regulatory space for non-advice will continue to exist.

International microinsurance developments have not revealed any silver bullets that can be applied in South Africa, but confirm that multi-function models are required to achieve scale and viability at low premium levels. Traditionally, microinsurance in other countries has been distributed through microfinance

institutions (MFIs). However, MFI models have not achieved success in distributing *voluntary insurance* and are limited to their members. Furthermore, international experience suggests that insurers are not guaranteed a permanent distribution mechanism through MFIs as there are also other options available to MFIs to mitigate credit risks, including becoming insurers themselves. In addition, reinsurers are finding new ways of linking directly with microinsurance client groups and placing further pressure on the insurer to establish its value proposition. Significantly, none of the international intermediation models reviewed relied on passive sales methodologies but employed varies means and mechanisms to actively sell products to potential clients.

MARKET AND REGULATORY TRENDS SHAPING MICROINSURANCE INTERMEDIATION

Based on the market findings and regulatory analysis, three trends are identified that are currently shaping the intermediary market:

Trend 1: Opposing regulatory forces are increasing cost, bifurcating the market and risk closing down intermediation to low-income markets

Regulation increases costs and these costs manifest particularly on channels providing advice and on smaller and less sophisticated intermediaries. The impact of the increased costs have not yet resulted in an exit out of the market as the focus, to date, has been on registration and not yet enforcement. Furthermore, many of the lower-income intermediaries operate under the exemption provided to Category A intermediaries that will be ending in 2007. Indications from the industry are, however, that a large proportion of the Category A intermediaries may not be able to reach compliance by the time the exemption period expires.

Regulation bifurcates the market by allowing the option of non-advice selling. The space for non-advice intermediation has seen the entry of a number of new and innovative approaches, particularly by non-traditional intermediaries (e.g. retailers). The separation of advice and non-advice selling and the increased cost and difficulty of advice selling will result in advice-based channels being crowded out of the low-income market and companies pursuing the lower cost option of non-advice intermediation. These passive sales models have not yet been proven to be successful and may result in mis-selling if intermediation does not at least include verbal disclosure as a minimum requirement of client interaction.

Given that the models attempting to serve the lower-income market are largely non-advice-based and are crowding out advice-based models in this market, there is a substantial risk that regulatory rulings against non-advice selling may close down the only channels operating at the lower end of the market. Although the FSB has shown sympathy to the issue of access and have made adjustments to regulations to minimize the unnecessary costs on low-income intermediaries, the rulings of the FAIS Ombud are much more focused on consumer protection. As the interpreter of the FAIS Act the Ombud may not have the freedom to include access considerations in his rulings. The legal precedent set by current rulings of the FAIS Ombud (mostly on higher-income cases) suggests problems for the non-advice-based intermediary models and certainly raises questions on whether non-advice-based models will pass the FAIS test.

Trend 2: Controllers of client groups are entering into intermediary and insurance markets

Control over access to clients is increasingly emerging as a determinant of success in the low-income market for insurance. Controlling institutions, such as low-income groups, have the power to negotiate the terms of the relationship with insurers. A large concentration of clients at one location provides a volume proposition to insurers wishing to serve the low-income market, which could lower the costs of serving this market. In addition, using a trusted brand in the provision of insurance can help low-income groups to overcome the unfamiliarity and insecurity of a new financial services product.

There is evidence that both client groups and insurers are trying to gain or establish ownership of the low-income client base. Evidence of client groups trying to reinforce ownership of low-income clients, include:

- the rise of organised low-income groups (e.g. burial societies like Great North Burial Society) in the insurance space;
- players with existing infrastructure and low-income client concentration entering the insurance intermediation market (e.g. Pep stores); and
- various institutions applying for long- and short-term insurance licenses (e.g. Legalwise and Real People Life).

Insurers, in turn, are moving down the value chain by:

- buying distribution channels (e.g. Momentum buying Sage);

- re-establishing or broadening agency forces through franchising and call centre-support (e.g. Metropolitan Life's Retail Enhancement Initiative);
- developing broker support systems (e.g. Masthead initiative launched by Old Mutual); and
- changing their client focus from brokers to clients.

Based on the review of intermediation models operating in South Africa, it is clear that models operating in the low-income market will rely on partnerships with entities that control access to client groups. To ensure their relevance in such relationships insurers will need to offer a *clear and appropriate value proposition* to low-income clients and to controllers of client groups.

Trend 3: Brokers and advice-based models retreating to higher-income markets

Brokers currently dominant in high-income market. The distribution of insurance products in South Africa developed in such a manner that brokers have become the dominant intermediaries. Given the reliance of insurers on broker distribution, insurers cannot easily introduce alternative distribution channels or decrease the prices of products sold through such channels. Such actions could effectively result in a situation where insurers start losing clients as brokers are able to simply move their clients to other insurers. This is particularly the case in the higher-income market where broker distribution is dominant.

New distribution channels emerging that impact on high- and low-income markets. Technological and distribution model innovation have led to the introduction of new lower-cost captive and independent intermediary models. These models are likely to impact differently on low- and high-income markets:

- *Broker dominance slows impact of new models in high-income market.* New captive models (e.g. call centres) present the insurer with low-cost strategies that also provide control over access to the client. Given the broker hold on the higher-income market, insurers cannot easily switch to the new channels and, where they can, they are not able to reduce prices through the lower-cost channel without risking channel conflict. It is, therefore, expected that insurers will introduce new channels gradually and without undercutting broker pricing. As it gradually builds up a client book in the new captive channels, the insurer will reduce its dependence on broker distribution. In addition, the proposed

move to fee-based independent advisors may result in further competition to the broker market. These models are unlikely to enter into the low-income market.

- *New multi-function models rapidly entering low-income market.* In the absence of dominant incumbent channels, low-income markets are rapidly adopting new (particularly multi-function retail and low-income group) models. These models utilise the no-advice space and will effectively exclude brokers from the low-income market (the little penetration they had). Initially the retail distribution models may be limited to the lower-income market. In the long-run, they are likely to extend upwards into higher-income markets (similar to where they operate in the UK market), a market in which they are likely to find it easier to operate as people are familiar with insurance.

Long-term market share of broker under pressure. The implication of the above-mentioned trends in the high- and low-income markets will be increasing pressure on overall broker market share. In the long-run, brokers may find themselves confined to serving a smaller, more specialised segment of the high-income market.

DRIVERS OF SUCCESSFUL INTERMEDIATION OF MICROINSURANCE

Leading on from the identified trends, three key drivers of successful intermediation of microinsurance can be identified:

- *The ability to cost-effectively collect premiums, especially cash premiums, and pay benefits*. This will be facilitated through the “touch points” referred to in the report, which, being multi-functional will help to reduce the costs by piggy-backing on existing infrastructure.
- *Active selling through trusted personal interaction*. Even more so than in the high-income market, insurance in the low-income market (with the possible exception of funeral insurance) has to be sold.
- *An appropriate product*. While perhaps beyond the definition of intermediation, the nature of the product cannot be completely removed from the debate about intermediation. In particular, three aspects of the product will impact on the ease and effectiveness of intermediation. Firstly, **cover must reflect needs** and, the value of the product and how it relates to risks faced by the poor, need to be effectively communicated as part of the intermediation process. Secondly, the **risk has to be manageable**. As a counterpoint to meeting the

needs, it must be noted that some low-income risks cannot be insured simply because it is not possible for the insurer to manage within the low premium value. The intermediary often has to play a role in selecting and managing the risk underwritten by the insurer and the extent of risks to be managed is often inversely related to the size of the premium. Finally, the **product must be sufficiently commoditised and/or simplified**. The structure and complexity of products directly impact on the nature of intermediation required. Essentially, it is argued that a simplified product with appropriate (calibrated) disclosure can substitute for advice.

CAN THE BROKER RE-INVENT THEMSELVES TO SERVE THE LOWER-INCOME MARKET?

A central question posed in this study is whether it is possible for the broker to re-invent themselves and operate in the low-income market. In considering this question, this study has shown that:

- The bifurcation into advice and non-advice selling will result in non-advice selling in the low-income market and advice-based selling in the higher-income market.
- While the complete absence of *disclosure* will not be in the long-term interest of the market, the study has argued that *advice,* as defined by regulation, may be too costly relative to the benefit provided in the low-income market. Instead, it is argued that *disclosure* should be set as the minimum standard rather than *advice*.
- The cost modelling exercise showed that brokers will find it difficult serving the LSM 1-5 market.
- Broker models are not playing a major role in the intermediation of microinsurance internationally.

This raises the question of whether the broker model is relevant to the low-income market. If the definition of a broker as an independent, *advice*-based sales model is used, this document argues that *advice*-based intermediation is not necessary and not feasible for the largest part of LSM 1-5. We conclude, therefore, that it may not be necessary for brokers to reinvent themselves to serve this market, as there are more promising avenues to pursue in other independent or captive advice models.

1. INTRODUCTION

1.1. BACKGROUND

This document presents the findings of a review of threats and opportunities to the intermediation of microinsurance in South Africa.

Microinsurance can be defined as any form insurance that is targeted at, used by and/or accessible by the poor[1]. Such insurance is relevant to the poor as they face many risks, which threaten their lives and their possessions and results in costly interruptions to the difficult process of asset formation. Formal insurance presents one risk mitigation mechanism which could support the management of these risks and smoothing the household asset formation process. Although largely still limited to higher-income consumers, insurers globally are slowly finding ways of extending their services to lower-income households. One of the key constraints has been finding appropriate and efficient distribution mechanisms.

South Africa is no exception to this. Until recently, the South African insurance industry did not actively focus on the servicing of the low-income market (with some notable exceptions), although it has always served the low-income market by default. Funeral insurance, due to its low premium values and high take-up by the low-income market can be considered a form of microinsurance. In terms of the provision of funeral insurance, microinsurance amongst South African low-income households has quite a high penetration. Approximately 15% of low-income[2] individuals in South Africa have some form of formal funeral insurance, compared to 21% of all adult individuals in South Africa that have some form of formal funeral cover (FinScope 2005). Compared to the take-up of microinsurance in other countries, penetration of funeral insurance in the low-income market is quite high.

The low penetration of other formal insurance products[3] in this market, however, has been the result of, firstly, a limited understanding of the financial needs of individuals with low-incomes and, secondly, the absence of glaringly obvious profit opportunities. However, the Financial Sector Charter (FSC)[4], which delineates the financial sector's (including the insurance industry) obligations towards previously disadvantaged and low-income groups, has triggered a re-examination of poorer households' financial needs. Other factors have also led to a renewed interest in the insurance market for lower-income households. The entry of non-traditional and

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[1] Microinsurance is not only limited to insurance for individuals, but also includes insurance products developed for and used to manage the risks of small enterprises. Microinsurance also extends beyond the provision of insurance by microfinance organisations and could include all categories of providers – government, commercial entities and non-profit organisations.

[2] For the purpose of this study, low-income individuals are those that fall in the Living Standard Measures 1-5. The Living Standard Measure (LSM) is a tool used to segment the wider South African market according to individuals' living standards. It uses location (urban vs. rural), ownership of household assets and access to services to group individuals into one of ten potential LSMs through calculation of a composite indicator (Eighty20, 2005). LSM 1 is the lowest LSM, containing the poorest individuals in terms of the composite indicator, while LSM 10 is the highest category and contains the wealthiest individuals if ranked according the composite indicator.

[3] Other (non-funeral) life insurance and short-term insurance.

[4] See Section 5.

non-insurer players has increased competition and may have hastened a “race for the market”, while higher-income markets are potentially becoming saturated, providing the search for new markets with greater impetus.

Similar to international experience, distribution in South Africa is a major challenge to expanding access to microinsurance. The South African experience presents an interesting case study of the interplay between multiple (and sometimes conflicting) developmental policy objectives and commercial initiatives to extend access to financial services. On the one hand, the Financial Sector Charter and new market opportunities are pushing financial institutions into the lower-income market. On the other hand, equally justifiable regulatory challenges around consumer protection and other distribution challenges are limiting the reach of commercial players and forcing a rethink of both policy and commercial strategies.

The rest of the document is structured as follows:

- Section 2 presents basic distribution concepts and discusses the impact of product nature and design on intermediation models.
- Section 3 provides information on the current intermediary market in South Africa, its key characteristics and distribution features.
- Section 4 presents the findings of a market segmentation analysis illustrating that the low-income market is not a homogenous group, but that different demand segments with varying product needs and distribution characteristics can be identified.
- Section 5 provides an overview of relevant regulation and highlights the impact of these regulations on the intermediation market.
- Section 6 reviews international trends in microinsurance intermediation, highlighting interesting examples and drawing lessons for South Africa.
- Section 7 presents our findings on the major market and regulatory forces shaping the intermediary market and what this means for the future of microinsurance intermediation in South Africa.
- Finally, Section 8 concludes by summarising the findings and highlighting the threats and opportunities to microinsurance intermediation identified.

Before commencing with the analysis, we outline the scope and limitations of the study, as well as some nomenclature that will be used in the remainder of the document.

1.2. PURPOSE AND SCOPE

Ultimately, the purpose of this study is to expand access to microinsurance for low-income households. In simple terms, this means improving the link between formal risk carriers and low-income customers. More specifically, the study reviews the threats to and opportunities in intermediating microinsurance in South Africa.

To achieve this within the scope of the project, the limits of the project had to be clearly defined to focus on:

- *Distribution.* This is done within the context of the overall insurance market and products distributed and this context is noted where relevant.
- *Intermediation models relevant to the low-income market.* We limit our focus to products and institutions relevant to lower-income households (i.e. excluding corporate and commercial business and excluding intermediaries that currently do not serve the lower-income market[5]). Although we acknowledge that government does play a significant role in mitigating the risks faced by low-income households, our analysis is limited to the distribution of microinsurance by *commercial entities and non-profit organisations*.
- We also believe that black (or emerging) brokers operating in the lower-income market deserve particular attention as they operate at the cusp of the market and are likely to be the most drastically affected by regulatory changes. Further note that the terms of reference of the study also required a particular focus on the ability of the broker to serve the low-income market. The future of the emerging broker is thus given special consideration.
- *Focus on long-term and short-term insurance* (South African nomenclature for life and general insurance). While some regulation impacting on the intermediation of medical insurance is considered, the analysis is limited to mainly long- and short-term microinsurance products. This does not suggest that medical insurance is less important for low-income households, but rather that medical insurance is a complex market requiring additional research that falls beyond the scope of the current project.
- *Standalone and voluntary products rather than embedded and compulsory.* Although not exclusively focusing on voluntary products, this was a particular focus area. Standalone insurance (in contrast to embedded insurance products) is a major microinsurance challenge. Embedded insurance, due to its hidden nature and the way it is sold by many retailers in South Africa, is also not necessarily considered appropriate
- for the needs of low-income individuals.
- *Insurance for individuals*. The study considerers insurance for individuals (on their own or as part of groups) and not SME or business-specific insurance.

1.3. METHODOLOGY

The information contained in this report was sourced through a variety of means.

Meetings with industry players. Interviews were the most important and useful source of information for this study. A wide range of industry players, including insurers, retailers, intermediary industry associations (brokers and others), administrators, regulators, insurance innovators and representatives of low-income groups, were interviewed between January 2006 and June 2006. See Appendix E for a complete list of individuals and organisations interviewed.

[5] Where relevant, we shall consider the potential of such institutions to serve the lower-income market even if they do not do so currently. Inclusion in the study will be based on the expression of any intention to enter the lower-income market.

Existing data sources. FinScope 2005[6] survey data was used to create a nuanced picture of the demand-side and the different groups within the low-income market.

International review. The information contained in the international review was sourced with the support of Enterplan. The review is based on a review of existing literature and telephone interviews with a variety of experts and players in the international insurance market.

[6] FinScope is a national household survey, underwritten and coordinated by the FinMark Trust. It is focused on measuring financial services needs and usage across the South African population. The FinMark Trust was created in March 2002 with funding received from the United Kingdom Department for International Development (DFID). Its mission is “making financial markets work for the poor”.

2. UNDERSTANDING INTERMEDIATION

2.1. GENERALISED MODEL OF INSURANCE DISTRIBUTION

Before proceeding with the analysis, it is necessary to clarify some terminology and provide basic context. Figure 1 presents a general model of insurance distribution as a basis for the rest of the analysis.

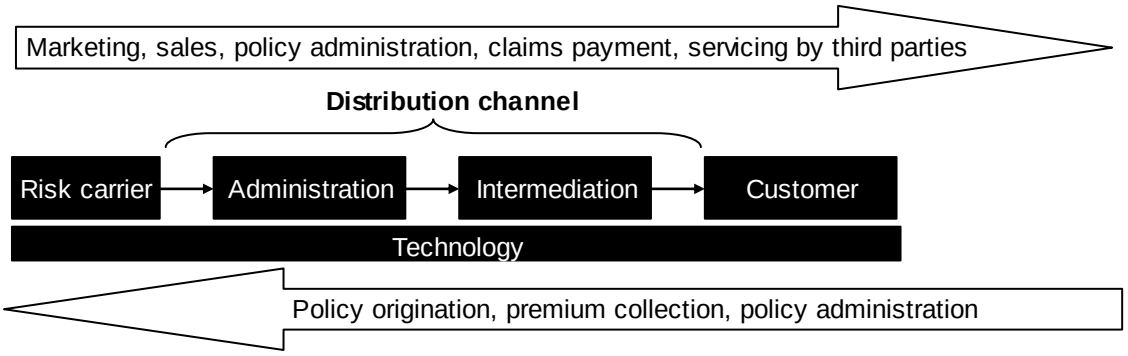

Figure 1: Functional model of insurance distribution

Source: Genesis Analytics adapted from Leach, FinMark Trust 2005

Distribution encompasses a variety of functions. Distribution is not only limited to sales activities and encompasses a variety of administrative and intermediation activities necessary to deliver the product to the customer. These functions include marketing, sales, premium collection, policy and client management, policy administration and claims payment.

Various institutional components and permutations. In addition, these distribution activities may be conducted by various entities and the roles of specific entities may vary from case to case. Figure 1 presents a picture of the generalised structure of insurance distribution. The major components of the distribution channel are identified as the risk carrier, administration, intermediation and a technology platform.

The relevance of the breakdown of activities and institutions presented above is that different institutions and functions may be subjected to different aspects of regulation, different cost structures or different incentives and may, therefore, present specific challenges with regards to distributing microinsurance.

- *Risk carrier:* In the above diagram, the risk carrier is most often a registered insurer. This is the entity that in the final instance is liable for the risk. In some cases, the risk carrier may also be a protected cell company (PCC) (or cell captive as it is known in South Africa), which is a separate legal entity formed by joint venture between a registered insurer and other entity in the distribution channel (e.g. a retailer).

- *Administrator:* Policy administration may be done at the level of risk carrier or intermediary or may even be outsourced to a specialised entity. In South Africa, significant cost reductions have been achieved by the insurer outsourcing the administrative functions to a specialised administrator entity.
- *Intermediary:* The intermediary is responsible for the activities that rely on client contact (e.g. policy origination) and may take a variety of forms including a direct sales division, captive or independent agents, retailers, etc.
- *Technology:* The technology platform may include a variety of technologies ranging from sophisticated electronic solutions using of cell phones to social technologies in the form of premium collection through self-help groups.

Combination of institutional and functional options determines defining characteristics. Various permutations of institutional and functional make-up are possible and the particular combination of institutional and functional structure and the relationships between the various components determine the ultimate features of a specific distribution model.

2.2. IMPACT OF PRODUCT NATURE AND DESIGN ON INTERMEDIATION MODELS

Even though the focus of this document is on distribution, it is impossible to separate distribution from the industry structure and the nature of products distributed. Although there is no dedicated analysis of products distributed to lower-income households in South Africa, product information is documented in the discussion of models and case studies. The characteristics of products distributed have a significant impact on the cost and nature of distribution mechanisms required and utilised.

- *Embedded and compulsory vs. standalone and voluntary products.* Embedded products refer to cases where insurance products are seamlessly (and often opaquely) integrated with other financial products or commodity sales. The most common example in the South African low-income market is credit life insurance on credit purchases of household goods. In contrast, standalone products are sold as financial products in their own right and do not have to be combined with the purchase of another product. While the former holds particular appeal to insurers (easy to achieve volume, low risk of anti-selection and low administration cost[7]), it has often been used to the benefit of the credit provider and insurer, rather than the consumer. Such insurance is often sold without the knowledge of the consumer, undermining the value it may have offered. Bundled products fall somewhere in-between these two categories where the insurance product is closely associated with another product, but not completely integrated. The distribution challenges for these different types of product combinations are quite different. Voluntary/standalone products are

[7] But with the bulk of the profits often being transferred to the intermediary and/or administrator.

much harder and costly to distribute. Volumes are not simply achieved on the back of other product sales. Clients need to be sold on the value of the product and the insurer faces risk of anti-selection.

- *Complexity of the product.* Complex products require more costly and time consuming distribution methods. In addition, more complex products may require higher levels of consumer education as the consumer is often unable to gain sufficient information and compare products[8].
- *Servicing requirements.* Short-term insurance products may experience multiple claims over the life of the product and each claim may require some level of verification and the benefit paid varies depending on the level of cover and the level of damage incurred. In contrast, funeral insurance pays a fixed benefit on the death of the policyholder or covered person.

[8] Care needs to be taken in classifying insurance products and complex or simple. Thus, for example, credit life with temporary and permanent disability, as well as retrenchment benefits, may in fact be a much more complex product than a pure life policy (usually classified as complex). Product complexity, in some instances, may refer to the complexity of the sale (whether advice from a broker is required), rather than the actual complexity of the product.

3. THE SOUTH AFRICAN INTERMEDIARY MARKET

Key findings from Section 3

• The intermediary market can be categorised into five distinct categories with distinctive features, reach and regulatory impacts:
  • Brokers;
  • Captive agents;
  • Independent multi-function intermediaries;
  • Captive multi-function intermediaries; and
  • Organised low-income groups.
• Traditional (and particularly advice-based) models have not been able to extend into LSM 1-5 and have generally been limited to the banked and employed.
• Cost modelling suggests a limited role for the advice-based sales model of brokers in LSM 1-5.
• A number of new intermediary models are emerging that extend beyond the banked and employed and are able to serve LSM 1-5. These models:
  • Can collect cash premiums;
  • Rely on tick-of-the-box selling and the brand of distribution partners;
  • Place control over access to the client group with the distribution partner (rather than the insurer); and
  • Use technology in a simple, but effective manner.
• Although the new models will place the products within reach of low-income customers, it is not clear whether they will achieve take-up.
  • Claims processes lag sales and premium collection innovations;
  • Models provide product disclosure on demand rather than by default;
  • Some models rely on existing, limited membership;
  • Products still mostly limited to funeral policies; and
  • Models employ a passive sales model.

This section provides an overview of the current and emerging intermediary market for microinsurance in South Africa. As noted in Section 1, the review focuses on current or emerging models that are relevant for microinsurance distribution.

The findings are presented in three parts:

- Section 3.1 introduces and categorises various intermediary models. The purpose is to clarify the terminology used in the rest of the document, but also to consider the different regulatory and market characteristics of the various categories.
- Section 3.2 presents the findings of a cost modelling exercise assessing the viability of the emerging broker model under different scenarios and testing the feasibility of distributing the new Financial Sector Charter short-term and long-term insurance products through emerging brokers.

- Section 3.3 concludes with an evaluation of the microinsurance distribution potential of the models reviewed.

3.1. MAPPING THE INSURANCE INTERMEDIARY LANDSCAPE

In this section, the broad intermediary landscape in South Africa is categorised and discussed. The purpose of the categorisation exercise is to create an intermediary framework that allows for a more granular understanding of the market. More specifically, the categorisation of intermediaries will assist in illustrating how:

- Regulatory impacts may differ across categories;
- Low-income impact may differ across categories
- The relationships of the various categories with insurers may differ, allowing us to better explain changing power balances in the market; and
- Different categories may have different drivers of behaviour.

Traditional brokers and agents have always been the dominant intermediaries in the South African insurance industry. A 2003 report estimates that independent brokers and tied-agent sales forces are responsible for more than 90% of total new insurance business production (Uys, 2003: 14). However, recently a host of other intermediaries, such as retailers, have also started distributing insurance. These changes are not unexpected as they mirror international trends (see Section 6). Nevertheless, recent changes in markets, technology and the regulatory environment warrant a re-examination of the various intermediary categories and specifically what they imply for the distribution of insurance.

3.1.1. CRITERIA USED TO MAP THE MARKET

Six criteria were used to categorise the intermediary market and distinguish between different intermediary categories in South Africa. The criteria and their various meanings are explained below.

- **Captive/independent:** An independent intermediary is free to sell the products of different product providers, while a captive intermediary is limited (by contractual terms) to the products of one product provider. A captive intermediary is one that is either owned by the insurer or, through a joint venture, is bound to one insurer.
- **Relationship with one insurer/many insurers:** This criterion is distinct from the first criterion in that an independent agent may still opt for a relationship with only one insurer. While the first criterion relates to the contractual relationship, this criterion relates to the decision or choice of an independent intermediary to establish a relationship with one or many insurers.
- **Client ownership**: This criterion assesses whether the intermediary has control over the client base or control over *access* to the client base. Client ownership mostly resides with the party that controls access to the client. The level of control has implications for strategic actions that can be taken by intermediaries and product providers. Where an intermediary ‘owns’ its client base, it could move to a different insurer and take the client base with it.

- **Product ownership/innovation**: The product can be owned by either the intermediary or the product provider. Ownership will mostly determine who drives the product innovation or design process. However, certain intermediaries might choose to be involved in the product design process even if they do not own the product.
- **Private benefit/member benefit**: Product sales and any income earned in the distribution process can be to the benefit of client(s) (see Category 5: Organised low-income groups) and thus for member benefit, or can lead to the generation of profits for private benefit (for the insurer and/or intermediary).
- **Multi-function/sole function**: Certain intermediaries' sole function is selling insurance, while others combine the selling of insurance with other activities (e.g. the provision of funeral services, the provision of banking or other financial services, the selling of general retail products). This is relevant for low-income intermediation as multi-function intermediaries are able to share costs amongst a broader range of activities.

Using the above criteria, one can divide the intermediary market into distinct categories. In addition, the categories will also be matched with potential distribution groups emerging from the demand-side segmentation in Section 4. It is important to note that although certain criteria may be the same across a few categories, usually at most one or two criteria are important in distinguishing one category from the others.

3.1.2. CATEGORIES

Applying the criteria discussed in Section 3.1.1, the following categories of insurance intermediaries can be identified in the South African market:

- Category 1: Brokers;
- Category 2: Captive agents;
- Category 3: Independent multi-function intermediaries;
- Category 4: Captive multi-function intermediaries; and
- Category 5: Organised low-income groups.

These categories are described in the sections to follow, where examples of each category are also provided. The categories are visually presented in Figure 2. In Figure 2, a dotted rectangle around the intermediary and product provider indicates a captive relationship, while the absence of such a line indicates independence. The number of functions performed by an intermediary (one or multiple) is indicated by the lines connecting the intermediary to the client and their relevant captions.

A note on the position of third-party administrators (TPAs). It is important to note that although third-party administrators can play an essential role in the distribution of insurance products, they do sometimes (especially in the provision of funeral insurance) form part of the intermediation chain for each of the categories. In this section, they are therefore not discussed as a separate intermediary category, since administrators can assist in the functioning of any of the intermediary

categories. In cases where administrators form part of the intermediation chain, they normally provide *a link between the insurer and the intermediary*.[9]

The primary purpose of third-party administrators is to provide efficient and low-cost *administration of policies*. These services include managing policyholder records, receiving premiums, payment of claims, and so forth. The third-party administrator may also design the product and, although the risk is underwritten by an insurer, effectively manage access to the client base. In some cases problems have been experienced where the administrator illegally (fully or partly) self-insures the client base.

It is possible to distinguish between two types of third-party administrators. Administrators operate in the life insurance environment, while underwriting management agents (UMAs) operate in the short-term insurance environment. In contrast to administrators that tend to handle purely administrative functions on behalf of insurers, the functions of the UMA go beyond that of the administrator as the UMA sometimes *accepts risk and pays claims on its own (not merely on behalf of the insurer)*[10].

Defining likely reach of the categories. In the following sections and Figure 2, the reach of each of the intermediary categories is indicated. In each instance, reach is defined in terms of specific LSM categories. The Living Standard Measure (LSM) is a tool used to segment the wider South African market according to individuals' living standards. It uses location (urban vs. rural), ownership of household assets and access to services to group individuals into one of ten potential LSMs through calculation of a composite indicator (Eighty20, 2005). LSM 1 is the lowest LSM, containing the poorest individuals in terms of the composite indicator, while LSM 10 is the highest category and contains the wealthiest individuals if ranked according to the composite indicator. It is important to note that while more tailored segmentation tools such as the Financial Services Measure (FSM)[11] are available and would have been more applicable to this exercise, we have stated reach in terms of the LSM as the FSC uses this segmentation tool to set its access targets[12].

We distinguish between two types or levels of reach. The shaded grey blocks in Figure 2 indicate reach in a post-FAIS environment, while the blocks containing diagonal lines (in addition to post-FAIS reach) indicate LSM groups that were also reached in a pre-FAIS environment. Thus, blocks with diagonal lines indicate uncertainty about whether the intermediary category will be able to reach into that LSM group in a post-FAIS environment.

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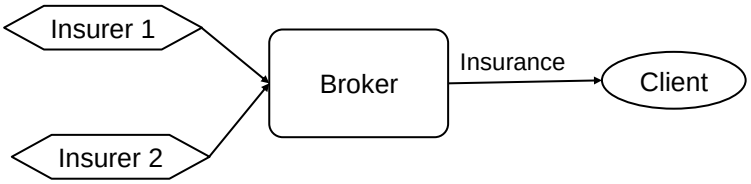
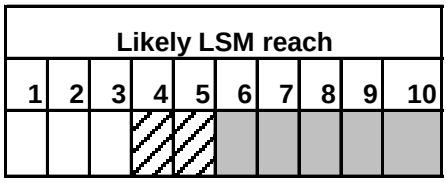
[9] Some administrators, however, do not retain their traditional role and may evolve to become intermediaries or insurers in their own right.

[10] According to South African legislation (Republic of South Africa, 1998a and 1998c), only registered insurers and reinsurers can carry risk. The acceptance of an unregulated risk component, as sometimes done by an underwriting management agent (UMA), raises concerns.

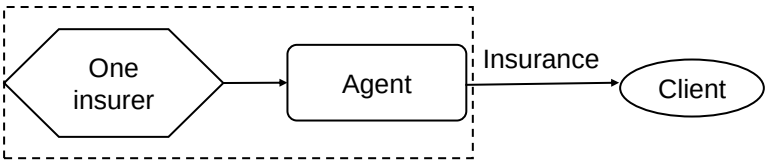
[11] The FSM is a composite measure which divides individuals into one of eight tiers based on financial penetration (or take-up of financial services), attitudes to money, physical access to banks and their connectedness and optimism (FinMark Trust, 2005: 32).

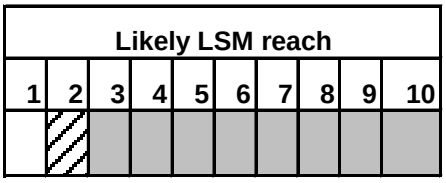
[12] The FSC specifies access targets in terms of LSM 1-5.



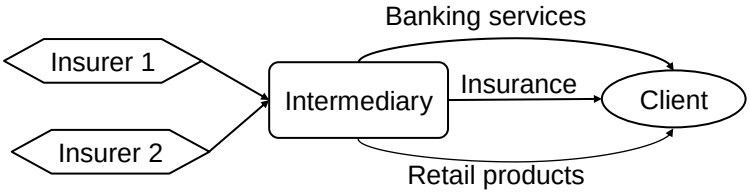


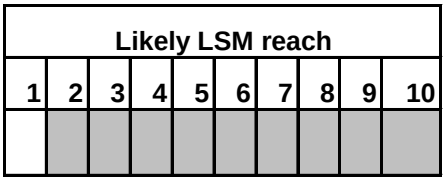
Intermediary category 1: Broker



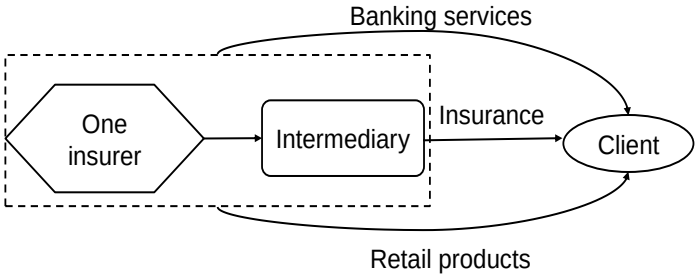


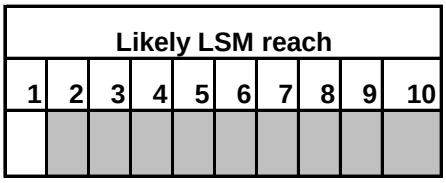
Intermediary category 2: Captive agent



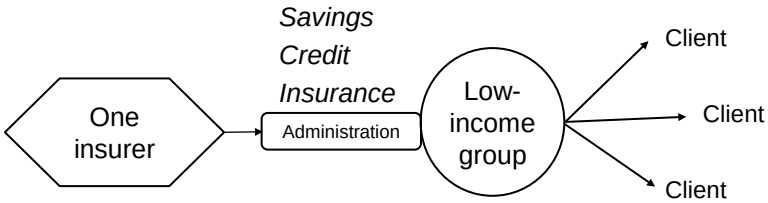


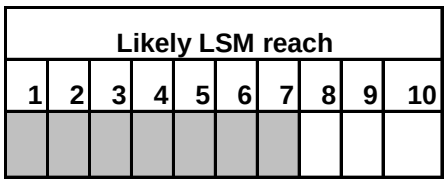
Intermediary category 3: Independent multi-function intermediary





Intermediary category 4: Captive multi-function intermediary





Intermediary category 5: Low-income group

Figure 2: Intermediary categories and likely LSM reach

3.1.2.1. CATEGORY 1: BROKERS

Description. The broker is an independent intermediary, able to have relationships with as many insurers as it chooses to and with the sole function of selling insurance to clients. Access to the client is usually controlled by the broker, while the product provider or insurer is responsible for product development and innovation and also owns the product. Income is usually received in the form of commission. Furthermore, the broker represents the interest of the *client* and, therefore, provides independent advice, based on the client's specific needs and the characteristics of the various products available. See Box 7 for a brief discussion on the issue of broker independence.

Products. Brokers can intermediate any type of insurance or financial product, although some choose to specialise in a product type, e.g. short-term insurance.

Category examples and LSM reach. The LSM reach of brokers is dependent on specific broker examples. It is important to note that large corporate *brokerages are not included* in this discussion as they are not currently serving the low-income market and not likely to do so. Consequently, the discussion is limited to mainly smaller brokerages and standalone brokers. Four broker examples are briefly discussed in the following paragraphs:

- the traditional broker;
- the emerging broker;
- the shared brokerage; and
- networked brokers.

The *traditional broker* serves middle-and higher income clients on an individual basis and generally is able to quite easily comply with the educational requirements of FAIS. In contrast, the *emerging broker* often derives from a low-income community, has fewer or lower qualifications than the traditional broker and generally sells simpler products. Box 1, below, describes the difficulties of finding a distribution mechanism for low-income products and the inability of the broker to successfully distribute these products.

Box 1: Case Study: Cre8 and iKhaya Protector

The example of Cre8's iKhaha Protector illustrates the impact of distribution challenges on attempts by the industry to create innovative products for the low-income market.

Nature of the organisation. Cre8, the research and development division of Alexander Forbes, can best be described as an insurance innovator delivering a range of services, including:

- Creating, marketing and managing insurance products and services;
- Managing a database of loss (actuarial) information that can be utilised in insurance product development; and
- Providing skills development services in the area of underwriting.

Creating a low-income product. Cre8 has for the last 18 months actively been trying to enter the LSM 1-

3 market with an appropriate product. It designed a home owners' insurance product specifically for this market and has used local municipality facilities to assist with the placement. The main challenge has been successfully distributing the product – to date only 6 policies have been sold (Botha & Small, 2006).

iKhaya Protector. The product, iKhaya Protector, is specifically targeted at the owners of government subsidised entry-level homes with a minimum insurable value of R30,000 and a maximum insurable value of R100,000 (Cre8, 2005). The iKhaya Protector provides insurance for house structure only, as the risks associated with this product first need to be thoroughly tested in the low-income market before venturing into other insurance product categories (such as household content). Whereas two years ago, the owners of government-subsidised housing still had to pay a certain percentage of the market value of the house to purchase it and therefore had to have some source of income, payment is no longer required (Botha & Small, 2006). In many cases, the owners are unemployed and often also unbanked.

Distribution. Originally the product was distributed through the KWASA Development & Housing Resource Co. that acted in the capacity of a brokerage. In order to limit sales and transaction costs, the product was sold at local ward meetings, allowing brokers to reach many individuals in one location (Botha & Small, 2006). However, the brokers had limited success as the policies have to be paid upfront and in cash. Upfront meetings was problematic as ward meetings were held in townships and all attendees were aware of the fact the brokers carried cash (as much as R30,000) with them (Botha, 2006a). After consultation with various municipalities, this distribution channel is no longer utilised. A key obstacle in distributing the product to lower-income clients was the absence or limited realisation (due to limited financial education) by low-income individuals that the product offers them real value (Botha, 2006c).

Cre8, subsequently, entered into negotiations with the national government's Department of Housing about the possibility of the Department purchasing the product on behalf of government subsidised homeowners (Botha & Small, 2006). As the houses only officially belong to the individuals/owners after they have resided in it for five years, the houses remain the asset of national and provincial government for the first five years. Government thus has an insurable interest in these houses for their first five years of existence. However, Cre8 was recently informed that the Department of Housing will not be making any financial contribution to the rollout of this insurance product (Botha, 2006b).

The idea underlying Cre8's negotiations with the Department of Housing was to gradually, during the first five years of residency, shift insurance payment responsibility from government to the homeowner. This period of migration would have provided an opportunity for consumer education. Homeowners would have been familiarised with the idea and importance of household structure insurance (Botha & Small, 2006). It was thought that if the deal was successfully negotiated with government, it would mean that the providers of iKhaya Protector would have access to a database of homeowners with whom it could interact after government's responsibility for ensuring appropriate risk cover on these houses ended (Botha & Small, 2006). Communication with clients (also for claims resolution) would have occurred through a contact centre, but premium collection remained an unresolved issue. Although cash collection of premiums is more suited to the economic profiles of the product's target market, cash collection without the necessary infrastructure can be very expensive.

Cre8 is continuing its search for appropriate distribution channel(s) for iKhaya Protector.

In addition to the lone traditional and emerging broker, brokers are also clustering to share in regulatory compliance costs. Brokers belonging to a *shared brokerage* form part of an institutional network of brokers, such as Masthead, established with support from an insurer[13]. Masthead was originally launched by Old Mutual in June 2004, but Metropolitan Odyssey, Auto & General and Sanlam are now also participating in the initiative. According to media reports, Liberty Life is still negotiating the possibility of joining Masthead (Gunnion, 2006). Such networks allow brokers to share in and thus limit the final impact of compliance cost. However, the impact of the shared brokerage on the broker's independence needs to be questioned.

Whereas the shared brokerage is mainly driven and sponsored by insurers, another version of the shared brokerage is *networked brokers* who independently (without insurers' involvement) cluster together to share the costs of certain compliance expenses and backroom administration activities. In order to share in these benefits, brokers have to pay a certain percentage of their income to the network. Like the shared brokerage, the network limits the negative financial impact of regulation such as FAIS.

Box 2: Opportunity International's Micro Insurance Agency

Opportunity International. Opportunity International is a network of microfinance organisations assisting low-income individuals in the elimination of poverty through the provision of financing for income-generating activities. It has operations in 29 countries in Africa, Asia, the Americas and Eastern Europe and has managed to reach 850,000 borrowers (Leftley, 2006). It currently has an outstanding loan portfolio of $180m. In 2002, Opportunity International started developing insurance products as a response to the needs of MFI clients in Africa (Leftley, 2006). In 2005, Opportunity International established the Micro Insurance Agency, with offices in a few countries. Rather than developing insurance products on a once-off basis for MFIs, the Micro Insurance Agency fulfils a more permanent role in the economy where it acts as broker/intermediary.

Opportunity International is currently setting up a Micro Insurance Agency (MIA) office in South Africa.

MIA to position itself as innovative intermediary focused on low-income market. The Micro Insurance Agency in South Africa will facilitate the brokering of deals between micro-finance organisations and other commercial organisations wishing to provide insurance to their clients, and insurance companies. As discussed in Section 3.1.2.5, South African microfinance organisations often find it difficult to negotiate directly with insurers due to limited experience in the insurance industry and/or lack of insurer intent. It has been explicitly articulated by these organisations that a type of catalyst (organisational or individual) in making the initial connection with an insurer would be very useful and eliminate many difficulties. However, MIA's function will not be limited to mere negotiations. It will also be involved in the market research process to identify the insurance needs of various organisations' clients and to, with the cooperation of the insurer, create products able to fulfil these specific needs. In addition, it will handle all policy administration, removing the administrative burden from both the MF or other organisation and the insurer.

Competitive advantage. Opportunity International has invested in the development of a sophisticated

[13] Insurers form the main drive behind shared brokerage initiatives as these initiatives generally enable them to regain some control over the independent broker network (see Section 7.2).

management information system (MIS), that facilitates the easy and central management of all policies issued to MFIs and other partners through an eMerge server placed in Denver, with smaller eMBUs servers placed in the country of operation.

Possible clients for the Micro Insurance Agency

NGO microfinance sector. As mentioned in Opportunity International's business case for a microinsurance intermediary in South Africa, the NGO microfinance sector in South Africa is relatively small, with only two financially sustainable organisations with sufficient scale for the provision of insurance two clients, SEF and Marang. SEF has decided to self-source its insurance (see Box 6) and will be starting the roll-out of insurance projects in September 2006. This only leaves one other microfinance organisations, Marang, to potentially utilise the services of MIA. Opportunity International also intends launching a commercial MFI in South Africa around the end of 2006 or early 2007. Once the client base of this MFI has been successfully established, MIA will sell insurance policies to the clients of the MFI. However, MIA staff members do not see the success of MIA being dependent on the take-up of policies by the commercial MFI's clients. A lack of possible partners in the NGO microfinance sector will require the MIA to move beyond its traditional business model and create partnerships outside of the MFI sector if it is to be successful.

Commercial microfinance sector. Large commercial microfinance providers such as African Bank and Capitec will most likely be able to broker their own deals with insurers and would not want to add an additional cost layer to their product offering. This leaves the medium-sized MFIs[14] as potential clients for the Micro Insurance Agency. However, in its business case for MIA in South Africa, Opportunity International mentions the risk of consolidation amongst the medium-sized MFIs. Consolidation implies achievement of economies in scale. Under such circumstances, the resultant MFI(s) will not require the services of MIA and will be able to negotiate its own deals directly with insurers. A further risk or difficulty in servicing the commercial microfinance sector is the fact that most of the loans issued by these organisations are for a term of only one month. This makes it very difficult to distribute funeral and non-credit life insurance to the MFIs clients.

Retailers and cell phone banks. The business case for MIA also mentions the possibility of partnerships with banks using mobile technology, e.g. Wizzit Bank or MTN Bank, as well as partnering with retailers. In the latter case, it is argued that while large retailers such as Edgars and Shoprite most likely have the capacity to broker their own deals with insurers, other small retailers (no examples provided) might be more in need of assistance for the MIA. The same argument that applies to retailers can also be made applicable to the banks using mobile technology. Wizzit Bank, for example, is already distributing funeral insurance (obtained from African Life) to the Apostolic Church and use two administrators to handle all policy administration. It is not clear where the MIA would fit into such a structure, unless it is able to assist with policy administration at much lower prices than the current administrators. Although MTN Bank does not currently provide insurance to its clients, its Standard Bank affiliation means that it will have access to all Standard Bank insurance products and will not necessarily require a third party to help broker deals.

Treatment of FAIS. It seems as if MIA, like most of the retailer insurance models, will be relying on the regulatory gap that has been created for tick-of-the-box selling. However, this selling approach and thus also the viability of the MIA's partnerships are at risk until the regulatory uncertainty around tick-of-the-

[14] The business case/plan for the Micro Insurance Agency uses Thuthukani as an example of a medium-sized MFI.

box selling has been resolved (see Section 5).

3.1.2.2. CATEGORY 2: CAPTIVE AGENTS

Description. Captive agents are intermediaries that have an exclusive relationship with one insurer (i.e. contractually bound) and whose sole-function is selling insurance. The insurer is able to access the client[15], but generally only interacts with the client through the agent. The insurer owns the product and is responsible for product innovation and administration. The agent provides limited assistance with administration. Captive agents generally receive commission on products sold, although some insurers have salaried-agent forces.

Most brokers start their careers as captive agents for a specific insurance company and after a few years, once they have built up a large enough client book, gradually start to transform themselves into brokers. This allows agents initial exposure to and learning within a supportive insurance environment, while also providing them the chance to establish relationships with a sufficient number of clients before establishing their own businesses.

Products. Depending on the insurance company by which the captive agent is employed, captive agents sell any form of insurance. The nature of the employer company will determine in which insurance area the agent specialises.

Category examples and LSM reach. The LSM reach of the intermediary category of captive agents is dependent on specific agent examples. Four agent/agency examples (and their various LSM reach) are discussed:

- the traditional agent;
- the call centre agent;
- the franchised agency, e.g. Liberty Life;
- the tiered-agency force; and
- the call centre-support agency force (e.g. the Retail Enhancement Initiative (REI), recently implemented by Metropolitan Life)

Agents can sell their policies through a variety of communication channels. The *traditional or doorstep agent* is an individual who visits the prospective client's home or another venue of choice (e.g. worksite) and who then, through face-to-face interaction, tries to sell a policy to the prospective client. The reach of the traditional agent is generally limited to LSM 6-10, although the agent (especially in a pre-FAIS environment) would also be able to serve banked and employed individuals in LSM 5.

[15] The insurer has full information on the client and contracts directly with the client. If the agent leaves, the relationship continues and the insurer can initiate sales of other products to the client without going through the same agent. However, in most cases, the client prefers to continue the relationship with the agent, rather than the insurer.

Call centre agents are selling policies telephonically from in- and out-bound call centres, with initial interaction with the prospective client often initiated over the internet (e.g. the agents that work for direct insurers such as Outsurance, Dial Direct and 1LifeDirect). Given current regulatory requirements, call centre agents have the ability to serve banked and employed individuals in LSM 4-10, although call centre agents could probably also serve banked and employed individuals in LSM 3.

Insurance companies are currently helping to establish a new form of agent – the owner of the *franchised agency*. Franchised agencies receive financial support from insurance companies to either exclusively sell their policies or reach an insurer-specified sales target while allowed to also sell the policies of other insurers. This agent example can be considered a hybrid between an agent and a broker. Franchised agencies are provided with more independence than traditional agents, but more system and compliance support than the traditional brokerage. Franchised agencies operate from infrastructure situated outside the insurance company and mainly serve higher-income clients. Insurer systems and compliance support allow one-time brokers and former insurance agents to better handle increased regulatory compliance costs. These agencies are currently serving LSM 7-10.

The *tiered-agency force* is a direct reaction to the financial impact of FAIS legislation on insurance intermediaries. A South African funeral insurer with a chain of captive funeral parlours is currently planning to create a tiered-agency force to support funeral insurance sales in and outside its funeral parlours. The tiered-agency force will operate through a distinction between primary and secondary agents. Primary agents will be FAIS registered and compliant and will be allowed to provide advice, while secondary agents will not be FAIS-registered agents and will simply be presenting a tick-of-the-box sales option to prospective clients, as well as collecting premiums. The insurer intends having one primary agent per funeral parlour. In principle, this idea is supported by a recent guidance note issued by the FSB on intermediary services and representatives (see Section 7.1). Although originally targeted at retailers and other intermediaries using tick-of-the-box selling, the interpretations contained in the guidance note are potentially just as applicable to the idea of the tiered-agency force. As regulatory compliance will be less onerous and costly for the secondary agent, this type of agent will probably be able to serve LSM 2-5. Some uncertainty around the tiered-agency force's ability to reach LSM 2 has been indicated in Figure 2 with a lined block (rather than full shading).

The *call centre-supported agency force* is a recent innovation by insurers. The basic premise of the model is that centralised call centre support to traditional insurance agents will decrease the time spent with clients and increase the efficiency with which client details are captured. The agents visit prospective clients at their homes or other venues and after the policy sale has been closed, phone the call centre to provide the company with client information and immediately effect policy cover. The *Retail Enhancement Initiative (REI)* provides call centre support (during the sales process) to brokers and agents selling Metropolitan Life

products. This support is intended to help intermediaries more easily comply with regulatory requirements in order to limit the negative impact of legislation on intermediaries. The REI also allows for underwriting to take place telephonically. More details on this agency example are provided in Box 3. The REI has the potential to limit the negative impact of regulations on intermediaries, thus allowing agents to serve lower LSM categories than they normally would. In addition, the REI is also of interest because it serves as illustration of insurers' attempts to gain greater control over the client base (see Section 7.1 for more on this force).

Box 3: Case Study: Metropolitan Life's Retail Enhancement Initiative

Metropolitan is one of South Africa's three biggest insurance companies. Whereas originally it was focused on life insurance only, it has broadened its scope to include a range of financial services. Metropolitan provides life insurance, employee benefits, asset management and health management services. The retail division of Metropolitan Life, a wholly-owned subsidiary of Metropolitan, recently launched a Retail Enhancement Initiative (REI).

What is the REI? The REI, the first such initiative in the world, provides call centre support during the sales process to brokers and agents selling Metropolitan Life products. It assists agents and brokers in registering a client's acceptance of a policy quote at head office and collecting detailed client information. The request for a new policy is made telephonically by the broker or agent phoning the Metropolitan Area for Customer Enrolment (ACE) Centre. The ACE Centre captures all policy details through information provided by both the intermediary and the client. This process takes place at no cost to the intermediary.

In cases where underwriting is required, it is also completed telephonically. This will help to decrease the number of medical examinations and other tests required and will also assist Metropolitan in reaching clients in areas where these services might not be available (Metropolitan Life, 2006a). According to Metropolitan, international research has demonstrated that clients are more open and forthcoming about their health status and other personal information if the risk is assessed through verbal communication processes (Metropolitan Life, 2006b).

REI process. The REI process seamlessly integrates into the broker or agent's normal interaction with the insurance client. The intermediary first visits the client and conducts a financial needs analysis (FNA). Upon completion of the FNA, the intermediary presents a policy option(s) and quote(s) for the relevant policy selected. Once the client has accepted the generated quote(s), the broker/agent telephonically contacts the ACE Centre. The policy details and client information are captured by the staff in the ACE Centre and all information is voice-recorded. The client talks to the call centre agent after the agent/broker has spoken to the call centre. The voice recording acts as proof of the contract between the client, Metropolitan Life and the broker/agent. The final policy is accepted telephonically and on completion of the call (after acceptance of the policy), the policy is issued and cover starts.

Benefits. The REI holds a number of benefits for Metropolitan Life. It is thought that it will lead to improved intermediary and customer service, better compliance enforcement, improved underwriting, a decrease in policy issuing time[16] and a reduction of the administrative burden placed on intermediaries (Metropolitan Life, 2006a & 2006b). The latter will enable brokers and agents to spend less time with clients, thus allowing them to serve more clients. Metropolitan estimates that brokers will spend (on

[16] In cases where all client information was available, "policy issue time decreased form an average of seven working days to less than a day from completion of the purchase" (Metropolitan Holdings Limited, 2005).

average) up to 40% less time with any specific client. Using the assumption that 25% of the time savings could be used to write more business, it implies 10% growth in earnings (Metropolitan Life, 2006b).

Implementation challenges. With the initial implementation of the REI in Metropolitan Life's *direct writer distribution channel*, the REI had a negative impact on direct writer business volumes. This is thought to be the result of change resistance and implementation challenges and it is expected that as REI stabilises, sales will increase. REI was only incorporated in the *general intermediary channel* during the first quarter of 2006 – it is expected that the general intermediary channel will have the same initial negative sales experience as the direct writer channel (Metropolitan Holdings Limited, 2006).

Low-income market. The REI will enable Metropolitan to serve low-income clients in a more cost-effective manner. As the REI enables Metropolitan to overcome geographical and infrastructural constraints, agents and brokers selling Metropolitan policies will now be able to serve even very rural areas (Metropolitan Life, 2006b).

Assessment. Although the REI does not reinvent the role of the agent, it assists agents in more easily complying with FAIS requirements. This allows agents to spend less time processing each client's policy application and, consequently, to see more prospective clients.

Although it seems obvious that the motivation behind this initiative is to better deal with the impact of legislation such as FAIS, it is possible that it is an attempt by the insurer to gain greater control over the client base (see Section 7.2 for a discussion on this identified force). This is achieved through better collection of client information and the establishment of telephonic contact with the client. The client is thus given a better idea of the face of the insurer as he/she not only deals with the representative (i.e. the agent or broker) of the insurer.

3.1.2.3. CATEGORY 3: INDEPENDENT MULTI-FUNCTION INTERMEDIARIES

Description. Independent multi-function intermediaries are free to have relationships with as many insurers as they deem to offer adequate value and appropriate products to their clients. This intermediary is multi-functional in that it not only sells insurance, but also sells a range of services or products, such as retail products (clothing, food, etc.), funeral services and banking services. Since the client only interacts with the intermediary and often also views the intermediary as the product provider[17], the intermediary controls access to the client and thus also owns the client. Although product ownership and innovation may still be handled by the insurer, multi-function intermediaries actively participate in the product design and are often initiators of products that suit their client base.

Products. Independent multi-function intermediaries can decide to sell one product only (such as the funeral insurance policy sold by Shoprite) or to offer a variety of

[17] Multi-function intermediaries have their insurance policies underwritten by insurers and some use their own branding on the policies sold. The branding of the multi-function intermediary could confuse the client about who the actual product provider is.

insurance products (bank model). Products could include funeral, long-term and short-term insurance.

Category examples and LSM reach. The LSM reach of this category varies significantly amongst the different models. Three examples of the independent multi-function intermediary (and their various LSM reach) are discussed in the following paragraphs:

- retailers, e.g. Shoprite (a low- to middle-income retailer);
- banks, e.g. Standard Bank; and
- independent funeral parlous and funeral parlour associations.

The general *retailer model* utilises over-the-counter selling of insurance products. Retail staff, who also perform other functions, are responsible for the selling of policies and premiums are collected in-store. Shoprite is a low- to middle-income *retailer* with a target market of LSM 3-8 (Shoprite Holdings Limited, 2005b). In 1999, a funeral policy underwritten by the HTG Life Ltd. was introduced at Money Market counters in all Shoprite stores. The Money Market counters are intended to increase shopping convenience, facilitate customer loyalty and provide a range of transaction services, including payment of television licenses and municipal accounts with approximately 220 third parties represented at the counters (Shoprite Holdings Limited, 2005b). Shoprite is responsible for the marketing, selling and premium collection associated with the policy, while HTG Life handles policy administration, claims management and payout (Bates, 2005). Premiums are collected at the Money Market counters, which imply that even unbanked individuals are able to purchase the policy.

Shoprite earns a fee on each policy sold. Money Market staff, who sell the policy, are not FAIS-registered agents and, therefore, cannot provide advice (see Section 5.5 for more discussion of what advice and disclosure entails). Customers can contact the HTG Life call centre to report claims and if they have any queries/policy changes. The product is not actively marketed to clients in-store and clients are expected to ask for the product at the Money Market counter. The passive selling approach, as well as the absence of financial incentives related to policies sold for Money Market staff, has not facilitated high policy sales – to date, only 6,000 policies have been sold (Bates, 2005). See Genesis (2006) for more background on the HTG/Shoprite initiative.

Banks sell insurance policies over the counter in bank branches and through separate bank brokerages. The *over-the-counter sales* in bank branches are targeted at a lower- to middle-income market and insurance sales to this market normally take place when a client opens a bank account or performs another transaction in the bank branch. *Bank brokerages* serve the upper-middle to high-income market and are staffed by brokers able to provide advice to prospective client. Together these two sales channels are able to serve LSM 4-10. See Box 4 for a detailed discussion on funeral insurance products sold through Standard Bank. This specific intermediary is of interest due to its ability to easily reach some low-income individuals with funeral insurance, specifically those with bank

accounts at Standard Bank. Although, theoretically, banks should be able to collect cash premiums, they only sell policies to bank account holders and deduct premiums via debit order. Claims are also paid into bank accounts.

Independent funeral parlours and funeral parlour associations (similar to a large retailer with a number of outlets) sell funeral insurance. For more information on funeral parlour associations and their role in negotiations with insurers, see the discussion on the Private Funeral Directors' Association (PFDA) in Genesis Analytics (2005). Due to their extensive geographic reach (i.e. every small town has at least one funeral parlour) and ability to collect premiums in cash, independent funeral parlours are able to sell *funeral insurance* down to LSM 2. It is important to note that funeral parlours sell *only* funeral insurance. Also, funeral parlours tend to see themselves as selling funeral service and not necessarily funeral insurance. They do not view the insurance policy as a separate financial service, but simply a way of prepaying (and locking in clients) for their services. For this reason, they are often not skilled or educated in financial services and will find it difficult to comply under the FAIS Act.

Box 4: Case Study: Standard Bank

Standard Bank Insurance Brokers (SBIB) distributes short-term, funeral and credit-life insurance. SBIB sells short-term insurance directly to customers in the high-income market, whereas funeral and credit-life insurance are sold in cooperation with Standard Bank branches and are generally targeted at the low-income market. Credit life insurance is a compulsory product sold to individuals that have loans from Standard Bank's Low-income Housing unit. For the purpose of this discussion, we focus on the distribution of funeral insurance (see Section 1.2 for an explanation of why we exclude credit life or embedded insurance from our focus).

Distribution to low-income clients. Standard Bank actively targets funeral insurance at the low-income market. Its funeral plan is sold to Standard Bank clients that have E Plan and Plus Plan accounts. E Plan and Plus Plan accounts are targeted at individuals in LSM 4-7, earning an income between R1,200 to R6,500 (Jawuna, 2006). Since this product is only offered to individuals with bank accounts, SBIB is guaranteed a premium collection mechanism (debit order). However, the mere fact that the insurance company can utilise debit orders as premium collection mechanism does not imply that premiums are always regularly paid. There often is no money available in clients' accounts and the policies are characterised by a 25% lapse rate (Brooke, 2006). The advantage of this collection mechanism is that it decreases collection costs and ensures some regularity of premium payment. Approximately 860,000 policies are currently active (Jawuna, 2006a). On average, Standard Bank sells 1,500 policies per day (Brooke, 2006).

The funeral insurance sales process. The funeral plan is sold by consultants, normally responsible for the opening of accounts and general retail banking queries, working in Standard Bank's branches. The consultants are trained to ensure that they understand the products, assessed and, if proven competent, are accredited to sell and provide advice on funeral and credit life products sold directly to customers. The staff members are registered as Representatives, which means that they meet the necessary FAIS Fit-and-proper Requirements applicable to Category A[18] agents. When clients open an

[18] The FAIS Act distinguishes between various categories of insurance intermediaries. Category A is subject to the lowest fit-and-proper requirements, but with severe restrictions on the type of products that can be sold (only funeral insurance).

E Plan account at the bank counter, they are offered the option of purchasing the funeral plan. The computer system will prompt the consultant to offer the product to the client. The consultant will tick the relevant box according to the customer's response. The consultant will also conduct a simple financial needs analysis (FNA) for every prospective client to determine whether the client can afford the policy and/or whether the client already owns other funeral insurance products, as well as talk the client through the policy wording (Jawuna, 2006b; 2006c). Upon finalisation of the sale, the client receives a policy membership card with the call centre number printed upon it. Clients can change policy information in bank branches with the assistance of a bank consultant or through the call centre (Jawuna, 2006b). The call centre is manned by SBIB staff.

In addition to in-branch sales, the call centre also undertakes outbound telephone campaigns during which it attempts to sell the funeral plan to existing E Plan clients who have not yet purchased the policy (Jawuna, 2006b). All contact centre agents are registered as representatives of the FSP (Jawuna, 2006b).

Technology. Standard Bank frequently utilises telephones and cell phones in its interaction with clients. Clients can enact policy changes through the contact centre. Telephonic communication decreases the need for face-to-face interaction during the claims process. Once a claim is lodged, all documentation required is explained to the client over the telephone so that the client will not need to visit a bank branch more than once (Brooke, 2006). An SMS is also sent to the customers to provide notification of unpaid debit orders etc (Jawuna, 2006a). Clients can then respond by ensuring that there is sufficient money in their accounts available for a premium payment.

Costs. Insurance sales through a network of bank branches is characterised by lower costs than selling insurance through other more traditional channels such as independent brokers or agents. The client is reached through a process of bank referrals and low-advice selling is employed. Cross-selling helps lower the cost of sales through greater client penetration rates. The most costly components of selling insurance through this intermediary are the creation and maintenance of a call centre and claims department (Brooke, 2006).

Assessment. The bank model is only able to reach banked individuals. However, it has quite an extensive geographic reach and infrastructural spread in urban and peri-urban areas due to Standard Bank's network of 746 branches (Standard Bank, 2005), although it does not allow for the servicing of deep rural areas. The easy access to individuals' bank accounts provides Standard Bank with a convenient and inexpensive premium collection mechanism – the debit order. Since all policyholders have bank accounts, there is no inconsistency between the way premiums are collected and the manner in which claims are paid. Successful claims can simply be paid into the client's bank account. Policy claims are simply paid into the bank account of claimants. Furthermore, clients are provided some advice (covering both needs analysis and disclosure) by the bank consultant upon the purchase of their funeral plan and can also contact the call centre for additional product and process disclosure. Although this model is limited to individuals banking with Standard Bank, the inclusion of advice on sales makes this an appropriate model for selling to the lower-income market and the combination with bank processes makes this cost-effective for the intermediary.

3.1.2.4. CATEGORY 4: CAPTIVE MULTI-FUNCTION INTERMEDIARIES

Description. Captive multi-function intermediaries are contractually bound to sell the insurance products of only one insurer. This intermediary is multi-functional in that it not only sells insurance, but also sells a range of services or products such as retail products (clothing, food, etc.), funeral services or banking services. In some cases, the captive relationship takes the form of a joint venture where the intermediary has a vested interest in the success of the selected product. Although product ownership and innovation may still be handled by the insurer, some captive multi-function intermediaries have chosen to actively participate in the product design process (e.g. Pep Stores). By entering into a captive agreement with the insurer, the intermediary partly gives up his ownership of access to the client as the insurer will have full access to client details and can use this to sell products through other channels (e.g. call centre). However, this only applies to existing clients and the intermediary will remain important for future sales.

Products. Captive multi-function intermediaries may sell one product only (such as funeral insurance sold by Wizzit Bank or captive funeral parlours) or offer a variety of insurance products (Pep/Hollard and Edcon/Hollard). Products could include funeral, long-term and short-term insurance.

Category examples and LSM reach. The LSM reach of captive multi-function intermediaries is dependent on specific manifestations of this intermediary. Three examples of the captive multi-function intermediary (and their various LSM reach) are discussed:

- retailers, e.g. Pep/Hollard and Edcon/Hollard;
- captive funeral parlours; and
- banks, e.g. Wizzit bank.

Two interesting retailer examples of this intermediary category are provided by the Pep/Hollard joint venture, formally launched in March 2006, and the Edcon/Hollard joint venture (Edcon Insurance Services), established in June 2001. The Pep/Hollard joint venture is discussed in more detail in Box 5. This example is interesting due to its ability to serve low-income clients through cash collection of premiums and its extensive branch network, servicing even small towns in rural areas.

Retailers. It is important to note that there are distinct differences between the Pep/Hollard and Edcon/Hollard examples. In the case of Pep, a cash clothing retailer, insurance products are sold on a cash basis to clients and clients are not obligated to buy any other product in order to obtain the insurance. Pep thus utilises a stand-alone insurance model. In contrast, Edgars and Jet, two clothing retailers that form part of the Edcon retail group, sell insurance only to accountholders, utilising an accountholder model. This implies that clients have to be willing to purchase retail goods on credit *before* being able to purchase insurance products. As clients have to fill in a detailed application form on which a credit score is calculated before qualifying for a store account, Edgars and Jet have detailed client information available *before* selling insurance to clients. This

"screening" of insurance clients has probably led to better premium persistency (than will be achieved by Pep). Since Pep has no client information available (due to its cash-only nature), selling insurance affords them an opportunity to get to know their client base. Client information collected during this process can be utilised in the cross-selling of other insurance and/or financial products and in the design of better products. Collectively, Edgars and Jet are able to reach LSM 3-10, while Pep is able to reach LSM 2-10.

Funeral parlours. As mentioned, funeral parlours have vast geographic reach and are able to collect premiums in cash. Due to these factors, captive funeral parlours are able to sell funeral insurance to LSM 2-6. However, their product range is limited to funeral insurance. Although it is expensive to set up funeral parlours, their core function (the provision of funeral-related services) allows potential cross-subsidisation of the distribution of funeral insurance.

Banks. Wizzit Bank is a virtual bank that provides cell phone banking services specifically targeted at all unbanked individuals (16m) in South Africa. As the majority of unbanked individuals fall in LSM 1-5, Wizzit includes these individuals within its target market. The Wizzit bank account is opened by Wizz Kids, young individuals from low-income communities. The average Wizz Kid has completed matric (Richardson, 2006) and should thus be able to meet the general fit-and-proper requirements of category A agents[19] (as required by FAIS) quite easily. The Wizz Kids are currently offering the funeral insurance product as part of the sale of the Wizzit bank account (to increase their earning potential on each transaction) and are also selling the products to a large affinity group, the Apostolic Church, of which many members have opened Wizzit bank accounts (Richardson, 2006). One large obstacle to the extension of bank accounts (especially to low-income individuals) and, thus also of insurance products, is the Financial Intelligence Centre Act (FICA). Wizz Kids find it very difficult to deal with the address verification requirements of the Act (see Section 5, where this Act is discussed). Wizzit is potentially able to reach Wizzit bank account holders across LSM 1-10.

Box 5: Case Study: Pep and Hollard Insurance

Nature of organisations and relationship. Pep, a cash clothing retailer targeted at the low-income market, is a wholly-owned subsidiary of Pepkor. Pep has a branch network of 942 stores distributed across South Africa (Müller, 2006). Through a joint venture, Pep partnered with Hollard Insurance, a company offering both short- and long-term insurance through an array of distribution channels, to provide insurance to its customers. Their products and joint venture was formally launched on 21 March 2006 (Gunnion, 2006a).

Target market and products offered. Three products, specifically targeted at individuals in LSM 2-6, were launched in the form of insurance "starter-packs". The products have a monthly premium of R19.99 each (Gunnion, 2006a). Clients do not have to purchase all three products and only have to buy the product(s) that they require. The initial product offering (it is possible that it will be expanded) includes the following products:

[19] Category A agents are only licensed to sell funeral insurance.

- Family funeral insurance (R5,000 cover for the main member and spouse, less for children and double the benefit in the case of accidental death).
- Family personal accident insurance (R5,000 cover for the main member and spouse, less for children)
- Cell phone insurance (if the cell phone was purchased at Pep it is replaced with the same model, up to the value of R1,000).

Marketing and sales. The insurance policies, with similar packaging to cell phone "starter packs", are simply placed on the shelves of all Pep stores. When the customer pays for the package at the till, the cashier captures the policy number and a telephone number for the client. As the cashier is simply performing an administrative duty, he/she is not required to be a FAIS-registered agent. The Hollard call centre will phone the client within 36 hours to capture and verify all client information. During this interaction with the call centre, a financial needs analysis (FNA) is not completed, but the client can request disclosure or explanations on certain aspects of the policy (Inglis, 2006). The client is also able to phone the call centre on a call share number (at the cost of a local call). The cell centre/helpline is staffed by FAIS compliant personnel that are able to disclose product and process information upon request (Edwards, 2006). A cool-off period of 30 days applies during which the client can still decide to cancel the policy and claim the first premium back (Inglis, 2006).

Claims payment. Hollard insurance will pay all valid claims on the funeral insurance product to a nominated bank account or (for unbanked individuals) through a nationwide network of burial societies/funeral parlours (Inglis, 2006). The personal accident insurance is paid out in exactly the same manner as the funeral insurance (Inglis, 2006). All claims on the cell phone insurance product are settled through Pep stores. When the claim has been assessed and deemed valid by Hollard Insurance, the claimant can collect a replacement phone from their nearest or most convenient Pep store (Inglis, 2006). The cell phone insurance policy does not offer the option of a cash payout as the intention behind the insurance is to ensure that the claimant is in exactly the same position after the loss as before it (Inglis, 2006).

Premium Collection. Clients receive a policy card with their purchase and are required to pay their monthly premium at a Pep store. During the transaction, the card with the policy number has to be displayed by the client and the cashier collects the money, while also recording the details of the client. If premiums are late, customers receive an SMS reminding them to pay their premium. A 30-day grace period is provided (Edwards, 2006).

Remuneration. Pep sales staff do not receive remuneration for policies sold. Financial incentives are set in terms of the overall sales of a specific Pep branch, with staff being rewarded with bonuses when certain targets are met (Edwards, 2006). Pep receives a retail commission on all policies sold and the underwriting profits are shared with Hollard according to the arrangements of the joint venture (Edwards, 2006).

Costs. This retail model is not burdened with high distribution costs. As all Pep infrastructure has already been established[20] and sales staff are already in place, the only real cost (to Pep) is the addition of the three new products to the total Pep inventory of products (Edwards, 2006). The products are not allocated a special position in the store and are simply placed on some of the open shelves, thus not implying additional display costs (Edwards, 2006). However, it is important to note that shelf space

20 The insurance sales component is easily integrated into its normal till system and the insurance management component remains with Hollard who utilises their existing systems.

carries a particular premium in retail stores and that there might be some opportunity cost associated with placing the insurance product directly on the shelves.

Assessment. Pep's infrastructural capacity allows it to collect premiums in cash at any Pep store. The model is characterised by low distribution costs as the only real cost associated with the roll-out of the insurance product is the one-time addition of the three products to Pep's inventory of products. The model is structured in such a manner that disclosure is provided upon request, i.e. the client has to contact the call centre to clarify confusing aspects of the policy. Although the ability of the model to collect premiums in cash and its infrastructural reach augers well for its success as a low-income model, it only provides disclosure on request and therefore cannot be considered totally appropriate for the needs of low-income individuals. Furthermore, placing the onus of payment on the client by expecting him/her to come in-store to pay the premium could lead to high(er) lapse rates.

3.1.2.5. CATEGORY 5: ORGANISED LOW-INCOME GROUPS

Description. The organised low-income group that distributes insurance to its members has recently established itself as a new intermediary category. The basic reason for the existence of the low-income groups is often not related to insurance[21], but in most cases focused on the provision of credit (microfinance organisations) or the facilitation of savings (savings and credit cooperatives) or other financial services. Some of these groups are member-owned and all monetary surplus derived from their activities is used to the benefit of group members, e.g. stokvels. Others are, however, not owned by the members and all profits/surplus derived is reinvested to serve its members in the best possible manner (e.g. the Small Enterprise Foundation (SEF)). These groups are all client-facing and the intermediation of insurance is initiated as a client collective process rather than by an existing intermediary or product provider.

Although these groups normally have a relationship with only one insurer, the group is independent in the sense that if the products of a specific insurer no longer meet the needs of its clients, it can move to another insurer. These groups, including burial societies, microfinance institutions, trade unions and even the apex body for a number of savings and credit cooperatives, identify the need for insurance amongst their members and react by establishing a relationship with the insurer of their choice. The group members form the clients of the intermediary and the group (acting as intermediary), thus owns the clients. The management staff of the group drives the product innovation process (with the help of the insurer) and products are tailored to meet the needs of the group members.

Low-income groups receive an intermediation fee from insurers for their role in the intermediation process. In some cases, administration is handled by an external administrator while, in other cases, the low-income group takes responsibility for policy administration. Low-income groups often experience great difficulty in establishing a link with the appropriate insurer. They do not always have the necessary skills to negotiate the terms of a contract with an insurer. In addition, it

[21] Except burial societies that do provide informal insurance (but also emotional support and other forms of assistance to their members).

seems as if insurers may lack the interest and intent to actively try and meet the needs of such groups despite large member numbers. Insurers generally find it difficult to create products innovative enough to suit the needs of low-income groups' clients. However, this might be the result of the inability of insurers to see low-income groups as profitable clients.

It is important to note that the intermediation role of low-income groups can evolve. Some low-income groups, such as burial societies, can move from a role where it provides informal insurance to its members to an intermediary role where it sells formal insurance policies underwritten and structured by a formal insurer to its members. In some cases, the low-income group can even evolve from an intermediary role to become an insurer in its own right.

Although organised low-income groups (through their intermediary function) can catalyse consumer education processes and fulfil insurance needs amongst their members, they have limited reach in terms of number of clients as their insurance offering is restricted to members. International experience (e.g. India) has demonstrated that although these organisations have some initial role to play in opening up the low-income market to insurance, they are not optimal in the distribution of *voluntary insurance* over the longer run and are replaced by formal insurers selling directly to their members (see Section 6.2.1).

Products. Low-income groups try to fulfil the most basic insurance needs of their clients first. For the examples discussed, this means first offering funeral insurance before extending the range of insurance products offered. Some of these groups offer credit life insurance to cover loans taken out from the group or sub-groups, while others (e.g. Lesaka) also offer short-term and legal insurance.

Category examples and LSM Reach. The LSM reach of the intermediary category of low-income groups is dependent on specific manifestations of this intermediary. A number of examples of organised low-income intermediaries can be identified:

- burial societies, e.g. the Great North Burial Society;
- apex bodies, e.g. The Savings and Credit Cooperatives League of South Africa (SACCOL);
- a union-owned third-party administrator, e.g. Lesaka; and
- microfinance organisations (MFIs), e.g. the Small Enterprise Foundation (SEF).

Burial societies. The Great North Burial Society is a large burial society, providing cover to between 15,000 and 20,000 members. It provided funeral cover underwritten by a formal insurer to its members, but due to regulatory constraints affecting this arrangement, is now considering becoming an insurer in its own right. Due to the nature of its membership, the Great North Burial Society's reach probably extends to LSM 1. See Genesis Analytics (2005) for more information on the Great North Burial Society.

Apex bodies. The Savings and Credit Cooperatives League (SACCOL) of South Africa provides funeral and credit life insurance to its members. In addition to

voluntary funeral insurance, it is compulsory for members (savings and credit cooperatives) of SACCOL to buy *credit insurance* from SACCOL to cover the full loan book. SACCOL has 40 savings and credit cooperates as members, representing 15 000 individuals. Of these individuals, 2,000 have opted to purchase funeral insurance. An informal client survey in 2003 found that the average monthly personal income of the individual SACCO members is approximately R3,000. This implies that SACCOL's insurance probably reaches individuals in the higher low-income to low middle-income categories, i.e. LSM 4-7.

Third-party administrators are typically not member-governed, but operate to generate profit. One exception to this rule is Lesaka Administrators, with the clients being both 'owned' by the administrator (i.e. not under the control of the insurer) and owners of the administrator. Lesaka is owned by a number of unions (essentially low-income employed groups), of which the union members form the client base of the administrator. It is, therefore, similar to a bargaining group through which the union members can negotiate underwriting with formal insurers and provide their own administration to reduce costs. This setup has ensured that the efficiencies gained through the administrator have been applied to the benefit of the client and has resulted in lower cost premiums to members than generally available in the open market. It does, of course, also benefit from the compulsory nature of the schemes provided through the unions, which have contributed to lower premiums (Genesis, 2005).

Lesaka does not see itself as an intermediary, but rather as a product provider, since it designs its own products (funeral and legal insurance) and then finds an underwriter who is willing to underwrite them. Premiums are collected in one of three possible ways: the government payroll deduction system, private sector payroll deduction systems or through debit orders. Its products are currently underwritten by SAfrican and Old Mutual. Lesaka has 700,000 employed members spread over LSM 4-7, of which it is estimated that 80% have bank accounts (Le Roux, 2006b).

International experience has demonstrated that *microfinance institutions* (MFIs) often form the initial catalyst for the provision of microinsurance. From an international perspective, there have been two main reasons why microfinance organisations have partnered with insurance companies to provide insurance to their members/clients. Firstly, MFIs may want to cover the risks associated with unsecured lending, for example, through the provision of insurance such as credit life and medical insurance for clients. This has been the main impetus behind the insurer, AIG's, involvement in microinsurance in Uganda. Secondly, insurers may want to partner with MFIs in situations where regulation mandates them to provide cover to a certain percentage of poor individuals, as the Insurance Regulatory and Development Authority (IRDA) forces insurers to do in India (see Section 6.2.1). In South Africa, however, the MFI sector is much smaller than in Uganda and India. This implies that even though South African MFIs could assist in distributing insurance to lower-income individuals, their impact will be limited to the number of existing clients. The main driver of the relationship is, therefore, the MFI seeking to provide additional value to its members.

An interesting example of a South African microfinance institution, the Small Enterprise Foundation (SEF), is discussed in Box 6. SEF is currently in the process of finalising negotiations with an insurer that will allow it to distribute insurance products to its members. SEFs interaction with insurers demonstrates the difficulties that lower-income groups experience in connecting with insurers and issues that have to be addressed when developing products for the low-income market.

Box 6: Case Study: The Small Enterprise Foundation (SEF)

Nature of the organisation. The Small Enterprise Foundation (SEF) is a non-profit microfinance institution based in Limpopo. It is focused on the elimination of poverty and unemployment through the provision of microcredit. This is achieved through two programmes – the Micro-credit Programme (MCP) and the Tshomisano Credit Programme (TCP). While the first targets micro loans at very small, but existing enterprises, the second programme targets women who live below half the poverty line and are not already involved in business, but who want to start their own enterprises. In the case of the TCP, SEF starts its work within a specific community by first conducting a participatory wealth ranking (PWR). After completion of the exercise, SEF field staff visit the poorest households to motivate women to start income generating enterprises. As these women do not have sufficient funds, microcredit becomes the means through which businesses are started. Given the nature of its credit programmes, SEFs insurance offering will be targeting individuals in LSM 1-5, although the majority of its clients can be classified as LSM 1-3.

SEF utilises the Grameen Bank's loan methodology by requiring potential members to form themselves into groups of five members. These groups are rigorously tested before being recognised as official groups. Upon achieving official group status, loans are issued (Lampe, 2006).

The need for insurance. Through focus groups with SEF clients, it was identified that the primary insurance need of SEF clients is for funeral insurance. It was discovered that although clients require emotional and non-financial support (such as assistance with food preparation) at the time of a family member's death, they also require a cash payout. Whereas burial societies do provide a small cash payout in the event of death, their main function is the provision of emotional and other support, while a funeral parlour policy provides for the funeral services. As households often need cash for the funeral itself or to sustain them after a breadwinner's death, it was thought that a formal funeral insurance policy would help address this need (Lampe, 2006).

The benefits of insurance. SEF concluded that the provision of funeral insurance to clients would help to (Lampe, 2006):

- Address the **economic vulnerability** of clients and prevent decline into poverty upon the death of a spouse or child;
- Mitigate the **risk of debt arrears** in the case of death in the immediate family;
- Improve **client retention** over the longer-term as SEF will be able to provide another service or benefit in addition to microcredit provision; and
- Create an **additional revenue stream** for SEF to improve its financial sustainability.

Upon completion of the focus groups, SEF decided that it wanted to offer insurance products to clients through acting as an intermediary that also performs some administrative functions (client information

collection and processing) and handles premium collection.

Product requirements. During the focus group process, SEF clients indicated that they initially want a product that only covers the core family (member, spouse and children). At a later stage, they would consider adding other family members (such as parents and extended family) to the policy. SEF wanted as few restrictions as possible, packaged in a simple product. It approached a number of insurers for quotes on existing products, but found that products already available in the market had too many drawbacks for both SEF members and SEF as an intermediary (Lampe, 2006):

- Products generally were too expensive for SEFs clients;
- Some products offered a too drastic tiered-structure in terms of benefits, i.e. there was too large a difference between benefits offered to adults and children;
- Products had too many exclusions and restrictions (such as age restrictions) and too long waiting periods; and
- Product price structure allowed too small an administrative fee for SEF to make the provision of insurance financially viable to the organisation as premium collection is an expensive process.

Linking with an insurer. SEF experienced many difficulties in finding the right insurer and also the right individuals within insurance companies to connect with. It experienced that many insurers were not receptive to offering products to low-income groups. SEF approached a number of insurance companies, with some never even replying to its request for quotes and/or a meeting. It found that an individual or organisation acting as a catalyst in finding the right insurer would have been useful (Lampe, 2006).

Although SEF was aware of the fact that they could have utilised an intermediary such as a broker in finding the right insurer, it felt that this was not a feasible option (Lampe, 2006). SEF would still have to do most of the administrative work and a further consideration was the protection of client confidentiality. A broker would also have added an additional cost layer to the final insurance premium.

The product. The product, as negotiated with the insurer that will be providing the funeral insurance, will offer three levels of cover for the core family (member, spouse and all legal children):

- Level 1: R3,000 cover for member, spouse and children older than 15, half the amount for children aged 14 or younger. This entails a monthly premium of R20.
- Level 2: R5,000 cover for member, spouse and children aged 15 or older, half the amount for children aged 14 or younger. This entails a monthly premium of R25.
- Level 3: R10,000 cover for member, spouse and children aged 15 or older, half the amount for children aged 14 or younger. This entails a monthly premium of R45.

Distribution process. SEF will be responsible for sales, premium collection, claims assessment and also payout. Premiums will be collected in cash by loan officers or staff collecting monthly loan repayments. All claims will be lodged through loan officers, who will also assess the claims. Claims will be paid in the form of a cheque, deposited directly into a bank account of the recipient's choice or will be received through a Post Bank/MTN wire transfer.

Other considerations. As SEF will not be offering the funeral policy to non-clients, it is concerned that individuals within the communities in which it is operating will try to access its microcredit products in order to access the insurance offered (Lampe, 2006). It was therefore decided that clients will not be

able to participate in the insurance offering until their second loan cycle has been completed. When the individual completes a third loan cycle, she may continue to participate in the insurance even if she decides not take any further loans. This implies that the client will not always have to be in debt in order to keep participating in the insurance offering. This differs from the way other international MFIs have traditionally sold their insurance products.

The issue of moral hazard will be addressed through SEFs careful group selection process used in the microcredit programmes.

Dealing with FAIS. SEF intends merely "presenting" and not actively selling (it will not be providing any advice) the product to its clients. It will be selling the funeral product under the insurer's Financial Service Provider (FSP) license and, consequently, will not need to register as an FSP. All loan officers involved in the sales process will be registered as agents of the FSP and will simply be using the tick-of-the-box sales method (Lampe, 2006).

Assessment. While the provision of insurance through an MFI is laudable, international experience has demonstrated that MFIs often fail as insurance intermediaries due to the difficulty of integrating insurance processes with credit processes and management. The absence of advice also does not augur well for the fulfilment of client needs. However, the products were only arrived at after consultation with SEF clients and negotiations with insurers – this at least assists in addressing the creation of appropriate products. Due to the economic profile of its microcredit clients, the insurance will mainly be targeted at individuals in LSM 1-3, although some clients could be classified as LSM 4-5. Although premiums will be collected in cash, this initiative will not be able to open up the low-income market to insurance. Nevertheless, it does provide a useful learning process to the benefit of intermediaries, insurers and clients, which could initiate the extension of access to insurance for a large number of individuals.

3.2. COST MODELS

3.2.1. PURPOSE OF THE ANALYSIS

In considering what intermediation models are the most appropriate to serve low-income clients, it is necessary to generate some approximation of relative costs. This analysis attempts to quantify the costs of *emerging brokers* distributing insurance. It seems that the emerging broker model, due to its individual nature of operation and the provision of independent advice, is the most expensive distribution model. Estimation of broker costs, consequently, provides us with a rough idea of *maximum* costs when distributing insurance to the lower-income market and we assume that other distribution models are associated with lower costs.

The purpose of the section is thus *to understand whether the emerging broker model, in its current or in a variant form, is able to (in a financially sustainable manner) serve the low-income market*. Alternatively, the purpose can be understood as to provide an assessment of the *limits* of the emerging broker distribution model. Given recent product developments in the low-income market, we have decided to use a proposed Mzansi short-term product (developed by

SAIA) and the CAT Standard funeral insurance product (developed by the LOA) to quantify the costs associated with distributing low-income insurance products through the *emerging* broker (see Section 3.1.2.1).

3.2.2. ASSUMPTIONS AND MODEL STRUCTURE

There are a number of issues that impact on the costs of a distribution model. In this analysis, we have drawn on interactions with industry players to ensure that our assumptions regarding these issues are as realistic as possible. It must be noted that the model does not try to approximate the costs of the average emerging broker, but rather creates a "frontier" model. This means that we try to model the lowest realistic costs possible to assess the limits of products and markets that could be served by the emerging broker. The basic assumptions and structure of the model are noted below (The reader is referred to Appendix C for detailed information on models and assumptions):

Start-up model. The model assumes that the broker does not have an existing portfolio of policies and is starting his/her business anew.

Costs included in model. The model includes consideration of transaction costs incurred in selling or servicing policies, as well as overhead costs. Costs have been based on various submissions in response to the National Treasury discussion paper (2006) on commissions in the life insurance industry, and interviews with various players and service providers. The costs are aimed at modelling *minimum* costs rather than average costs. Accordingly, our costs are mostly lower than costs reported in the submissions by intermediary and insurer representative bodies to National Treasury.

Cost item assumptions. Detailed costs assumptions and related calculations are contained in Appendix C.

Income received. Detailed income or commission assumptions are contained in Appendix C.

Sales model. A variety of sale models were used in the modelling process and the results for these are shown in Table 1 and Table 2.

- *Single broker selling individual policies only.* The most basic model is based on a single emerging broker selling on individual basis only and assuming that the broker can sell 15 policies on average per month[22]. It is important to note that this is quite a liberal assumption and thus presents a best case scenario.
- *Individual and group selling.* This model assumes that, in addition to the 15 individual policies a broker can sell, he/she also sells to one group (assumed to average 30 individuals) every two months. Like the assumption above, this is a quite liberal assumption and presents a best case scenario.

[22] The area in which the broker operates, i.e. urban or rural, was not taken into account in the assumption that the broker sells 15 policies per month.

- *Multiple brokers.* We used a scenario of three brokers sharing infrastructure, with each broker able to, on average, sell 15 individual policies and policies to one group every two months.
- *Single broker plus runner.* In addition to the three brokers of the previous model, we provide for three additional sales assistants for the broker. These assistants do not provide advice, but sell policies using the tick-of-the-box approach and, on average, sell 10 policies per month.
- *Multiple brokers plus runners.* This model extends the previous model to three brokers, each with three sales assistants.

Products. To simplify the analysis, our models are based on the broker selling one of two possible products. Given recent product developments in the low-income market, we have decided to use a product based on the proposed Mzansi short-term product (developed by SAIA) and one based on the CAT Standard funeral insurance product (developed by the LOA). For more background information on the products used for the cost modelling, see Appendix C.

Lapsing/surrendering. Again to simplify the analysis, the models do not factor in lapsing, surrendering or claims on policies. It, therefore, presents a type of 'best case'[23]. Introducing these events will impact negatively on the models.

Sensitivity analysis. In order to test the sensitivity of our findings to specific assumptions, we conducted a number of sensitivity analyses which are presented in the summary tables and the discussion below. The scenarios used in the sensitivity analyses are:

- Double sales volume assumptions;
- Double sales transaction costs;
- Halve sales transaction costs; and
- Remove estimates of FAIS-related overhead costs (e.g. recurring compliance and training costs, annual registration fees, etc.)[24].

The discussion of findings deriving from our models is structured around the type of product sold. For each model variant and sensitivity scenario we present three outputs:

- *Time to break-even.* The number of months required for the broker to break even on monthly basis (i.e. in any specific month income exceeds costs). This does not take into account the financing of any losses made leading up to the break-even month.
- *Volume at break-even.* The number of policies in the portfolio at break-even. This is relevant to consider whether the model can realistically manage the portfolio.
- *Cumulative loss at break-even.* This shows total losses over the period leading up to the first break-even month[25].

[23] Industry players indicated that lapse rates in the low-income market can equal anything up to 50%.

[24] The FAIS-related costs used in the model are based on assumed compliance with all the requirements of FAIS and not the actual level of compliance in the market.

3.2.3. RESULTS OF MODELS BASED ON SHORT-TERM INSURANCE PRODUCT

		Sensitivity tests					Impact of FAIS
		Original estimates	Double sales/month	Double premiums	Double direct sales costs	Halve direct sales costs	Take away FAIS fixed costs
Only individuals	*Time to break even (months)*	87	57	38	not after 95	64	75
	Volume at break even	1305	1710	570		960	1125
	Cumulative losses at break even	**R 380,873**	**R 321,164**	**R 162,542**	**R 777,946**	**R 236,737**	**R 281,656**
Add in groups	*Time to break even*	45	39	21	76	33	39
	Volume at break even	1350	1755	630	2280	990	1170
	Cumulative losses at break even	**R 216,425**	**R 238,732**	**R 95,816**	**R 516,359**	**R 128,588**	**R 165,433**
Multiple brokers (3 brokers, no secretary)	*Time to break even*	38	34	18	68	27	34
	Volume at break even	1140	1530	540	2040	810	1020
	Cumulative losses at break even	**R 154,381**	**R 183,765**	**R 67,972**	**R 406,934**	**R 83,874**	**R 124,272**
Single broker, 3 runners	*Time to break even*	34	34	16	66	23	31
	Volume at break even	2040	3060	960	3960	1380	1860
	Cumulative losses at break even	**R 235,339**	**R 331,765**	**R 102,271**	**R 703,680**	**R 113,932**	**R 195,772**
Multiple brokers and runners	*Time to break even*	31	32	14	61	20	29
	Volume at break even	1860	2880	840	3660	1200	1740
	Cumulative losses at break even	**R 186,957**	**R 282,760**	**R 80,852**	**R 607,702**	**R 82,569**	**R 162,352**

Table 1: Results of broker models selling the short-term product (and sensitivity analyses)

Source: Genesis calculations based on data from industry players, submission to National Treasury

It seems unlikely that emerging brokers, in the standard model and in other models, will be able to sell the short-term product to the low-income market. The lone emerging broker selling to individuals does not appear to be a viable or financially sustainable option for serving the low-income market. It takes more than seven years (87 months) to break-even (where total monthly commission received is greater than total costs) at which point, the broker has accumulated a debt of R380,873 (see Table 1). Although still not arriving at a favourable outcome, moving to a higher volume sales model (the group sales model) improves time to break-even and debt at break-even significantly. Break-even time is almost halved (although it still takes almost 4 years to break even) and debt, although still substantial, is considerably lower at R216,425 (see Table 1). Of all models, the multiple-brokers-and-runners model appears to fare best. However, it still takes more than two and a half years to reach break-even, at which stage the broker has accumulated a debt of R186,957. The lag period to break-even and debt accumulated at break-even does not provide attractive market opportunities and will discourage entry into the emerging broker market.

[25] This is simply done on present value basis and does not take into account the cost of financing these losses. Including the financing costs will have a negative impact on the models.

Simply increasing (or doubling) volumes does not allow brokers to serve this market. An examination of figures derived from the sensitivity analysis on the doubling of policies sold per month leads to the conclusion that there is a ceiling or level of policies sold beyond which additional volumes do not provide any beneficial impact to the models. In the case of the runner and multiple-brokers-and-runners model, a position is reached where the financial position of the broker actually worsens when more policies are sold. The only model that really benefits from a doubling of the policies sold per month is the individual model. The reason why the addition of volumes or group-selling does not make a significant difference to the financial position of the broker is that a point is reached where the costs associated with the selling and, in particular, *servicing* of existing policies is greater than the commission that can be earned from a low-premium product.

Increasing premium levels significantly, results in a more favourable position for the broker model. Contrary to the effect of doubling the number of policies sold, the doubling of premium values does have a very favourable impact on the financial situation of the broker (Table 1). The doubling of the premium from R45 to R90 has the following impacts:

- The *individual model* is still unsustainable (and a large debt of R162,542 is accumulated), but time to break-even becomes more feasible (it decreases to 38 months) and the policy volumes at the break-even point more realistic (decreases to 570 policies). This demonstrates that when premiums are high enough, the broker (in its current form) is able to serve individuals. However, the premiums required for the broker to successfully serve individuals may be at levels that are only affordable at the upper-end of the low-income market or even beyond the low-income market.
- The *group sales model* and the *multiple broker model* become more feasible at a premium of R90, although debt levels are still high (R95,816 and R 67,972, respectively) and time to break-even is still long.

<u>Note:</u> If the premium is four times greater (this scenario is not shown in Table 1*) than originally assumed (i.e. R180), most models (except the individual model) break-even within 10 months, although debt levels are still higher than R30,000. This demonstrates the extent to which premiums would need to increase in order for these models to be feasible.*

It is important to keep the different Mzansi product options in mind when interpreting these figures. Some products are priced at more than R90 and arguably, intended for the upper end of the low-income market. However, even if these products would allow the emerging broker to operate on a financially sustainable basis, demand from the low-income market will be limited.

Even an environment without the FAIS Act would not improve the broker's feasibility in serving this market. Although FAIS has a substantial impact on overhead costs (up to 20%), the impact of overhead costs on feasibility is overshadowed by the continued impact of direct sales costs. If all FAIS cost components were to be removed from total overhead costs, it only makes a

marginal difference to the financial sustainability of the broker in selling the Mzansi product (compare the last column of Table 1 to the original column). The time to break-even is only marginally reduced and cumulative losses remain high for all models.

Although the impact of FAIS on direct costs is not explicitly modelled, we can assume that the FNA and other reporting requirements imposed by the FAIS Act will increase the amount of time spent to complete an individual sale. FAIS may also translate directly into increased trips to see the client and an increased amount of paper that may need to be printed. To understand whether the broker's viability would increase if direct costs are reduced, we halved direct costs (see Table 1). The results indicate that even a significant reduction in the broker's direct costs does not improve the broker's financial position sufficiently.

Up-front, rather than as-and-when commission could create a more viable situation for the broker. A scenario in which commission on the R45 premium is received at a 3.25% level on an up-front basis (the same payment structure as that of the funeral product) was also modelled (not shown in Table 1 or Table 2). This provides some indication of the difference in viability between an up-front and an as-and-when commission structure. While the individual selling model was not viable using these assumptions, the other models all became profitable after either the 7th or 13th month, with accumulated losses only amounting to between R25,000 and R42,000. This shows that selling of even a moderate to low premium product (R45) on an up-front commission basis allows the broker model to achieve a position of relative financial sustainability. This is not a suggested solution for the distribution of short-term microinsurance, but gives an indication of the power of up-front commission on the viability of the broker model.

3.2.4. RESULTS OF MODEL BASED ON LONG-TERM PRODUCT

This section looks at the distribution of the funeral product. It is important to remember that, in contrast to the short-term product, an up-front commission structure applies. Consequently, from the 19th month onwards the level of commission earned does not change as the broker is selling the same number of policies thereafter and all commission is paid within the first 19 months after a policy sale (refer to Appendix C for a discussion of the commission structure).

		Sensitivity tests							Impact of FAIS
		Original position	Change comm. @ 10% commission	Double sales/month	Halve premiums	Double direct sales costs	Double direct servicing costs	Double overhead costs	Take away FAIS fixed costs
Only individuals	**Time to break even (months)**	19	1	7	never	never	19	never	13
	Volume at break even	285	15	210			285		195
	Cumulative losses at break even	**R 42,610**	**R 0**	**R 26,509**			**R 45,326**		**R 27,556**
Add in groups	**Time to break even**	7	1	1	19	7	7	13	7
	Volume at break even	210	30	30	570	210	210	390	210
	Cumulative losses at break even	**R 16,558**	**R 0**	**R 0**	**R 63,042**	**R 39,675**	**R 17,025**	**R 64,675**	**R 9,106**
Multiple brokers (3 brokers, no secretary)	**Time to break even**	7	1	1	13	7	7	7	7
	Volume at break even	210	30	30	390	210	210	210	210
	Cumulative losses at break even	**R 7,343**	**R 0**	**R 0**	**R 37,423**	**R 30,459**	**R 7,809**	**R 35,445**	**R 2,196**
Single broker, 3 runners	**Time to break even**	7	1	1	13	7	7	7	1
	Volume at break even	420	30	30	780	420	420	420	30
	Cumulative losses at break even	**R 3,787**	**R 0**	**R 0**	**R 50,854**	**R 50,020**	**R 4,720**	**R 41,104**	**R 0**
Multiple brokers and runners	**Time to break even**	1	1	1	7	7	1	7	1
	Volume at break even	60	60	30	420	420	30	420	30
	Cumulative losses at break even	**R 0**	**R 0**	**R 0**	**R 36,253**	**R 40,805**	**R 0**	**R 22,674**	**R 0**

Table 2: Results of broker models selling the funeral/long-term product (and sensitivity analyses)

Source: Genesis calculations based on data from industry players

The current broker model will be able to serve the low-income market with higher premium products under an up-front commission structure. The first column in Table 2 illustrates the potential for the broker to serve the low-income market and, especially the upper end of the low-income market, through the sale of a R75 premium product under an up-front commission structure. As can be seen, even a model that serves only individuals is able to break even after 19 months, with cumulative losses totalling R42,610 (at a more manageable level if compared to the findings for brokers selling the short-term product[26]). The other models all reach break-even faster and at lower debt levels. If it is assumed that, in general, risk premiums for life products are higher than R75, Table 2 indicates that the broker should be able to play a role in the low-income space and find the selling of these products viable. As mentioned, 3.25% is a very conservative commission rate for funeral insurance as commission rates are uncapped. If the commission rate is set at 10%, all models are profitable in the first month.

Note: A R75 premium for a funeral insurance product is probably too high for the average low-income client as a product providing the same levels of cover could be purchased for lower premiums at certain providers (e.g. banks and retailers).

Broker models will not be able to penetrate very deep into the low-income market with low premium values. As soon as the premiums are halved, the individual emerging broker never breaks even (see Table 2) and even the group model starts approaching high debt levels at break-even. In addition, the group model never really becomes strongly profitable (a monthly profit of R552 is the largest profit generated) and by the 44th month the model starts generating losses again. Only the variant business models seem like they may be viable in a situation where the premium is halved. This is especially true for the models where the overhead costs are shared by multiple brokers and debt levels at break-even are approaching R30,000. We have not explicitly considered the financing options available for the reviewed models, but this may present a problem.

Variant broker business models may still be able to play a role in the low-income market even if selling, servicing and overhead costs were to increase. It is possible that selling, servicing or overhead costs were underestimated. To analyse the sensitivity of selling, servicing and overhead costs, these costs are doubled. All models, except the individual selling model (see Table 2) break even by the 7th month under each scenario. In addition, where the servicing costs are doubled, all models, except the individual selling model, break even with quite low accumulated debt levels.

The removal of FAIS fixed costs creates a more viable situation for the emerging broker. When FAIS fixed costs are removed (up to 20% of total overhead costs), the financial situation of the emerging broker becomes more viable. The lone emerging broker is able to break even after 13 months, while the number of policies sold at break-even decreases to 195 and accumulated losses at break-even decrease to R27,556. The situation is even better with the individual

[26] However, this might still be too high a level in order to obtain financing from a bank or other organisation.

broker selling to groups who breaks even after seven months with accumulated debt totalling only R9,106, while accumulated debt at the break-even point for the small brokerage or multiple brokers is only R 2,196. The “runner” and “brokerage with runners” models break even after one month, with no accumulated losses or debt.

High sales volumes may assist in making the low-income market slightly more attractive. In a scenario of doubled sales volumes, all broker models (except the lone emerging broker) break even within the first month. However, the lone emerging broker only achieves break-even after 7 months and 210 policies sold, with an accumulated debt of R26,509.

3.3. CONCLUSIONS ON AND ASSESSMENT OF SELECTED MODELS

This section concludes by providing an overview of the performance of a selected number of intermediation models on criteria relating to their potential for microinsurance distribution as well as summarising the findings from the cost modelling.

The evaluation of specific models is mostly focused on those models already operating in the low-income market or on models that have the potential to serve this market. It does not constitute an exhaustive analysis of all the models operating in the low-income market. Furthermore, the ratings allocated to various aspects are our conclusions based on available information and conversations with these and other players[27].

[27] See Appendix B for an explanation of the various criteria used and notes on the calculation of specific scores.

Category	Model	Example	Cash	tick-of-box	FAIS impact		Access Score	Likely LSM reach									
					Cost	Advice		1	2	3	4	5	6	7	8	9	10
Broker	Independent traditional broker		X	X	●●	✓	●										
	Independent emerging broker		X	X	●●●	✓	●										
	Shared brokerage	Masthead	X	X	●	✓	●										
	Networked emerging broker	Small brokers	X	X	●●	✓	●										
Captive agent	Traditional agent		X	X	●	✓	●										
	Direct sales (telephone only): Long term	1Life	X	X	●	✓	●●										
	Direct sales (telephone only): Short term	Outsurance	X	X	●	✓	●										
	Direct sales and network marketer: Long term	Clientele	X	X	●	✓	●●										
	Franchised agency	Liberty	X	X	●●	✓	-										
	Agent + call centre compliance and admin	Metropolitan (REI)	X	X	●	✓	●●										
	Tiered agency force	HTG	✓	✓	●●	✓	●●●●										
Multi-function (independent and captive)	Bank counter/broker	Standard Bank	X	X	●	✓	●●										
	Independent funeral parlour (multi-function)	Small parlours	✓	✓	●●●●	X	●●										
	Cash retailer/OTC plus limited call centre support (independent)	HTG/Shoprite	✓	✓	●	X	●●										
	Cash retailer/OTC plus call centre support (captive)	Pep/Hollard	✓	✓	●	D	●●●●										
Low-income groups	Union owned low-income group	Lesaka	X	✓	●	D	●●●										
	MFI	SEF	✓	✓	●●●●	D	●●●●										

Table 3: Evaluation of selected intermediation models on ability to successfully serve the low-income market

X – model negatively relates to this criteria

✓ - model positively relates to this criteria

D – model provides disclosure on demand from client

● → ●●●●

Low → High

Traditional (and particularly advice-based) models have not been able to extend into LSM 1-5 and have been limited to the banked and employed. These models are shown at the top of Table 3 and fall in the broker and agent categories. There are some interesting model variations that reduce cost (also FAIS compliance cost) and improve the reach of some of the models (e.g. call centre support for agents and brokers in the Metropolitan REI model), but these models are still unable to penetrate significantly into LSM 1-5. Where models have been able to extend to the lower LSMs, this has been based on group sales, which were mainly limited to larger employers. Most of these models are based on advice and the FAIS will eventually reduce even the limited penetration in LSM 1-5 (darker shaded areas in Table 3).

Cost modelling suggests limited role for advice-based sales model of brokers in LSM 1-5.

- *The low value of products sold to the low-income market and inability to cope with significant volumes will make it difficult for the emerging broker in its current form to play a role in the low-income market.* This conclusion applies to both the Mzansi short-term product and the funeral/long-term product.
- *Emerging broker models operating under a complete as-and-when commission structure will not be able to serve the low-income market.* Although the variants of the broker model achieve financial sustainability faster and at lower debt levels, it is possible that accumulated debt levels for an as-and-when commission structure will simply be too high to source financing.
- *An increase in premiums or commission levels affects the financial viability of the broker model the most.* In the case of the short-term product, premium levels that were doubled decreased accumulated debt (compared to the original estimations), while also decreasing time to break-even and the number of policies at break-even, the most of all the sensitivity analyses. When commission levels were increased from 3.25% to 10% for the funeral insurance product, all models achieved break-even within the first month. This provides a clear indication of the difficulties faced by brokers in selling low-premium products to the low-income market.
- *Although higher premium sales will allow the emerging individual broker models to be viable, it is likely that these higher premiums will be unaffordable to the low-income customer.*
- *Variants of the emerging broker business model seem to be able to serve at least the upper-end and possibly (under an up-front commission structure) lower into the low-income market.* This is shown by the multiple-broker-and-runner-model, which breaks even within 7 months when selling a R37.50 funeral product at a 3.25% up-front commission.
- *Changes from an up-front commission structure to a mixture between an up-front and as-and-when commission structure (a potential outcome of National Treasury's discussion paper) will threaten the ability of even the variant*

emerging broker models to serve the low-income market. We are unable to comment on the extent of this at this stage. However, increased commission rates (especially for funeral insurance, which is uncapped) may allow a mixture of up-front and as-and-when commission structures to be feasible.

- *Emerging brokers need to up-skill in order to survive in the market.* On the short-term side, the market is already operating on an as-and-when commission basis. In order for emerging brokers to operate, even utilising the reinvented models, they will need to focus on higher premium business. On the long-term side, there is still uncertainty about the exact form that regulations will take. However, it seems as if regulations are going to force the market from up-front commissions to a mixture of up-front and as-and-when commissions. We are not sure how far down this path things will go. What we do know, is that emerging brokers' margins will be squeezed and that they will need to attract higher premium business. As a result, for both long- and short-term insurance policies, emerging brokers will only be able to obtain higher premium business with better skills. To increase their skills, they will require financial and other support from government and/or the insurance industry. Better skills will allow them to continue to operate as individual brokers or, more profitably, in some of the potential variant business models suggested in this section. The outcome for the low-income market is that these emerging brokers may be able to cross-subsidise a certain amount of low-end sales with higher premium sales. As a result, the emerging broker may be able to play a limited role in the communities from which they derive from and which generally constitute the low-income market.

A number of new models are emerging that extend beyond banked and employed and are able to serve LSM 1-5. These models are shown at the bottom of Table 3 and fall in the multi-function and organised low-income group categories. They share a number of characteristics:

- *Ability to collect cash premiums.* A key advantage of the new models is that they are able to collect premiums in cash[28] or collect premiums through alternative means (to bank account or salary deduction). The result is that these models are able to serve the unbanked and those that fall beyond payroll deduction. An additional advantage of cash collection is the ability to collect irregular premiums, which will be critical for a large proportion of LSM 1-5 (see Section 4.6)
- *Reliance on tick-of-the-box selling.* Tick-of-the-box selling is where a model utilises a simplified sales process of simply 'ticking' the relevant box or space on a form if insurance is required. The sale is conducted without advice. In a few cases disclosure and/or advice is available on request of the client, but it is

[28] However, a concomitant disadvantage of the collecting premiums in cash is the possibility of higher policy lapse rates.

not part of the standard sales process. It often implies that the sale is completed (i.e. the client indicates that she wants to purchase the product) before any disclosure or advice on the product is provided (if any disclosure/advice is provided at all). One benefit of the tick-of-the-box method to the intermediary is that the sale can be conducted by a non-FAIS registered employee (see Section 5.3.2). Only one of the models provide advice upon request (the tiered-agency force), while two of the models offer at least disclosure (microfinance institutions and captive cash retailers). A potential concern is that a number of the new models do not offer disclosure as part of the basic sales process but only on request of the client. This means that the client has to know what to ask for in order to obtain sufficient information on the product. This can generally be assumed not to be the case.

- *Utilising brand trust and/or group affinity to facilitate sales.* The new models all utilise some form of brand or affinity power to facilitate an easier introduction of its insurance products to the lower-income market. The leveraging of brand power not only helps to reduce certain intermediation costs components such as advertising, but also helps to facilitate trust by potential clients in the offered insurance product(s). As clients are familiar with and trust the intermediary, it takes less time to sell the product and clients are willing to make the purchase without requiring significant face-to-face interaction. This argument applies to a strong, visible retail brand (e.g. the retailer models). Similarly, trust, as found in low-income groups, can also facilitate insurance sales.
- *Intermediary control over distribution channel.* The nature of the relationship with the distribution partner means that access to the client in most of the new models is beyond insurer control. The intermediary or distribution channel generally controls access to the client and forces the insurer to partner with these institutions. However, for at least one of these models (the captive cash retailer) the insurer has managed to structure the partnership in the form of a joint venture, which means that the insurer is also able to gain access to the client through direct access to client information. While the retailer controls access to new clients, the insurer, therefore, is in a position to interact directly with the existing clients even if the relationship between the insurer and retailer breaks down. We return to the issue of controlling access to client groups in Section 7.2).
- *Simple, but effective use of information technology.* A further key aspect of the new models is their simple, but effective application of **technology** for communication purposes. A number of the models utilise SMS reminders for clients who pay their premiums in cash and have cell phones or use systems of phone-back disclosure where the call centre responds on a missed call or SMS. For at least three of the models[29], a call centre is of central importance in communication with clients.

[29] Tiered-agency, independent retailer and cash retailer.

Although the new models will place the products within reach of low-income customers, it is not clear whether they will achieve take-up. Although the new models hold much promise, they have not yet proven their success. Our review has revealed some critical limitations, which raises questions about the take-up that will be achieved through these models and the level of service that will be provided to low-income clients.

- *Claims processes lag sales and premium collection innovations.* Although all of these models are able to collect premiums in cash, some have not been able to reconcile cash collection with claims payment processes and often still require a bank account to pay claims. One solution, especially in the case of the retailer models, would be to utilise the existing infrastructure of the retailer to facilitate in-store cash payments. However, problems arising out of this solution, such as security risks and possible cash flow issues, would first have to be addressed. It is, however, obvious that this misalignment in the distribution process would first have to be addressed if the low-income market is to be served successfully.
- *Disclosure on demand rather than by default.* The fact that a number of the new models do not provide advice and only provide disclosure on request creates a substantial risk of at least some mis-selling to clients occurring.
- *Low-income group models limited to membership*. The models that are able to extend to the lowest LSM categories (microfinance institutions and other low-income groups), cannot extend beyond their core membership. Particularly MFIs have limited membership and will only be able to intermediate insurance to their members.
- *Distribution still limited to funeral policies.* The only product actively being sold (with the exception of Pep/Hollard) is funeral insurance. Although we note this as a limitation, the extensive reach of and familiarity with funeral insurance also means that clients understand basic insurance products and are aware of them.
- *Passive model unproven in markets not familiar with insurance.* One of the most critical limitations of the current low-income distribution models is that (along with advice), they have also removed active selling from their sales model. A number of the new models employ a passive sales model, which relies on clients to approach a counter or distribution point rather than a sales agent approaching a client. This model has not yet demonstrated its success in the low-income market. In the case of the HTG/Shoprite example, take-up of insurance policies to date has been very low. The Pep/Hollard model has not been in existence very long and it is thus too early call for a verdict on sales numbers. However, for the Pep/Hollard model, full integration with the sales

process[30], incentivisation of sales at store level and contact centre sales support may result in more active promotion of the products.

[30] In contrast to the Pep/Hollard model where insurance products are placed on open shelves in the stores, Shoprite sells insurance products from a separate Money Market counter in the store.

4. SEGMENTATION OF THE LOW-INCOME MARKET

Key findings from Section 4

• A large number of unreached clients in LSM 1-5 are within reach of existing formal and informal client touch points.
  • 4.2m people in LSM 1-5 have bank accounts but no form of formal insurance.
  • 3.3m people in LSM 1-5 have a pre-paid cell phone but no form of formal insurance.
  • 1.4m people in LMS 1-5 have store account, but no form of formal insurance.
• For a large proportion of LSM 1-5, premium collection is, therefore, not the main constraint in reaching the uninsured as they are already accessing other formal and informal networks which could serve as a potential payment collection system.
• All the alternative client touch points are still beyond the control of insurers and will rely on partnerships with institutions that control access to the client groups.

4.1. INTRODUCTION

In this section, certain demographic and other characteristics of LSM 1-5 (or the low-income insurance market) are explored as part of the demand-side analysis. These characteristics were selected because they are able to provide some indication of:

- product characteristics required to succeed in the market;
- potential reach of insurance channels;
- distribution strategies that are likely to succeed in the low-income market; and
- likely insurance take-up.

Using the mentioned characteristics, the low-income market is segmented into groups or categories with specific profiles that have implications for how insurance is distributed to these groups. Although the categories and their descriptors do not allow us to measure actual demand for insurance, they do provide an indication of factors that could potentially drive demand and, consequently, allows us a glimmer of how the need for insurance (which we assume is there) could be fulfilled by insurers. In addition, some statistics around current microinsurance usage in LSM 1-5 are explored. This section should therefore *not* be considered a demand analysis, but rather viewed as a *demand-side analysis*.

4.2. SCOPE OF ANALYSIS AND RISK CONTEXT

Defining the low-income market. The FSC clearly states that insurers have to increase effective access and that this means (amongst other things) "a sufficiently wide range of first-order retail financial products and services to meet first order market needs and which are aimed at and are appropriate for *individuals who fall into the All Media Product Survey (AMPS) categories of LSM 1-5"* (emphasis added). The FSC definition of the low-income market is thus posed in terms of LSM 1-5, an asset-based segmentation of the low-income market.

In contrast, the Life Offices Association (LOA) uses a market categorisation based upon *individual income*, "using R3000 as the upper income"[31]. This implies that any individual earning a monthly income equal to or less than R3,000 would fall into the LOA's target market for the so-called CAT (Charges, Access and Terms) Standards products developed by the LOA to fulfil the targets set in the FSC. The income definition serves as practical proxy for LSM 1-5 as it is often difficult to determine an insurance client's LSM.

An income-based definition of the low-income market relates directly to the issue of affordability of insurance products. Using such a definition, it is much easier to answer the question of whether, given a specific monthly household or personal income, households would be able to afford paying a certain monthly insurance premium. However, since the FSC Council has not officially changed or adapted definition of low-income market, this analysis uses the LSM 1-5 definition of the low-income market.

Risk in the low-income market. Low-income or poor households are more vulnerable and exposed to adverse events. Vulnerability for this group is increased by uncertain or irregular incomes, the absence of an asset buffer and equally vulnerable social support structures. Not only are these households more vulnerable than other households, they are also more at risk. Low-income individuals normally live and work in environments with a higher probability of adverse events such as infection, accidents, theft and fire occurring.

Strategies to deal with risk. Individuals within these households can choose between one of two main strategies to deal with risk. Risk mitigation strategies, including insurance, savings and credit, can be used before or during an event to limit the impact of the adverse event when it does occur. Coping strategies, such as withdrawing children from school to save on educational expenses or reducing other household consumption, are used after occurrence of the adverse event. Insurance is only one of a number of risk mitigation strategies and it will not be rational for all households to insure themselves against all possible adverse

[31] Sid Kaplan, LOA Access Committee.

events, nor will households necessarily choose to insure (even if it is the rational choice). However, as insurance is the risk mitigation mechanism of choice for many households, it is necessary to understand the factors that determine and shape demand and also supply responses.

Insurance usage vs. need. Insurance usage cannot be considered indicative of insurance demand. However, establishing true levels of demand for a product within any market is difficult. In the South African context, the problem of insurance demand measurement in the low-income market is exacerbated by the fact that products (to date) have not been designed to meet the needs of this market (with some notable exceptions). In addition, financial literacy within this market is also not very high and certain insurance concepts unfamiliar[32]. Given the difficulty of establishing the real demand of insurance within the low-income market, this section uses insurance usage figures derived from FinScope 2005 to provide some indication of demand.

The meaning of derived numbers. It is necessary to emphasise that the segmentation process utilised in this study and the resultant discussion are focused on the demonstration of an *approach*, rather than on the absolute numbers or statistics derived from the approach.

[32] The proliferation of burial societies and relatively high usage of funeral insurance in the low-income market has supported an understanding of funeral insurance and its benefits. However, other insurance concepts, such as short-term insurance, are still largely unfamiliar to the low-income market.

4.3. THE CURRENT MICROINSURANCE MARKET

The microinsurance market in South Africa is limited in products offered and penetration achieved. Figure 3 shows the usage of insurance and other financial products across LSMs as recorded by the FinScope 2005 survey[33].

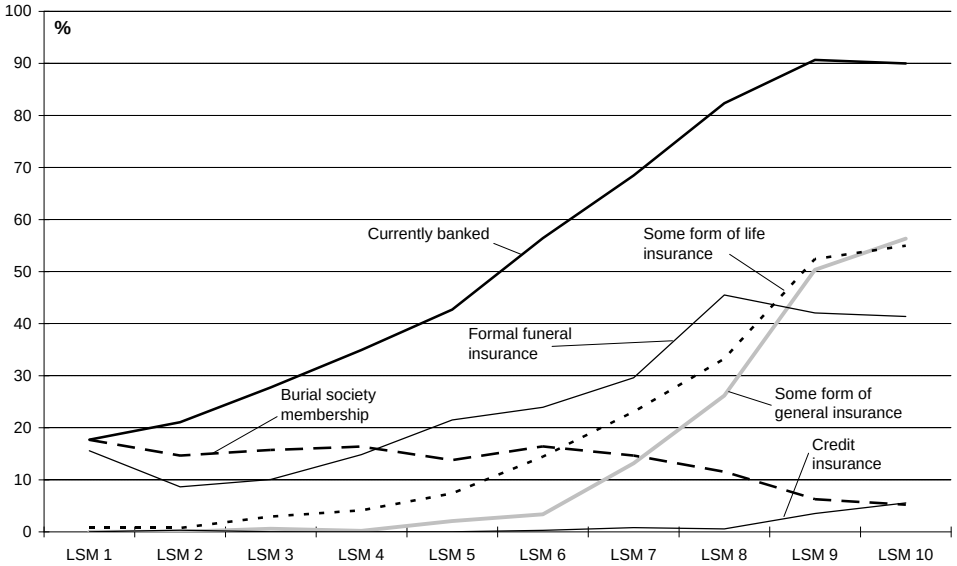


Figure 3: Usage of insurance and other financial products across LSMs
Source: FinScope 2005[34]

Based on the information captured in the FinScope survey, a number of observations can be made on the current microinsurance market:

Only funeral insurance achieves notable usage. 27% of individuals in LSM1-5 indicated that they have some form of funeral insurance (including formal insurance through a "big institution", insurance through funeral parlours, insurance through employer or burial society membership[35]). An important and still unanswered question on the success of funeral insurance is whether the 'success' achieved by this product is due to the characteristics on the supply-side (e.g. uncapped commissions) or simply because of the particular cultural demands around funerals in South Africa. In contrast to all other insurance products, funeral insurance seems

[34] In Figure 3, short-term insurance is represented by the general insurance category.

[35] For simplicity, we refer to burial societies in the same context as insurance products. Previous research, however, suggests that, although burial societies provide funeral cover, they do not provide insurance as defined in South African legislation as the benefits are not guaranteed. See Genesis (2004) for a more detailed discussion.

to be bought, rather than sold. However, irrespective of the drivers of the successful take-up of funeral insurance, what is clear is that the product's success in the low-income market will definitely contribute to the same market's receptiveness to other insurance products and they have now had some insurance exposure.

Of the funeral insurance usage, a large proportion is through informal burial societies. Of the 27% that have any form of funeral insurance, about 60% are members of a burial society and about 50% are only members of a burial society (i.e. they did not use any of the other funeral insurance products). Although a proportion of these may refer to formal funeral insurance products sold through informal societies, this is still quite limited and not expected to be a large component of the informal product usage. The bulk is still expected to be informal insurance products managed without any relationship with a formal insurer. In addition to showing the strength of the informal societies, this is also a demand signal for the need for products to manage risks faced by lower-income households.

Of the formal insurance usage, the bulk is through funeral parlours. Exploring funeral insurance usage further, the bulk (30%) of usage in LSM1-5, outside of burial societies, is provided through funeral parlours. From previous research (Genesis, 2004), this could be where the funeral parlour acts as the agent of the formal insurer but in many cases, this also presents illegal insurance schemes run by funeral parlours without any relationship with a formal insurer. The data available is insufficient for the disaggregating of these two components or to provide estimates of the extent of illegal insurance. Qualitative research suggests that the self-insured component may be substantial.

Other than funeral insurance use of formal life or general insurance products are restricted to the higher-income market. Figure 3 shows very limited usage of formal life or short-term (general) insurance below LSM 6. Of all individuals in LSM 1-5, only about 4% and 1% have, respectively, some form of formal life insurance or short-term insurance.

Bank accounts exceed insurance penetration at lower-income levels. The absence of bank accounts is often given as the reason by insurers why they cannot access lower-income households (due to the cost and difficulty of collecting cash premiums). While it may be true that the absence of bank accounts complicate the distribution question, Figure 3 shows that bank account usage exceeds usage of formal insurance products. This suggests that the premium collection and claims payment elements of distribution may not be the primary barriers. In addition, take-up of formal bank products suggests a familiarity with formal institutions and possibly some level of financial literacy.

The use of store cards suggests some potential of retailer distribution for extending the reach of formal insurance products. Although equally limited in LSM1-3, store card usage in LSM 4-5 exceeds formal insurance usage (if funeral insurance is excluded - of which the bulk is in any event distributed through funeral parlours) and suggests some potential for the distribution of other financial products through retailers. While 13% (2.4m people) of individuals in LSM 1-5 have a store card or account, 97% (2.4m) of the store card holders do not have general insurance, 79% (1.9m) do not have life insurance and 70% (1.75m) do not have formal funeral insurance. In addition, between 20% and 30% of store card holders in LSM 3-5 do not have a bank account. This presents a substantial and untapped market within reach of the retailers. This is a conservative signal as it is expected that insurance could be sold to a larger proportion of the retailers' client base than may currently use or qualify for store cards or accounts.

Even in the lower-income market, the bulk of formal life and short-term insurance is still sold through brokers and agents. While the question in FinScope 2005 on how insurance was bought is limited to the few individuals in LSM 1-5 who have purchased formal life or short-term insurance products (768,000 and 148,000 respectively), it is still interesting to note that 86% and 71% respectively reported to have purchased this through a broker or an agent. The distribution of formal funeral insurance was not explored by a similar question, but the analysis above suggests that the bulk of formal funeral insurance is sold through funeral parlours and that the component expected to be sold through broker or agents will be quite limited. The limited penetration of brokers and agents in the low-income market can probably be drawn back to low levels of profit achievable in this market through one-on-one sales (see Section 3.2). While the situation for funeral parlours is quite different from that of general retailers (primarily that funeral parlours insure the service that they, in fact, provide), it also confirms the need of formal insurers to consider distribution channels such as retailers.

Focus limited to LSM 1-5. Although Figure 3 visually presents insurance usage in LSM 1-10, the above discussion was focused on only LSM 1-5 as this is the category of interest for the rest of the section.

4.4. DEFINING THE DISTRIBUTION SEGMENTS

Why segment? The adult LSM 1-5 population is not a homogenous group. This population (consisting of 19m individuals) can for the purpose of assessing distribution potential, be divided into groups. Two main indicators were selected to create easily identifiable distribution groups: *banked status* and *source of income*. These indicators were chosen as they relate to the following factors that have implications for the distribution of insurance to this market:

- consistency of income (mainly captured by source of income data);

- accessibility of income through payment system (captured by both source of income and banked status); and
- current usage of formal financial services (captured by banked status).

Identifying groups. Using FinScope 2005 data, it was possible to determine the banked status (banked or unbanked) of the adult LSM 1-5 population. The same data was also used to construct five *sources of income* categories which were then applied to the same population:

- *Company income*: Individuals earning a regular wage or salary from a company. This source of income implies that insurers will most likely be able to access income through the payroll system and also employ worksite marketing in reaching these individuals.
- *Job income*: This category includes individuals earning a regular wage or salary from other individuals (e.g. domestic workers, farm workers). The fact that income is earned from an individual eliminates the possibility of payroll deductions.
- *State grant or pension*: Although the size of state grants or pensions might raise affordability issues in terms of insurance premiums, individuals in this group still earn a consistent form of income.
- *Other/irregular income*: Individuals falling in this category are self-employed in either the formal or informal sector. Income can be derived from a number of sources, including the selling of goods and rent from a room or property.
- *Unemployed:* Individuals in this group have no regular source of income. However, this does not imply that they receive no income. Some income is received from sources such as family and friends and/or Lotto winnings.

The combination of banked status and employment status thus segments the adult LSM 1-5 population into ten groups or categories. Two key factors were used to then collapse the ten groups into four groups (visible in the table below):

- Consistency of income; and
- Availability of a formal point of access for insurers.

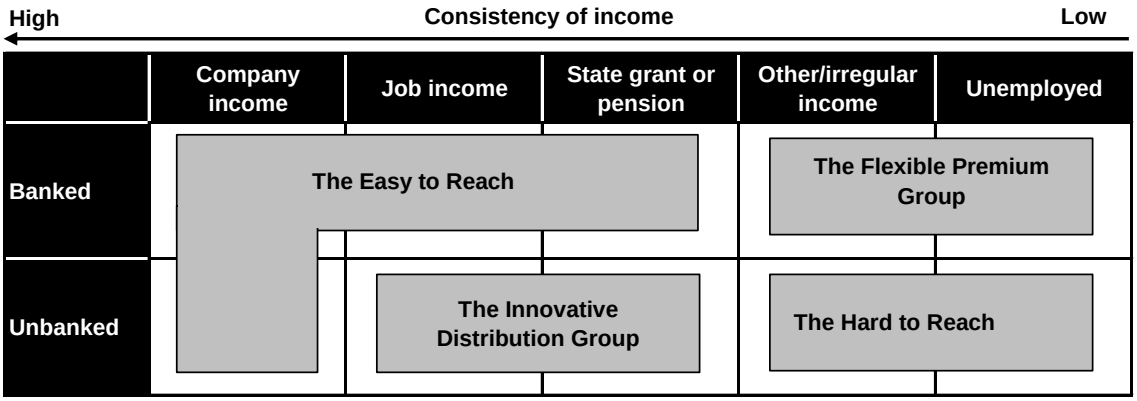


Table 4: Clustering of the four groups

Source Genesis

4.5. SALIENT FEATURES OF DISTRIBUTION SEGMENTS

The table below contains salient features describing the four groups. These features, together with the two factors used to create the four groups, allow us to create clear pictures of the nature of each group.

	Easy to Reach	Flexible Premium Group	Innovative Distribution Group	Hard to Reach
Group size	3.7m (19% of LSM 1-5)	2.6m (14% of LSM 1-5)	3.6m (18% of LSM 1-5)	9.4m (49% of LSM 1-5)
Major age category	25-29 years	18-24 years	60-64 years	18-24 years
Gender spread	45% female	52% female	66% female	46% female
Geographic spread	55% urban	57% urban	40% urban	47% urban
Banked status	97% banked (4% have Mzansi bank accounts)	100% banked (8% have Mzansi bank accounts)	100% unbanked	100% unbanked
Major LSMs	LSM 4 and 5	LSM 4 and 5	LSM 2-5	LSM 2-5
Major FSMs	FSM 3-6	FSM 3-5	FSM 1-3	FSM 1-3
Household income	R 2,644	R 2,651	R 1,204	R 1,627
Personal income	R 1,837	R 1,081	R 605	R 254

Table 5: Demographic and economic characteristics of the four groups

Source: Genesis calculations based on FinScope 2005 data

The Easy to Reach are waiting to be insured. Individuals in the Easy to Reach are similar in that they provide insurers with two possible points of access: bank account and/or payroll deduction. In addition, all individuals in the Easy to Reach earn a relatively consistent form of income. The formal points of access to this group, as well as its consistent income flows, makes it the easiest group (for

insurers) to sell insurance to. This group has the highest average personal income of all the groups and the majority of individuals are clustered in the higher LSMs (LSM 4 and 5). In addition, individuals have a high level of financial sophistication if the Financial Services Measure (FSM)[36] is viewed as indicative of level of financial sophistication.

The Flexible Premium Group requires intelligent product design. The income sources of individuals in the Flexible Premium Group are more inconsistent or irregular than that of the previous group, but the group still provides insurers with a formal point of access through bank accounts. The fact that this group is 100% banked implies that a formal means exist through which data on the income and expenditure of this group can be collected. However, the unstable income flows of the group mean that insurers will have to design insurance products that allow premium flexibility. This could, for example, be achieved by collecting premiums on a quarterly basis or designing products that requires only 9 out of a possible 12 premiums annually (with a choice on the months in which payment need to take place). The Flexible Premium Group earns the highest average household income (R6 more than the Easy to Reach) and the majority of individuals is also clustered in LSM 4 and 5. However, average personal income is almost R800 lower than that of the Easy to Reach. Like the Easy to Reach, this group is characterised by quite a high level of financial sophistication as indicated by the fact that the majority is clustered in FSM 3-5.

The Innovative Distribution Group stimulates insurance creativity. Individuals in the Innovative Distribution Group are similar in that their income flows are relatively consistent, but because they do not have bank accounts cannot be accessed through any formal points of contact. This implies that insurers will have to be particularly innovative in the design of distribution strategies and products targeted at this group, with both premium collection *and* claims payment requiring specific attention. The issue of product design is complicated by the low average personal income of the group and also low average household income. Fewer individuals are clustered in LSM 4 and 5 than in the previous groups and the group is characterised by a more even spread over LSM 1-5. LSM 2 is the largest category, with 31.4% of individuals falling in this bracket. Financial sophistication in the group is low, with more than 85% of individuals falling in FSM 1-3.

The Hard to Reach tests the limits of insurance distribution. The Hard to Reach is characterised by irregular and small income flows and provide insurers with no formal point of access to individuals in this group. Average personal income is very small and although household income is higher than that of the Innovative Distribution Group[37], it is questionable whether these income flows are sufficient to

[36] See Appendix D for an explanation of the FSM.

[37] The higher household income of The Hard to Reach compared to same income of The Innovative Distribution Group can be ascribed to larger household sizes.

support insurance premium payments. Like yhe Innovative Distribution Group, there is quite an even spread over LSM 1-5. Financial sophistication in this group is also low, with nearly 100% of individuals being classified as FSM 1-3.

4.6. REACHING THE FOUR GROUPS

In conclusion, this section provides a summary of our:

- evaluation of the distribution potential of the four groups; and
- an overview of the size of unserved markets within reach of existing formal and informal client touch points.

4.6.1. DISTRIBUTION POTENTIAL OF SEGMENTS

Our assessment of the distribution potential of the four segments is summarised in Table 6. The four criteria[38] used in this table are defined as:

- *Likely receptiveness to insurance.* This measure proxies the likelihood of demand for insurance by the uninsured by considering the take-up of formal and informal insurance products in the group as a whole (i.e. the current exposure to insurance). In groups with high take-up of either of these we propose that the likelihood of take-up of insurance by the uninsured is higher.
- *Extent of informal contact.* This measure rates the extent of interaction with informal networks as proxied by informal group membership. Any client touch point presents a distribution opportunity for insurance. In this case, we assess the extent of informal contact as a potential distribution point for insurance. High informal contact suggests that a strategy linking with informal groups may be effective.
- *Extent of formal contact.* This measure assesses the extent of contact of the group with formal client touch points (banks, airtime vendors, retail stores, etc.) Formal client touch points are even more convenient than informal client touch points as it is more structured and likely to be easier to link with formal insurance structures. High formal contact, therefore, suggests that the group is within easy reach of existing formal structures.
- *Variety of distribution strategies available.* This measure simply provides an indication of the feasibility of different distribution approaches in reaching a particular market. Specifically, we consider individual sales, group sales and over-the-counter distribution (e.g. through retailers). A high score on this measure suggests that the group is reachable through a variety of strategies.

[38] See Appendix E for more details on the construction of each rating.

Distribution criteria	Easy to Reach	Flexible Premium Group	Innovative Distribution Group	Hard to Reach
Likely "receptiveness" to insurance	●●●	●●	●●	●
Extent of informal contact	●●●	●●●	●●●	●●
Extent of formal contact	●●●	●●●	●	●
Variety of distribution strategies available	●●●	●●●	●●	●

Table 6: Evaluation of distribution potential of the four groups

Source: Genesis

The evaluation of distribution potential is also captured in the discussions around certain conclusions below.

The Easy to Reach and Flexible Premium groups are the most "receptive" to insurance sales. Using current insurance usage and financial sophistication as indications of likelihood of insurance take-up of "receptiveness) of a group, most insurance take-up is likely to come from the Easy to Reach and the Flexible Premium Group. Formal insurance usage is the highest amongst The Easy to Reach[39]. The group also has quite a high level of financial sophistication, which indicates that financial literacy levels and levels of personal financial control could support insurance sales to individuals within the Easy to Reach. Approximately 71% of the group is clustered in FSM 3 and above (up to FSM 7). Of the four groups, the Flexible Premium Group has the second highest insurance usage[40]. High levels of financial sophistication also support the idea of "receptiveness" to insurance in this group – 67% fall in FSM 3 and above (up to FSM 8).

Both formal and informal insurance usage in the Innovative Distribution group is higher than that in the Flexible Premium group. However, more than 98% of the Innovative Distribution and Hard to Reach groups fall in FSM 1-3 raising questions about their receptiveness to formal insurance.

Formal contact points extend well into the Easy to Reach and Flexible Premium groups, but is very low in the Innovative Distribution and Hard to Reach groups. Formal sector contact points such as bank accounts, airtime vendors and retail stores are used extensively by the first two groups. Almost 100% of individuals in these two groups have a bank account, a store account or a pre-paid cell phone. The latter two groups fall beyond the reach of these touch points.

[39] Almost 25% of individuals in this group have a funeral policy with a large financial institution (or through their employer), while 15% has funeral cover through an undertaker or funeral parlour. Approximately 14% has some form of life insurance, while 8% has some form of medical insurance.

[40] 11% of this group has a funeral policy with a large financial institution (or through their employer), while 9% has funeral cover through an undertaker or funeral parlour. Almost 8% has some form of life insurance.

Even informal contact points in the Hard to Reach are limited. The level of informal contact points is distributed quite similarly across the first three groups, but much lower in the Hard to Reach group. Informal networks may, therefore, not provide access to this group.

Passive models may provide access to Hard to Reach, but low receptiveness of this group questions the effectiveness of passive sales models. The first three groups have some potential for individual, group and over-the-counter (OTC) strategies. In the Hard to Reach, individual sales will not be cost effective and accessible groups are limited. Retailer strategies may place insurance products within reach of individuals in this group but their low current exposure to insurance raises questions over the effectiveness of passive sales models.

4.6.2. SIZE OF UNSERVED MARKETS WITHIN REACH OF EXISTING FORMAL AND INFORMAL CLIENT TOUCH POINTS

A clear finding of this review is that there are a large number of individuals in LSM 1-5 who are not currently using any formal insurance but are within reach of formal and informal distribution channels (see Table 7). While the preceding analysis noted some findings on the propensity of such clients to take up insurance, this section shows the numbers of individuals within reach of specific channels. Specifically, we note the number of people within reach of touch points beyond the banking sector, where these touch points are not only sales points but could also collect cash/electronic premiums.

Distribution segment	Banked	Pre-paid cell phone	Store card/ account	Burial society member
The Easy to Reach	2,025,381	704,749	494,702	417,179
The Flexible Premium Group	2,142,728	1,076,156	495,307	237,102
The Innovative Distribution Group	---	414,133	91,702	690,194
The Hard to Reach	---	1,116,492	282,806	812,825
Total LSM 1-5	**4,168,109**	**3,311,530**	**1,364,517**	**2,157,300**

Table 7: Individuals in LSM 1-5 without any formal insurance but within channel reach

Source: FinScope 2005

4.2m people in LSM 1-5 have bank accounts, but no form of formal insurance. This is a significant result as these individuals are already dealing with banks for financial services and having a bank account makes premium collection (i.e. debit order instead of cash collection) and claims payment far easier. In addition, banks have databases with extensive client information. This information can be used by providers in the design of suitable products for low-income clients. For example, by

understanding the flows of money into and out of accounts, products with flexible premium payment options can be developed to fit in with such irregular flows.

3.3m people in LSM 1-5 have a pre-paid cell phone but no form of formal insurance. These individuals regularly access airtime vendors, which could collect cash premiums and can be communicated with through cell phones. 44% of the Easy to Reach own at least one cell phone within the household and 36% of this group have their own prepaid cell phone. 51% of the Flexible Premium group have at least one cell phone within the household and 46% of the groups have their own prepaid cell phones. Beyond these groups, cell phone channels are especially relevant for the 1.5m individuals in the 'Innovative Distribution' and 'Hard to Reach' groups who are currently not banked. Partnerships with airtime vendors and cellular networks may also provide access to information on client behaviour that could be used to develop and target specific products[41]. The lessons from the Megatop/ITC e-Choupal model in India may be of particular interest to consider for this model (see Section 6).

1.4m people in LSM 1-5 have store cards/accounts but no form of formal insurance. Once again, this is a group of individuals who regularly access stores to pay accounts and purchase goods in cash. As a result, the lack of bank accounts is not a barrier in this environment and insurance premiums can also be added to the account, which creates a near debit-order system for premiums. Approximately 36% of The Easy to Reach has a store card or account, while 27% of the Flexible Premium Group has a store card or account. This implies that insurance premiums for more than a quarter of both these groups can be collected on an account basis when insurance is distributed through retailers. In addition, 400,000 individuals in the Innovative Distribution and Hard to Reach groups have a store card/account but are currently not banked. As with banks, retailers will have financial information (e.g. behaviour, card/account payment persistency) on their store card/account holders. This may be more limited for retailers than for banks, but will still be useful for insurance providers to keep in mind when designing appropriate products for this market.

2.2m people in LSM 1-5 are members of burial societies but have no form of formal insurance. The 1.5m individuals in the Hard to Reach and the Innovative Distribution Group are of particular significance. Firstly, the number of individuals in these groups that are members of burial societies provides an indication of the need for particularly funeral insurance, given that they are already using an informal risk mitigation product. Secondly, of this group, 1.2m individuals do not have a pre-paid cell phone or a store card/account. As a result, the burial societies present one of the only channels through which these groups can be reached.

[41] See Section 5.3.4 for a discussion on the impact of the proposed Privacy Bill on access to such information.

Despite the difficulties of linking with such informal networks, they remain a key access point for components of the market that fall beyond all other mechanisms.

The Financial Sector Charter targets are within (distribution) reach. The FSC requires that 1.2m[42] and 4.4m[43] individuals should have effective access to short-term risk insurance products and life assurance industry products, respectively by 2014. Taking the number of currently banked people in Table 7 who do not have any form of formal insurance (4.2m) provides an indication that there are already large numbers of low-income individuals within relatively easy 'distribution' reach. Furthermore, a large proportion of these individuals could be reached through the non-bank client touch points noted in Table 7.

[42] The FSC states that "6% of LSM 1-5 have effective access to short term risk insurance products and services" (Financial Sector Charter, October 2003) by 2014, which effectively equates to 1.2m people in LSM 1-5 (FinScope 2005).

[43] The FSC states that "a percentage (to be settled with the life assurance industry) of LSM 1-5 households have effective access to life assurance industry products and services" (Financial Sector Charter, October 2003). This percentage has been settled at 23% of the LSM 1-5 adult population by 2014 (LOA Circular No. 108/2005), which effectively equates to 4.4m people in LSM 1-5 (FinScope 2005).

5. SOUTH AFRICAN REGULATORY FRAMEWORK FOR INSURANCE INTERMEDIATION

Key findings from Section 5

• Most insurance regulation is designed to correct information asymmetries and thereby empower and protect the consumer.
• Regulation can be imposed on the market in three ways – by regulating who may enter the market (institutional regulation), by regulating what products may be sold (product control regulation); and by regulating how products must be sold (functional regulation).
• In South Africa, regulation is being driven by two policy goals: 1) empowering and protecting insurance consumers, and 2) simultaneously seeking to extend access to insurance into the low-income market. These goals can and do conflict. Higher levels of consumer protection translate into higher compliance costs and a more expensive product which, in turn, makes it difficult to extend access.
• To date, regulation in the insurance intermediaries' market has focussed on institutional and functional regulation – this has created real costs for insurers and intermediaries.
• The acts that regulate the insurance and insurance intermediaries' markets are the Long-term Insurance and Short-term Insurance Acts, 1998, the Medical Schemes Act, 1999 and the Financial Advisors and Intermediaries Act, 2002. Also relevant is the draft Privacy Bill and National Treasury's proposals on the restructuring of commission.
• Regulation is impacting directly on the intermediation of microinsurance by
  • increasing the cost of intermediation, particularly for intermediaries operating in the low-income market; and
  • bifurcating the market into advice-based (mostly high-income) and non-advice-based models (mostly low-income).
• Conflicting regulatory objectives may result in the closing down of the only models serving the lower-income market.

This section provides a review of the South African regulatory environment as it pertains to insurance intermediation. In particular, it focuses on potential challenges to the intermediation of microinsurance presented by the various pieces of legislation and changes currently occurring.

- Section 5.1 describes the basic framework within which the review of regulation pertaining to intermediation is set.

- Section 5.2 alludes to a policy lens framework which is used to consider the conflicts and trade-offs amongst the various pieces of legislation and policy behind the legislation.
- Section 5.3 outlines the key policy and regulatory documents impacting on the intermediary market and considers their likely impact (Further details on the legislation is contained in Appendix A).

This analysis provides the basis for considering the regulatory trends impacting on the intermediation of microinsurance as described in Section 7.1.

5.1. REGULATORY FRAMEWORK

Is there a need for regulation? Before discussing *how* regulation is applied to the insurance and insurance intermediary markets, it is worth asking the question *why* regulation should be applied at all.

At the heart of insurance is the same simple transaction: a provider of a product sells it to a consumer. The product itself is a promise: that in return for the payment of a premium, and on the occurrence of a certain event, the provider will pay to the consumer an agreed benefit. Sometimes the product is distributed and sold through the intermediation of a third part. The difference between the provider and the intermediary is that the provider carries the risk of honouring the promise, while the intermediary is a conduit only, used for distributing the product and advising the client on the value of the competing products or competing providers.

If the parties to this transaction are willing to transact, why should the state intervene at all? This goes to the very heart of the role of the state in private markets. Regulation is not necessary for all private transactions but, without going into a detailed defence of regulation, it can be of use where real-world markets are imperfect. Usually, this is where insufficient information is available to consumers to make economically rational decisions. In other words, the state intervenes to correct the flow of information so that more efficient and rational economic decisions are made.

In the case of insurance, specifically, there is an extreme asymmetry of information between the provider and the consumer and, by implication, the intermediary and the consumer. Insurance is a complex product where the value of the product is not inherently visible to the consumer - insurance products are considered to be “credence goods”, i.e. where the quality is unknown even after the purchase has been completed. The consumer will thus only be able to assess the quality of the product purchased when a claim is made, at which time it is too late to affect the process. The information asymmetry is exacerbated by the absence of clear, comparable market prices. Most consumers will not be able to assess whether or not the actuarial calculations underlying a specific policy have resulted in a fair

price and, due to the complexity of the products and large variance in product features, consumers are generally not able to compare products. Also, insurance products carry a high cost of switching, so that where consumers do become aware of a better product offering, or realise that they have bought an inappropriate product, it is difficult to switch without losing money already invested in a specific product. There is also an incentive for providers and intermediaries to hide as much information as possible (e.g. on risk and other implicit costs of the product) while promising high returns, because they face little short-term accountability.

Another justification for regulation is that it is difficult for consumers to judge the quality of the provider (or intermediary) and to assess whether the provider has the long-term means and skill to honour its promise. Most consumers are not in a position to evaluate a company's or intermediary's financials. Moreover, insurance provision and intermediation have very low sunk costs of market entry. The business of providing both financial products and intermediary and advisory services can be entered at fairly low cost. In industries where the sunk, irrecoverable costs of entry are high, such as auto manufacturing, the costs of reputational damage are likewise high. The insurance industry is, consequently, more hospitable to 'fly-by-nights'.

The consumer is thus at a severe disadvantage compared to the provider and intermediary. As a result, most insurance regulation is designed to correct the imbalance by empowering consumers with knowledge of the product, and knowledge of and trust in the financial integrity of the provider, and quality of advice and service given by the intermediary. *How can the market be regulated?* Given that there is a valid role for regulation in the insurance markets, the second question relates to how the market can be controlled. As we have seen, though the forms of the parts of the simple insurance transaction may vary, at the centre of every insurance transaction are the same roles: a product provider (the formal risk carrier), a product, a client and an intermediary.[44] Breaking down insurance in this way helps us to see that there are three ways in which the insurance transaction can be regulated: the parties themselves can be regulated, the product can be regulated, or the way the parties interact can be regulated. On this basis, we identify three types of insurance regulation:

- ***Controls on the type and quality of institution offering insurance, and the type and quality of the institution offering intermediation. We refer to this as institutional regulation.*** It could also be called "who" regulation: *who* is permitted to provide insurance, *who* is permitted to distribute insurance, *who* is permitted to advise on insurance products and *who* may buy insurance? These controls normally apply on the supply side only - very rarely would a restriction be placed on whom may purchase insurance. Institutional regulation defines

[44] See Section 2.1 for the general insurance model.

the characteristics of the institutions that are permitted to be active in the market and erects barriers of entry to those who cannot satisfy these characteristics. For example, under South African law, only a registered insurer may legally sell insurance. Those who cannot satisfy the registration requirements are excluded wholly from the market. Likewise, only registered intermediaries may legally distribute insurance and offer advice on insurance products. Registered intermediaries must meet certain fit-and-proper requirements, report regularly to the regulator and so forth. Those who cannot meet these requirements are also excluded wholly from the market.

In effect then, the regulator, who is in a better position to judge the quality of these institutions, steps in on behalf of the consumer and excludes those players who fall below the quality threshold. The consumer can then feasibly trust the institutions in the market without having to conduct detailed economic research in every case.

- ***Controls on the methods and modalities that must be used in effecting the insurance transaction. We call this "functional regulation".*** It could also be called "how" regulation: how a sale of insurance should proceed (what information must be disclosed to the client, what advice must be given and how it must be given, what paperwork should be involved, whether there should be a cool-off period, how much remuneration should be paid to the intermediary); how claims should be processed; and so on.
- ***Controls on the products that can be sold. We call this "product control" regulation.*** It could also be called "what" regulation because it regulates what can be sold: what features must be included in a product, what terms must be present, the minimum benefits, restrictions of premium levels and so forth. Product regulation has been virtually absent in the South African insurance market - an exception is the minimum statutory benefits prescribed for medical scheme products. Otherwise insurers have been free to design products according to the needs of the market.

It will be useful to kept this framework in mind as we turn now to a description of the current regulatory framework in South Africa.

5.2. THE POLICY GOALS BEHIND INSURANCE REGULATION

What are the policy goals behind current insurance and insurance intermediary regulation in South Africa? As described above, the insurance and insurance intermediary laws in most countries are driven with one main policy goal in mind: to inform, empower and protect consumers. This is particularly so in South Africa. The ANC administration views itself as having a firm role to play in correcting the wrongs of the past and in improving the lot of its largely poor and financially uneducated constituency. Prior to 1994, these consumers had very few benefits and rights; the insurance industry was the preserve of the educated and upper

classes. Poor people who attempted to enter the formal insurance market, faced a complex environment where products were sometimes oversold by unqualified people, with too little disclosure, poor advice and with very little recourse to hold poor performance to account.

Unsurprisingly then, the regulation we have seen implemented in the last decade has been very strongly aimed at empowering consumers, particularly low-income consumers. Consider for instance:

- The Long-term Insurance Act, 1998 (including the Policy Holder Protection Rules of 2001) (the Long-term Act). This is partly institutional regulation designed to limit entry to the insurance market to appropriately capitalised and supervised long-term insurers; and partly functional regulation designed to clarify the process of selling insurance and the rights of the consumer in that process. (Interestingly, it focuses very little on product control.)
- The Short-term Insurance Act, 1998 (the Short-term Act), which is partly institutional regulation designed to limit entry to the market to appropriately capitalised and supervised short-term insurers; and partly functional regulation designed to control how short-term insurance is sold, and to crystallise the rights of the consumer in that process. (It also focuses very little on product control.)
- The Medical Schemes Act, 1998, which is partly institutional regulation designed to limit the entry of providers of medical insurance as medical schemes, and partly functional regulation designed to control how medical schemes are sold. In contrast to the insurance acts, the Medical Schemes Act does also focus on product control – it prescribes certain minimum benefits that must be included in every medical scheme product.
- The Financial Advisory and Intermediary Services Act, 2002 (FAIS). This is the most relevant act for the insurance intermediaries' market. Until the late 1990s, the intermediaries' market was not heavily regulated institutionally, functionally, or through product control. Intermediaries could enter the market with no formal registration or training, and operate with low levels of supervision and at relatively low cost. The products that were on the market were for the main part unregulated. Intermediaries were also relatively free to transact as they chose. Following a wave of consumer complaints about mis-selling and inappropriate advice, FAIS was introduced to regulate the advice-giving and intermediary service market. FAIS is a piece of institutional regulation that prescribes who may act as an intermediary and advice-giver, as well as functional regulation in that it regulates how advice and intermediary services must be provided.
- The Privacy Bill: The draft Privacy Bill (described below) will be a piece of functional legislation that empowers the consumer with a right to data privacy.
- The National Treasury paper on commission restructuring (described below, (National Treasury, 2005) is a policy document with implications for institutional and functional regulation as it may redefine who is allowed to give advice and

how that advice must be given and charged for. Again, the thrust of this legislation is to improve conditions for the consumer.

However, consumer protection is not the only policy goal at play in the financial markets. Government is also driving another policy goal: that of increasing access to financial services for low-income persons. This goal is most obviously manifest in the Financial Sector Charter (FSC)[45] and the political pressure surrounding the whole black economic empowerment (BEE) process. In effect, the FSC forces insurers to sell insurance products to individuals falling in LSMs 1 to 5, a virtually untapped market.

How do these two policy goals interact? Regulatory policy can never be all things to all people, and policy goals sometimes conflict with each other (see Genesis, 2004), as indeed these do. The rights and benefits that are provided to the consumer are not created without cost. They are established through positive actions by insurers and intermediaries, which generate real increased costs. Invariably, this is eventually passed back to the consumer in the form of higher premiums. This makes the other policy goal in question (providing poor people with access to financial products) more difficult to achieve. In effect, there are two opposing policy forces at work: one has the goal of extending access to financial products (which demands lower prices) while the other has the goal of increasing levels of consumer protection (which invariably creates higher costs and so higher prices). It is also important to note that (as noted in Section 3.1) regulation does not impact equally on all entities. In the case of the FAIS Act, it impacts more heavily on intermediaries providing advice than on those that do not. It is also interesting to note that while the introduction of FAIS has drawn intermediaries into the regulatory net, it is primarily insurers that will face the most pressure from the FSC as many of them compete for the lucrative business of managing government's financial assets. The trade-offs between these objectives is depicted in Figure 4.

[45] The FSC is technically not part of regulation. It is a voluntary industry code negotiated with government as observer. However, it does carry the threat of government sanction through potential denial of access to government business. There is also an implicit threat of government intervention in the market if the objectives are not met.

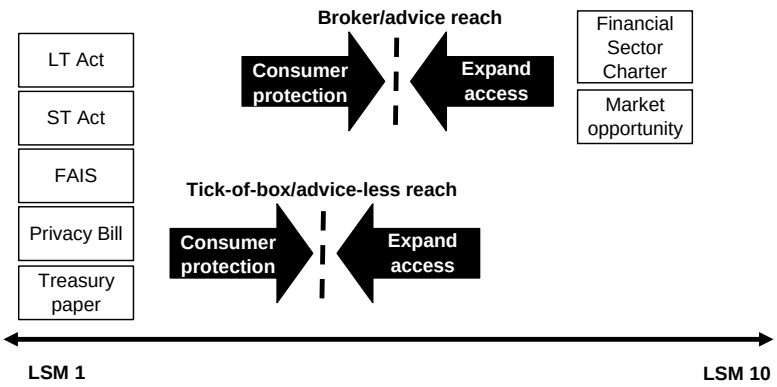


Figure 4: The relationship between two policy goals

Giving priority to consumer protection and empowerment can make activities and channels more expensive and these are likely to be replaced by new models that better suit the higher-cost environment. If one policy goal is to open access to insurance products, then it must be recognised that increasing consumer protection may simultaneously close down certain channels of providing that access

5.3. CURRENT AND FORTHCOMING LEGISLATION IMPACTING ON INTERMEDIARIES

This section provides an overview of the regulation and potential regulation that has relevance to the insurance intermediary market. The direct impact of the relevant pieces of legislation is noted. This cumulative impact is the creation of three regulatory trends which are discussed in the next section. A detailed description of the specific terms of the acts is available in Appendix A.

5.3.1. LONG-TERM INSURANCE AND SHORT-TERM INSURANCE ACTS

Both the Long-term and Short-term Acts, which are mirrors of each other, impose institutional regulation (controlling who may act as a long- and short-term insurer, as well as setting out their compliance and reporting duties) and functional regulation (setting out the methods and modalities that must be used when effecting an insurance transaction).

Both long-term and short-term insurers are obliged to register with the FSB in order to legally sell insurance. Long-term insurers must provide R10m start-up capital, and short-term insurers R5m. They must maintain approved ratios of capital, liabilities to assets, and long-term insurers must also employ an actuary to ensure that policies are “actuarially sound”.

The insurance acts also contain terms relating to the structure and levels of commission that may be earned by an intermediary. Commission is capped at a statutory limit contained in the regulations. For instance, the commission on an individual life product or health and disability product is capped at 3.25% while commission on the sale of short-term personal lines insurance (insurance sold to a natural person) is capped at 12.5% and motor insurance is capped at 20%. Funeral products have been left unregulated and commission on such products is thus uncapped.[46]

The Long-term Act also includes the Policyholder Protection Rules (PPR) which were introduced in 2001 to regulate disclosure requirements (functional regulation). The PPR stipulates that an insurer and intermediary must have a written agreement, and such an agreement may only be entered into if the intermediary is registered under FAIS.[47]

Impact on intermediaries: The obvious effect of the insurance acts is to control the price of intermediary services, i.e. intermediaries cannot charge above a certain price threshold for their services even if they wish to.

5.3.2. FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT

FAIS is a classic piece of consumer protection legislation that regulates the financial advice and services industry. With the introduction of FAIS the intermediary market changed (in a relatively short space of time) from one with virtually no barriers to entry, low compliance duties and negligible accountability, to one with significant barriers to entry, new reporting and compliance duties and substantial penalties for non-compliance (institutional regulation). It also imposes standards for the provision of advice and the conducting of intermediary services (functional regulation).

A positive outcome of FAIS is that the quality of intermediary serving the market is improving, and so, in time, will the quality of financial advice. This should enhance long-term public trust in the use of financial products, and encourage citizens to save and insure. On the down side, the consumer benefits enabled by FAIS have been associated with increased costs, which have been borne by the intermediaries themselves.

FAIS raises the cost of intermediary business in four ways:

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[46] During the course of our research no policymaker or official could explain from a policy perspective why assistance business has been left uncapped. It may be that there is lower risk of consumer abuse in this market because benefits are strictly limited (a maximum of R10, 000) and premiums are relatively small. It may also be because policymakers recognised that funeral insurance is widely and enthusiastically used by lower-income consumers and they did not want to remove the intermediary incentives to go out and provide a socially and culturally important insurance.

[47] Part IV of the PPR

FAIS increases barriers to entry: In the pre-FAIS era, almost any person could become an intermediary; by contrast, FAIS excludes many potential entrants. Any person, natural or juristic, who provides advice or intermediary service or both (as they are defined in the Act) in respect of a financial product, must first be registered with the regulatory body (the Financial Services Board (FSB)) as a licensed financial services provider (FSP). The applicant must demonstrate certain "fit-and-proper" characteristics i.e. show that s/he is of good character, has a minimum level of education and experience, and is operationally and financially sound. Applicants who are unable to convince the regulator of these requirements are excluded from the market absolutely. Others will have to invest in further education and training. These requirements increase the costs of entering the market appreciably, and raise new barriers to entry (institutional regulation).

FAIS raises infrastructure costs: Whereas an intermediary was once able to run a business quite informally, now the intermediary is required to put in place a minimum level of infrastructure, including a fixed business address, communication facilities, a typing and photocopying service, an adequate filing system, a bank account and another bank account for client funds. The increased infrastructure raises costs directly (institutional regulation).

FAIS raises compliance and reporting costs: Any FSP with more than one key individual or representative must appoint (or employ externally at its own expense) a compliance officer who must report annually to the FSB. In addition, the FSP must maintain full accounting records and must (at its own expense) appoint an external auditor to audit the financial statements and report to the FSB.[48] The provider is also obliged to pay an annual levy to the FSB. These compliance and reporting duties add significant costs to the business of an intermediary (institutional regulation).

FAIS raises transaction costs: FAIS introduces many duties for the intermediary when dealing with a client. Among these are the duty to supply factually correct information and to confirm this in writing upon request, to disclose the nature and extent of any remuneration, to deliver documents to the client for safekeeping (this potentially inhibits the use of cell phone sales or other paperless models of distribution) and, where financial advice is given, to conduct an analysis of the client's financial needs. These additional duties increase the transaction costs for intermediaries (functional regulation).

FAIS impact on intermediaries: The institutional regulation terms of FAIS increases barriers to entry into the market, and pushes up the costs of operation. The functional regulation terms pushes up the costs of giving advice.

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[48] Section 19 of FAIS. The FSB has relaxed this requirement in respect of Category 1 FSPs (general FSPs) who do not receive or hold clients' money as assets or who do not receive premiums. Such intermediaries do not need to have their financial statements audited by an external auditor but would still need to provide unaudited financial statements to the registrar. See Board Notice 96 of 2003. To assist, the FSB has provided intermediaries with a pro-forma version of what financial statements should look like.

5.3.3. THE NATIONAL TREASURY PAPER ON CONTRACTUAL SAVINGS IN THE LIFE INSURANCE INDUSTRY

In March 2006, National Treasury produced a discussion paper (National Treasury, 2006) that proposed *inter alia* changes to the structure of commission on long-term products. While most of the paper is focussed on savings products, risk products are loosely included. The paper is a discussion piece only, but it presents a policy view that may result in changes to legislation with far-reaching effects on intermediaries. The proposals include:

A move to a hybrid commission structure: Currently, commission on long-term products is paid upfront. The paper proposes a move to a hybrid system where part of the commission will be paid upfront with the balance paid over the term of the policy on an as-and-when basis. If intermediaries are forced to forgo upfront commissions in favour of a hybrid commission structure, the most telling effect will be on short-term cash flow. It is debatable whether all intermediaries will be able, or will wish, to bear the disruption in cash flow until they are able to build up a sufficiently large as-and-when book to restore flows. Even if an interim model were introduced to bridge the change-over, as has been suggested, the proposals will reduce the incentives of independent intermediaries to either enter or to continue to operate in the market. Worse affected will be small independent intermediaries (agents, by contrast, would probably be able to rely on the transitional sponsorship of their insurer employers[49]) and those operating on low margins, namely lower-income brokers who have less resources to carry the break in cash flow. The potential impact of changes in the commission structures were noted in the cost models discussed in Section 3.2.

The payment of ongoing commission to an intermediary should be conditional upon ongoing support to the policyholder, and the policyholder should be able to switch intermediaries and redirect commission to another intermediary. In effect, this will allow a client to switch intermediaries “mid-stream”. Intermediaries will be forced to maintain high standards of client service and follow-up care. This will bring benefits to the consumer at least with respect to investment products. However, it will also raise intermediary transaction costs while introducing cash flow vulnerability for intermediaries.

An intermediary will have to disclose to the client whether he is an “insurer agent”, (who can either be tied or independent) or an “independent financial advisor”. The distinction is that insurer agents will be remunerated by the insurer only, while independent financial advisors will be remunerated by the client only. Insurer agents will not be able to call themselves advisors or to provide advice - only independent financial advisors will be able to do this. This proposal turns the FAIS regime on its head because FAIS already licences intermediaries who, once

[49] In fact, the paper does suggest that transitional arrangements are found for small and emerging brokers - such as financing and income support by insurers.

licensed, are qualified to give advice. The National Treasury paper removes that right, placing the fulcrum under *the source* of payment rather than the qualifications of the intermediary – no matter how qualified an intermediary, if payment comes from an insurer, then the intermediary cannot be said to be giving "advice".

Box 7: The independence of the broker

The impact of incentives on independence. The broker (in contrast to a captive agent) represents the interest of the *client* and is, therefore, thought to provide independent advice, based on the client's specific needs and the characteristics of the various products available. Accordingly, commission is paid by the client as it is a reward for representation. However, the fact that it is paid out of the client's premiums but via the insurer has led to some confusion about who is actually paying the broker.

Although it is true that the payment is taken from the client's premium and that the client is, therefore, technically paying for a service provided, it is necessary to note that *the client does not negotiate the price for the service with the broker*. This is done by the insurer, which means that *the insurer is actually (possibly rightly) seen as the payer of the commission*. Certainly, the fact that the insurer mostly sets the level of the commission (rather than the client) supports concerns over the true independence of the broker and whether they truly represent the interest of the client.

Consideration should be given to the establishment of higher standards of intermediary education through a new accreditation system. It is not clear exactly what the new accreditation system would look like or whether those already qualified under FAIS would have to re-qualify under the enhanced system.

Until there is more evidence of improved disclosure, consumer education and competition in the insurance market, regulation of commission should remain in place. Treasury proposes that intermediary commissions should stay capped for now.

Potential impact on intermediaries: If implemented, the Treasury proposals will not be positive for insurance intermediaries, at least not in the short-term. They increase regulatory duties on intermediaries, while keeping commission capped. They also threaten short-term cash flow and add new accreditation criteria. This is not good news for an industry which is already aging and whose members, even before the proposed regulatory changes, operate on a cost/benefit ratio that has not been attracting many new entrants into the industry.

At the same time, the rational intervention cannot be argued away. Care should be taken, however, to implement the proposed policies in such a way to minimise cost and take into account the varied nature of the products and intermediaries considered.

5.3.4. THE PRIVACY BILL

In South Africa the right to privacy is protected by both the Constitution and the common law but there is no formal legislation in place to enforce privacy as it relates to consumer data. This will change with the introduction of the Personal Information Protection Bill ("the Privacy Bill"), currently being drafted by the SA Law Reform Commission, which is expected to become law in early 2007. This is a proposed piece of functional regulation.

The Bill regulates the collection, storage and processing (use) of personal information by the public and private sector. Information can only be used if the consumer gives his or her consent. So-called "special personal information" relating to religion, race, politics, health and sexual activity, will require the express consent of the client. Other personal information can be processed where either express *or* implicit consent is given. Consent would be implied, for example, where the information is obviously necessary for the performance of a contract to which the person is willingly party.

The Bill is of particular interest to the long-term insurance industry because insurers and intermediaries hold detailed financial, medical and personal information about their clients. Financial intermediaries, acting on behalf of their clients, access this information for the purposes of financial planning. At the very least the Bill will require the FSP to make sure that before any information is used, the client has expressly or impliedly given his consent, and in the case of special personal information, that the client has given his express consent. The obligation will be on the intermediary to ensure that it takes appropriate measures to ensure the safety and integrity of information so gathered. In addition, the client will be entitled to obtain information held by an intermediary free of charge. The expense of providing the systems to honour these requirements will be carried by the intermediary.

Where a client feels information has been used without consent s/he will be able to lodge a complaint with the proposed statutory body, the Information Protection Commission (IPC) to which the intermediary will be obliged to answer.

Notably, the Bill will also prevent the purchasing of client databases without the express consent of each person in the database. This will inhibit the operation of some insurers who rely on such purchases to gain access to new clients. The final act will thus strengthen the position of those who already have access to client databases e.g. retail account databases, and will strengthen their position as 'owners' of access to these clients.

Impact on intermediaries: The Bill, as proposed, will require intermediaries to revise their processes and systems to comply with the bill. This will require additional compliance spending.

5.3.5. MEDICAL SCHEMES AND THE LIMS PROCESS

Private medical scheme membership in South Africa is currently the preserve of the wealthy and middle classes. The government, eager to extend private medical scheme membership to lower-income groups, constituted a consultative process in 2005 to consider the introduction of a low-income medical scheme (LIMS). It is envisaged that the product that develops out of this process will be available by 2008.

Most of the focus in the LIMS process was on product design and only limited thinking seems to have been applied to the question of distribution. The final report on LIMS[50] concludes that the best way to distribute the LIMS product would be through use of brokers and employers, although strong reasons for this choice are not given. No alternative models have been seriously considered at this time (Clarke, 2006).

Of particular interest to this review is the potential of improving distribution models by increasing the variety of products that can be sold by a single intermediary. ***Would it be feasible, then, for potential lower-income insurance brokers to cross-sell LIMS in order to boost revenues? We believe this is unlikely for four reasons.***

Firstly, the LIMS product will be made available at between R150 to R200 per month (Broomberg, 2006). While this is considerably cheaper than schemes which offer the prescribed minimum benefits (which start from around R350 per member per month), it is still considerably higher than the lower-level insurance products considered in this report, which range in premium from R20 to R75 per month. Accordingly, there will be limited overlap between the two markets.

Secondly, an intermediary cross-selling medical schemes and insurance products would be obliged to hold dual accreditation in terms of both the Medical Schemes Act (no person may act as a broker for a medical scheme unless the Council for Medical Schemes (CMS) has granted accreditation) and FAIS (a person selling a medical scheme product must register as a FSP with the FSB). A broker thus accredited would be considered well qualified and is unlikely to focus on serving the less profitable low-income market.

[50] Consultitative Investigation into Low Income Medical Schemes, Final Report, 7 April 2006

Thirdly, to register with the CMS the broker must have a high school education and a minimum of two years experience. Applicants without the necessary experience may apply as long as they have a matric and can show they will serve two years apprenticeship under a fully accredited broker. The matric requirement would exclude some FAIS Category A (See Appendix A) insurance brokers (who are required to have only a Standard 8), and brokers who do have a matric would need to find an accredited medical schemes broker to be apprenticed to for two years. This would be discouraging for most insurance brokers.

Finally, in terms of the Medical Schemes Act, a broker can earn, for each member s/he introduces to the scheme and continues to service or advise, a maximum of R50 per member per month or 3% of contributions per member per month, whichever is the lesser.[51] This is paid on an as-and-when basis. A broker selling a LIMS product would thus earn around R4,50 per member per month (for a R150 product), which is not enough to entice brokers into this market. In the consultative process around LIMS, a broker focus group assured the task team that the LIMS product could be distributed by brokers without increasing the statutory cap of 3% commission. However, at this rate, it is unlikely that the intermediary service would include the higher levels of advice and follow-up services normally expected for health products (Broomberg, 2006). In other words, at the current statutory cap brokers will not likely choose to distribute the LIMS product and, if they did, it would be on condition that after-sales service and follow-up would be minimal. This would not be conducive to keeping up policy persistency because medical health products require a greater degree of follow-up care which, in turn, may lower the long-term credibility and feasibility of the LIMS product.

Impact on intermediaries: There will be no impact on existing insurance intermediaries but the accreditation required and commission capping under the Medical Schemes Act would make it difficult for low-income insurance intermediaries to cross-sell LIMS products to boost income.

The cumulative impact of the regulatory environment and new developments described above are resulting in significant changes in the market. These changes are described in Section 7.

[51] Section 28 of the regulations to the Medical Schemes Act, No 131 of 1998

5.4. OTHER LEGISLATION AND POTENTIAL LEGISLATION

In addition to the above legislation, there are other areas of regulation which do not directly pertain to the intermediation of insurance but may, nonetheless have an impact. These regulations are in the process of being finalised or implemented and the full implication is, therefore, not clear. We highlight the legislation and its potential impact below, but it would require further research to establish the exact impact it will have on the intermediation of microinsurance.

5.4.1. THE NATIONAL CREDIT ACT

The National Credit Act (NCA) became effective on 1 June 2006. The aim is to regulate the granting of consumer credit by all credit providers, and the Act sets a new framework for every credit transaction ranging from mortgage loans to microloans. The policy goal behind the legislation is to empower consumers – by regulating and rationalising the credit industry in order to prevent reckless lending, misleading disclosure, anti-competitive practices and the high costs of credit. The Act establishes a National Credit Regulator who will ensure that the credit regulations are enforced.

Although the Act is effective from June 2006, it is only partially applied at present – its introduction has been staggered to allow credit providers to come to terms with the reforms gradually. Full implementation will occur by end of 2007.

Even though the definition of credit agreement specifically excludes a policy of insurance, the Act does hold some relevance for the insurance industry regarding credit life insurance. Where credit is given, the provider may require the consumer to take out credit life insurance, or in the case of a mortgage bond, house insurance on the structure of the mortgaged building (as was the case under the Credit Agreements Act which the NCA replaces). The NCA, however, makes it clear that the consumer cannot be expected to take out insurance at an “unreasonable cost” having regard to the actual risk at stake. Moreover, where the credit provider proposes use of a particular insurer, the consumer must be given, and informed of, the right to choose an alternate insurer.[52]

What does this mean in practical terms? In the past, credit providers were able to pressure applicants to take out cover offered by an insurer of their choice - often this was the lender’s own subsidiary insurance company. The credit applicant would then have credit and insurance payments rolled into one monthly bond repayment. The NCA requires financiers to inform applicants of their right to take an insurance policy with an insurer of their own choosing. These obligations will apply to all credit providers– the consumer must be given the right to choose the

[52] See Section 106 (4)

insurance. The credit provider may not charge any surcharge or fee on the insurance payments.

***Impact on intermediation*:** The impact of the NCA on insurance intermediation is not yet clear as the relevant sections of the Act is subject to quite varying legal interpretations and has not been fully enforced. In principle, the NCA should increase competition between insurance providers, because a credit provider will no longer be able to embed an insurance product in a credit agreement to the extent that the client may not even know about it (as is often the case with credit life policies[53]). Theoretically, this opens up the opportunity for competing insurance products to be offered or intermediated to credit clients. The eventual impact, however, depends on whether the intentions of the Act stand up to the emerging legal interpretations. This will only be tested once the Act is fully enforced.

5.4.2. RICA

The Regulation of Interception of Communications and Provision of Communication Related Information Act (Act 70 of 2002 (RICA)) requires that cell phone service providers register the identities of new and existing customers who buy SIM cards. Subscribers will be required to show their ID books and provide proof of their home and postal addresses. The law aims to curb crime by allowing police to intercept cell phone communications. It comes into force on 1 July 2006. From that date, SIM cards can only be activated after full identity details have been provided.

There are great concerns in the telecoms industry that it will prove impossible to register the 33 million cell phone subscribers in South Africa, some of whom are without ID books or proof of residence. Cell phone companies are likely to encounter similar problems in identifying and verifying the identity of their clients as did the banks under the FICA legislation.

Impact on intermediation: This legislation has the potential to undermine the use of the cell phone as a channel of distribution of insurance products, especially in the low-income market, as it is low-income consumers who will have the most difficulty proving identity and residential address details. On the other hand, once the registration process has been completed, it will be possible to link a specific cell phone to a person's identity, which might assist in the development of models which rely on secure channels of communication. The development around RICA should be monitored closely to assess the impact on the use of cell phone technology in the distribution of financial products.

[53] See Genesis (2006) for a discussion of embedded credit life policies sold through furniture retailers

5.4.3. NATIONAL TREASURY'S PROPOSALS ON RETIREMENT REFORM

In late 2004, Treasury published its recommendations for the future of retirement savings in SA. The aim of the reform is to help South Africans make adequate provision for retirement by improving the regulation and governance of established retirement funds, and by providing greater access to retirement saving mechanisms for the informal sector and low-income earners. For this latter purpose Treasury proposed the creation of a National Savings Fund (NSF) – a fund for people who earn irregular income (i.e. not in formal employment) or are in formal employment but earn less than the tax threshold. These persons would be able to make intermittent contributions to the fund, which will probably be managed by the private sector but overseen by the government.

Impact on intermediaries: Few details are provided in the paper and no firm policy direction has emerged. The paper does not actually clarify whether the NSF will be an intermediated product or not, so it is difficult to assess its impact on intermediation. If we assume the NSF, as a basic and cheap form of saving, is not to be intermediated to keep costs down, then it may be the case that the fund entices some low-end consumers away from broker-sold policies. Even so, the impact is likely to be peripheral to risk intermediation as it concerns savings products only. It may have some impact on intermediaries who sell both risk and savings products but this is tenuous until the reforms are crystallised.

5.5. ADVICE AND DISCLOSURE

Our concluding findings on the overall impact of regulation on the development of the intermediary market will be discussed in Section 7. However, it is necessary to note some findings on the definition, value and cost of advice at this point.

The issue of advice is central to the current impact of regulation on development of the intermediary market and the cause of some confusion and conflict. Further research will be required to develop recommendations, but what is clear is that some clarification around the issue of advice is required. The following three specific issues are of interest here:

- Firstly, we argue that the definition of advice needs to be clarified. Importantly, a distinction needs to be drawn between *advice, disclosure and consumer educatio*n. Transaction-based advice cannot compensate for consumer education.
- Secondly, this needs to be reflected in the distinction drawn between advice-giving and non-advice-giving intermediaries. Currently, regulation distinguishes between advice-based sales and non-advice-based sales and the latter does not include disclosure. For the lower-income market, there is, therefore, currently a trade-off between advice with limited (or no) access (due to the cost

of providing advice) or access without any advice. We argue that the latter position holds some risks for both clients and insurers. While it may be acceptable not to require advice in sales to lower-income households, we argue that disclosure remains essential. Both for the protection of the consumer and the profit interest of the insurer and intermediary.

- Thirdly, we argue that the independence of advice issue raised in the National Treasury discussion paper may not be critical to the low-income market.

5.5.1. WHAT EXACTLY IS ADVICE?

Regulation currently distinguishes between advice-based and non-advice-based sales. By implication, it defines what information provided during a sales process is not considered to be advice.

We propose that a more clear distinction should be drawn between different types of information provided during the insurance sale process. When an insurance intermediary interacts with a client, information is passed from intermediary to client. At least three types of information can be distinguished: advice, disclosure and consumer education.

Advice. Advice constitutes the passing of information which not only informs a client of the financial products available to him or her, but is *also* coupled with **express guidance** and a **recommendation** as to which type of financial product or which specific product is best suited to the client's needs. A definition of advice is given to us in law which concurs very closely with this - the FAIS Act defines advice as:

- *"…any recommendation, guidance or proposal of a financial nature*
- *furnished, by any means or medium,*
- *to any client or group of clients*
- *in respect of the purchase of or investment in any financial product." (section 1)*

The key part of this definition is that a recommendation, guidance or proposal must be given to the client.

Disclosure. Disclosure is not as neatly defined in law as advice is, but we venture that all information that is not considered advice, but which is **germane** to the client and which the client could **reasonably** expect to know of and be told before entering into a contract of insurance, would fall into this category. For this reason it could also be called "contractual information". It would include:

- Overarching factual information describing what the contract does and broadly what the rights and obligations of the parties are, including a description of the

premium, a reasonable explanation of the nature of trigger events, the benefits s/he can expect, and who the beneficiaries will be.

- Factual information about the procedure for entering into the contract.
- Specific factual information on the administration of the contract, for example, when, where and how premiums must be paid; if and how premiums will increase; and how and to whom the benefits will be made available.
- Relevant information about exclusions and caveats that the client would reasonably want to know about. This information is relevant if it would lead the client not to enter into the contract, or to seek to enter it on different terms.
- Information about the nature of the relationship between the intermediary and the product provider; an indication of nature and extent of intermediary remuneration; and what charges the client can expect to pay in addition to the premium.
- Any other information that is given without making any express or implied recommendation, guidance or proposal.

The objective of providing disclosure information should be to put the client in a position in which he or she reasonably understands the terms of the contract before entering into the contract. A simpler transaction, say the sale of a soft drink, would not require this information because it would be implicit that the client reasonably understands the terms of transaction because they are simple. However, because insurance is a) a more complex product than a soft drink and b) a credence good where the value of the product is not immediately tangible or obvious and is known only to one of the parties, and c) it may lead to a long-term obligation for the client, it is appropriate that the client can expect a higher level of disclosure than in a more simple transaction.

Consumer education. The third type of information that may be imparted by an intermediary to a client is generic knowledge about financial products in general. An example would be information about the concept of insurance and how a generic insurance product works.

In environments of low financial literacy (as is expected to be the case in the low-income market), consumer education may be very important. However, care should be taken on how this is provided. Based on the current experience, we argue that the insurance transaction (although contributing to consumer education through disclosure and education) should not be relied on for consumer education. This does not suggest that it does not have value to the client, **but simply that it is not feasible to provide this within reasonable cost given the small size of the transaction, and also that the intermediary should face no legal obligation to impart to the client consumer education (as opposed to disclosure or advice)**.

5.5.2. WHEN IS ADVICE REQUIRED AND WHO CAN PROVIDE IT?

FAIS is explicit that where an intermediary provides advice, he must be registered as a FSP or representative (as we have seen, registration is a costly process) and is obliged to carry out a needs analysis. FAIS is not explicit about what must be done to satisfactorily conduct a needs analysis or under which circumstances advice is required. It only requires that the FSP, prior to providing the advice in question, must take "reasonable steps" to seek from the client information about his financial situation, product experience and objectives, and must then conduct an analysis of the information, and identify the products that will be appropriate to the client's risk profile and needs. The FSP must also take "reasonable steps" to ensure that the client understands the advice given and is in a position to make an informed decision.[54]

Beyond these general pointers, there is little guidance for intermediaries on exactly how a needs analysis should be conducted. This has created some confusion in the market. Intermediaries have been left to form their own interpretation of the law. In complex (and higher-value) cases, for example, where the client wishes to structure an entire retirement plan, the trend in the market is to conduct an "holistic" or "full" needs analysis, that is, one that takes account of all the particulars of the client's circumstances across a range of financial products. Where the client's needs are simpler (and of lower value), for example, she wants to buys a single funeral policy, the tendency is to conduct a "simple" or "single" needs analysis, alternatively to avoid giving any advice and so not conduct a needs analysis at all.

Opposing views of FSB and FAIS Ombud on when advice is required. The FSB has shown itself to be sympathetic to the view that only a simple needs analysis is required for simple products and that advice is not always required. It has, however, shied away from putting out an official guidance note, presumably to avoid civil claims from disgruntled consumers who feel their needs analyses, although technically sufficient, were not in fact appropriate.

In contrast, the rulings of the FAIS Ombud suggest that the requirement for advice is based on the needs of the client and not the nature of the transaction. This issue will probably only be settled definitively through the determinations in time of the FAIS Ombudsman. The Ombud's initial determinations appear at odds with the FSB's view. The Ombud previously ruled (in Stephenson v Nedbank) that a FSP must always conduct a needs analysis where giving advice and that this cannot be a superficial assessment. However, the facts of the Stephenson case concerned a complex investment product, and whether the Ombud will take the same view of needs analysis for low-premium, simple risk product is yet to be established. This is discussed in more detail in Section 7.1.

[54] Part VII (8)(1) of the General Code of Conduct, Board Notice 80 of 2003

5.5.3. THE TRADE-OFF BETWEEN ADVICE AND ACCESS

Based on the above, we argue that a situation where a ruling by the Ombud results in advice being required for all insurance transactions holds negative implications for access and may not be in the best interest of the consumer. At the same time, we argue that a situation where all low-income insurance transactions are conducted without even sufficient disclosure is, similarly, not in the interest of the consumer. In terms of the cost-benefit trade-off, we propose that the simplification of products in addition to appropriate disclosure and the 30 day cool-off period provided under the Policyholder Protection Rules will be sufficient to assure informed decisions at reasonable cost.

5.5.4. INDEPENDENCE OF ADVICE

In addition to the above, the National Treasury paper suggests introducing a distinction between independent and other types of advice. The question is whether this is relevant for the lower-income client group? As argued above, we propose that disclosure is much more important than advice and that appropriate and simplified disclosure would present a much better cost-benefit position than insisting on advice for all transactions. The extension of this argument to the independence of advice is clear. We propose that if additional costs will be incurred to introduce new categories of advice, that this will not provide significant additional value to the client group most affected, the poor.

5.6. CONCLUSIONS AND RECOMMENDATIONS

Regulation is being driven by two policy goals: 1) empowering and protecting insurance consumers, and 2) seeking to extend access to insurance into the low-income market. Unfortunately, these two policy goals can, and do, conflict. On the one hand regulation has improved the levels of consumer protection admirably. On the other, and as a by-product of the improved consumer protection, costs of insurance intermediation have increased and continue to do so. At the same time, incentives to operate in the market are falling.

Regulation is impacting directly on the intermediation of microinsurance in two ways:

- by increasing the costs of intermediation; and
- by making the provision of advice more expensive thus bifurcating the market into advice-based (mostly high-income) and non-advice-based models (mostly low-income). This trend is explained in the next section.

What seems clear is that, under these conditions, traditional means of intermediation (a broker) will not successfully reach the low levels of the market.

Secondly, low-income income intermediation, to the extent it does or could exist, will not occur with the provision of high levels of advice. If policymakers or the Ombud do insist on minimum levels of advice with every sale of insurance, then models currently serving the lower-income market will close down.

The challenge from a regulatory perspective, then, is to find policies that either:

- bring the cost of intermediation down or create more incentives to serve the lower-income market, or
- allow a level of advice or disclosure that is sufficiently limited that it does not push up the price of intermediation unduly, but sufficiently generous so that the low-income consumer understands the insurance product he or she is buying; or
- a combination of the above two.

What changes can be made to the regulatory environment to achieve this?

- Commission could be deregulated to encourage intermediaries to sell lower-value policies. A number of intermediary groups have been lobbying for this. However, in light of comments on deregulation in the Treasury's commission paper, this is unlikely to occur in the foreseeable future and at least until such time as Treasury is satisfied that disclosure standards and consumer education have improved significantly. Beyond agreeing that at a graduated approach to deregulation is the correct one to follow, we are not able to comment on the medium-term effect of deregulation of commission without further study of other jurisdictions and sectors where deregulation has been implemented.
- Lower the barriers to entry and compliance duties (set out in FAIS) for intermediaries selling low-value products. This could defeat the object of the Act, which was, in fact, designed with the intention of keeping certain intermediaries out of the market, and of ensuring those in the market comply with certain minimum standards. We recommend, therefore, that exclusion and costs incurred in compliance with the Act (as the FAIS department moves from registration to enforcement and the grace periods for Category A applicants expire) be monitored. A cost benefit analysis of FAIS is required.
- Deal with the issue of advice. The expensive part of FAIS concerns the giving of advice - not only must advice-giving intermediaries be registered as FSPs or representatives, but an advice-based sale requires the completion of a needs analysis which pushes up the transaction costs. Potential mitigants of this problem are:
    - Clarification is needed on what constitutes minimum compliance for a basic needs analysis. Some brokers do not see lower-income selling as viable because they assume a full needs is required in every circumstance.
    - There is confusion in the market about what constitutes advice and thus when a needs analysis is required, and when disclosure alone is sufficient. The definitions of what constitute advice, disclosure and consumer

education need to be clarified, and a clear distinction drawn between the three concepts.
    - Non-advice based, tick-of-the-box selling that is accompanied by full and meaningful disclosure should be allowed but clarity must first be given as to what constitutes full and meaningful disclosure. It is in the interest of the insurance and intermediation industry to draft a Code of Conduct around minimum disclosure on non-advice sales (especially if it is lobbying for deregulated commission structures (see first bullet)).
    - Although his mandate is to act in consumers' interests rather than to expand access, the FAIS Ombud should be sensitised to the threats posed by a clamp down on tick-of-the-box selling.
- Ensure that different accreditation regimes (e.g. FAIS and Medical Schemes) are similarly aligned for products of similar complexity, so no unnecessary duplication takes place.
- Finally, there are three pieces of young or embryonic legislation that need to be monitored and assessed as they develop:
    - RICA should be closely monitored to assess the impact on the use of cell phone technology in the distribution of financial products.
    - The developments around Treasury's commission restructuring proposals need to be monitored closely. There is currently some uncertainty as to what the proposals mean for risk-based intermediation. More research will be needed on the impact of the proposals on impact on intermediaries, particularly those serving the low-income market.
    - The developments around the NSF need to be monitored. It is not clear yet if the NSF will be intermediated or not. If it is, it presents a potential opportunity for intermediaries. If it is not, it could undermine part of their existing client base.

6. INTERNATIONAL TRENDS IN THE INTERMEDIATION OF MICROINSURANCE

Key findings from Section 6:
• The *MFI-linked partner-agent model* is more suitable for the distribution of *compulsory* microinsurance products than voluntary products. Insurers are not necessarily guaranteed a permanent distribution mechanism through MFIs as, there are also other options available to MFIs to mitigate credit risks. • *Mutual insurance models* have been utilised by consumer groups as an alternative way to distribute insurance to their members. This is usually in response to a lack of perceived value offered by insurers. • Insurance can be successfully distributed to low-income individuals through the *innovative use of existing infrastru*cture. However, if complex technology is employed during the sales, premium collection or servicing processes, the intimidating nature of the technology (to low-income individuals) can be overcome through use of a trained intermediary. • The UK experience has demonstrated that as a minimum level for customer protection at least *full disclosure* is required.

As part of the review of microinsurance intermediation in South Africa, an international review was conducted to consider interesting models emerging from other countries, the potential lessons that could be identified for South Africa and to contextualise the development of the South African intermediation market within emerging global trends. This section presents the findings of this analysis by:

- providing a brief overview of intermediation models globally as context for the discussion;
- highlighting three prominent examples of intermediation models and considering their relevance for South Africa;
- reviewing the historical development of intermediation in the UK and the impact that regulation has had on this market; and
- based on the above, drawing out key lessons for the intermediation of microinsurance in South Africa.

6.1. MODELS EMERGING

From an international scan, four basic distribution models used for the delivery of microinsurance products to low-income individuals were identified. The key features of each of these models are as follows:

- **MFI[55]-linked partner–agent** (that corresponds with our concept of the low-income group)**:** The partner–agent model is one where the insurer uses another organisation to distribute insurance products to the agent's captive clients. Generally, in microinsurance distribution, these agents are MFIs and other forms of NGOs; the common factor being the agent already provides some form of financial services to its clients. The insurer is responsible for product development and pricing, and the agent is responsible for sales and service. Perhaps the best known example of this model is the partnership of AIG with MFIs in Uganda, offering group-based credit life policies. Opportunity International (OI) is developing and beginning to deliver a similar model, engaging with mainstream insurers to design and deliver assurance products to its customers. See Box 2 for a description of Opportunity International's Micro Insurance Agency and its intended role in South Africa.
- **Captive agent** (that directly corresponds with our concept of the captive agent)**:** The captive agent model is one where the insurer recruits and manages a direct sales force to sell and service the insurance products to low-income clients. The insurer is responsible for product development and pricing, as well as sales and servicing. This model enables insurers to maintain control of the business[56]. Examples of the captive agent model are Delta Life Insurance (Bangladesh) and, having changed from the MFI-linked partner-agent model, Tata-AIG (India) and CLICO (Ghana).
- **Mutual insurer** (that corresponds with our concept of the low-income group)**:** The mutual insurer model is a variation of the partner-agent model in that the agents[57] (and sometimes also clients) have a stake in the ownership of the insurer themselves. Most commonly, cooperatives, credit unions and other formal and informal mutual organisations that are already offering financial services choose to adopt this model. There is significant participation and interaction between insurer and its clients and this has had significant advantages in terms of shaping insurance product design, and facilitating client service. Examples of this model include TUW SKOK (Poland), the CARD network (Philippines), Servi Peru, Columna (Guatemala) and, on a smaller scale, MUSCCO and its member SACCOS in Malawi.

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[55] For simplicity we refer to MFI-linked partner-agent model, but this includes NGOs, cooperatives and self-help groups.

[56] It has to be noted that even with agency forces, the insurer is not able to retain full control over the client. It is typically found that agents start selling other products as well after a few years and, therefore, make the transition to broker. The largest extent of control is provided through a direct sales call centre, where the insurer retains the primary relationship with the client and also full information on its clients.

[57] In the case of TUW Skok, the insurance is distributed by individuals that are members of the cooperatives union.

- **Independent intermediary** (that corresponds with our concepts of the broker and independent multi-function intermediary)**:** The independent intermediary sells and services insurance products on behalf of many insurers, but does not carry any of the insurance risk. In many environments, broking licenses require significant capital outlays and special requirements in terms of staffing, training of field staff and other aspects. The greatest advantage of the independent intermediary is the *choice of insurers and products offered to clients*. The best known example of the independent intermediary model is Megatop/ITC (India) and Servi Peru (Peru)[58]. It is important to note that while TUW SKOK (Poland) is classified as a mutual insurer, it can also be considered an independent intermediary as it provides clients a choice between different insurance products also offered through its brokerage.

Globally, the following trends and conclusions have emerged around the four generic models described above:

The MFI partner-agent model central to initial entry of the low-income market. Globally, the MFI-linked partner-agent generally forms the entry point for a commercial insurer into a new low-income market/country. Given that premium income from individual low-income clients can be as little as $ 0.08[59] per month and margins per policy written are low, commercial insurers have favoured this approach in order to achieve scale and commercial viability as quickly as possible. Scale and viability can be ensured by offering the products on a compulsory basis only. A major initial driver of the use of this model have been MFIs wishing to cover the risks of unsecured lending, as in Uganda, through compulsory and group insurance, such as credit life and other products that mitigate lending risks. However, to succeed, MFIs must also have access to a large customer base, backed by good systems. For insurers, the low start-up costs are an incentive because there is no need to invest in market research and customer acquisition. This model can be readily rolled out[60] to other MFIs, especially if there is a well-developed microfinance sector.

Although appealing in some contexts and particularly for market entry/exploration by the insurer, the MFI-linked partner agent model has not been without problems. Particular difficulties in making the model work both to the benefit of the insurer and the MFI has seen insurers exploring alternative models and/or MFIs extending into the provision of insurance. See Box 8 for a discussion on the limitations of the MFI-linked partner-agent model.

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[58] Opportunity International (OI) is about to launch a microinsurance brokerage which will identify, develop, deliver and administer insurance for any organisation wishing to provide assurance to its low income customers/clients. OI will not accept any risk, but negotiate with commercial insurers who will underwrite the actual products.

[59] This example derives from India.

[60] AIG has successfully rolled out its 'boiler plate' products to 26 MFIs in Uganda and recently to other parts of East Africa.

Reinsurers now also offering microinsurance. It is important to note that reinsurers have also recently started extending microinsurance to MFIs. As reinsurers are only allowed to offer their products and services to *legally licensed insurance companies*, some reinsurers have established shell companies with legal insurance licenses in a number of countries. MFIs can, consequently, purchase the required reinsurance from these subsidiaries insurers of these holding companies. This implies that, in addition to the possibility of self-insurance, MFIs' choices in terms of possible insurance providers are growing.

Insurers exploring alternative distribution through direct sales. While the MFI-linked partner-agent model appears to be well suited for distribution of mandatory group microinsurance products, the demand for voluntary insurance products from MFI clients, coupled with problems that MFIs have faced to distribute these products has seen insurers turn to alternative models. Tata-AIG (India), Delta Life Insurance (Bangladesh) and, from 2006 onwards, GLICO, have discarded the MFI-linked partner–agent model and established their own (low-cost) community-based captive sales forces to deliver insurance to low-income clients. The driver for establishing the captive agent model also stems from a growing belief among insurers that insurance can be sold in a commercially viable manner to low-income people. An additional driver is the desire of commercial insurers to retain control over the front-end distribution process, which only the captive agent model can provide. (See Section 7.2 for a discussion on the drive by insurers to regain control over their distribution networks in South Africa.) The captive agent model appears best suited for use when insurers wish to:

- sell *voluntary* insurance products in volume to the poor, especially in high population density areas;
- exercise *close control* over agents because of the specialised nature of the products, particularly investment products (pension and savings related);
- establish a *dedicated delivery channel with low fixed costs*, where local community people are used as captive agents.

MFIs/NGOs/Cooperatives extending into the provision of insurance. Likewise, the mutual insurer model is typically used in contexts where:

- a well developed cooperative/credit union network exists that requires a range of needs-based insurance services – mandatory and voluntary[61];
- the cooperative/credit union network has good systems and administration; and

[61] Mandatory and voluntary products can be distributed through the same network. Mandatory products help to cross-subsidise voluntary products and enhance the overall financial viability of the insurer.

- insurance distribution through this network is managed separately from other financial services, but with significant intermediary involvement in product design and distribution.

Independent intermediary utilised in contexts where client aggregators realise negotiation power and avoid exclusive relationships. The independent intermediary model does not appear to be common; and only two examples were identified during the course of this review. This is perhaps not surprising because insurers and mutual societies have, to date, had little interest in setting up brokers when they can sell direct or through partners to customers[62]. MFIs/NGOs/SHGs have typically had to enter into captive agreements with the insurer to incentivise the insurer to tailor products to the needs of its members. Increasingly, however, client aggregators are utilising their negotiating power to retain independence, also in South Africa. Furthermore, the emergence of new independent intermediaries has found receptive markets where MFIs/NGOs/SHGs have had difficulty negotiating *mutually beneficial agreements* with insurers and where sophisticated client management systems where not available. (See Box 2 of Opportunity International's Micro Insurance Agency which intends facilitating the structuring of insurance agreements between insurers and client groups (including MFIs) in South Africa.) It appears that this model seems to be suited to contexts where:

- the prospective independent intermediary has access to a large captive market through a well established channel/platform that already distributes other products;
- there are diverse client groups that require several types of voluntary insurance products and the range of products/insurers required is high;
- the intermediary can provide system support to the MFI/NGO/SHG;
- where increased levels of interest by insurers in microinsurance has resulted in client aggregators benefiting from a more sophisticated intermediary that can broker the relationship with one or more insurers; and
- microinsurance distribution can be managed separately from other business activities.

In summary. The global review indicates that the MFI-linked partner-agent model is the most common entry point for commercial insurers into low-income markets, usually through MFIs that offer a large and captive client base on which an insurance portfolio can be built. However, the evidence suggests that for delivery of *voluntary* insurance products to low-income clients, commercial insurers are moving away from the MFI-linked partner-agent model and choosing the captive agent model (Delta and Tata-AIG). Mutual insurance models are a special niche, and are used when there is strong credit union/cooperative network and their

[62] Two specific cases of mutual insurers establishing brokerages include TUW Skok and Servi-Peru. However, at least in the case of TUW Skok, the brokerage served only a temporary purpose in providing life insurance until TUW Skok was able to purchase a life insurance license.

clients require delivery of a range of mandatory/voluntary products[63]. The independent intermediary model is often not the model of choice as insurers can sell directly to clients. However, the independent intermediary model has been of use in situations where MFIs/NGOs/SHGs have experienced difficulties negotiating mutually beneficial transactions with insurers and these organisations wanted to provide clients with a range of products.

6.2. EXAMPLES OF INTERMEDIATION MODELS

This section will review three examples of the microinsurance intermediation models discussed in the previous section:

- The use of *MFIs as microinsurance intermediaries (or the MFI-linked partner-agent model)*. Specifically, we consider the varying experience of *AIG in Uganda and India* to gain an understanding of the limitations of the MFI model and conditions under which MFIs could be successfully utilised for intermediation. This is particularly relevant as MFIs in South Africa are in the process of incorporating insurance into their product offerings to members and are considering the various options available to them.
- The experience of *mutual insurers* and the intermediation approaches applied by mutual insurers. Here we consider the experience of *TUW SKOK in Poland*. In particular, we consider their rapid development over the last 15 years and the intermediation lessons learnt during this time. There are a number of cooperative bodies in South Africa of which some are considering incorporating microinsurance in their offering to members. The lessons from TUW SKOK may be useful in guiding this development.
- The experience with *innovative and technology-based independent intermediation models* in developing countries. We review the *ITC/Megatop* model of distributing insurance through grain trading technologies in India. Specifically we focus on understanding the impact of technology, regulation and relative costs in shaping the development and success of this model.

This is not an exhaustive list, but focuses on highlighting the most interesting examples found and those with some relevance to South Africa.

[63] Recent thinking among industry practitioners suggests that when planning new low-income insurance schemes, sponsors should first focus on determining who will be responsible for different insurance functions such as product development; sales and distribution; administration; and carrying the insurance risk. Thereafter it is necessary to assess the fit of the various delivery channels with these requirements, rather than opt for a distribution model that seeks to fit these key business considerations into the (constraints of) the particular model.

6.2.1. THE MFI-LINKED PARTNER-AGENT MODEL: INSURANCE DISTRIBUTION THROUGH MFIS IN UGANDA AND INDIA-[64]

As mentioned, for many insurers the MFI-linked partner-agent model forms the entry point into the microinsurance industry. In this section, we explore the differing experiences of one particular insurer, the American International Group (AIG) in two countries, Uganda and India.

The American International Group (AIG) and MFIs. The partnering of the international insurer, the American International Group (AIG), with MFIs in Uganda and India has achieved varying levels of success in these two countries. While AIG's partnerships with MFIs in Uganda proved to be successful from a financial perspective, AIG soon realised that it would not be able to meet insurance targets set by the Indian regulator through only the utilisation of partnerships with MFIs in India.

The Ugandan experience driven by MFIs rather than AIG. In Uganda, MFIs approached AIG out of their own accord to hedge their credit risk by obtaining specifically credit life insurance. In 1996, FINCA Uganda (then the largest MFI in Uganda) requested assistance from AIG in the development of a risk product that could assist households in recovering from the financial shock associated with death. Although AIG initially rejected FINCA's proposition, the arrival of a new managing director at AIG led to the development of a group accident policy[65], specifically for FINCA (McCord, Botero & McCord, 2005). In 1999, the same product was offered to an MFI in Tanzania and this led to the expansion of the product to MFIs in other African countries. From the very beginning, there was thus a *direct demand* for credit life insurance products by MFIs to cover the lives and credit risk of their clients. This direct demand, together with a relatively uncompetitive insurance market in Uganda, has contributed to the financial success of AIG's microinsurance business. AIG in Uganda derives approximately 10% of its total business from microinsurance.

AIG's Ugandan microinsurance success also due to the compulsory nature of the products. The fact that the MFIs only distribute the credit life product on a compulsory basis has definitely contributed (if not formed the main reason for) AIG Uganda's success in partnering with MFIs. The captive market (due to the compulsory nature of the products) ensures that AIG is able to achieve critical mass on the credit life products and avoid the prohibitively high transaction costs associated with selling on an individual basis. In addition, the fact that the policies

[64] This section was prepared based on web-based material from CGAP Good Bad Case Studies, as well as Enterplan, DFID and FDCF monitoring reports from Tata-AIG, and discussions with Tata-AIG Staff/Megatop/ITC/MFIs in India.
[65] Serving the same purpose as credit life insurance, but classified as a group accident policy as it is written under the short-term insurance sections of the general Insurance Act.

are sold on a compulsory basis helps AIG avoid many extreme anti-selection risks (associated with voluntary selling).

Some MFIs now moving away from AIG and looking for other ways to carry risks. Recently, AIG has experienced that MFIs are starting to evolve in their search for ways to mitigate credit risks. Although Ugandan insurance regulations (specifically the Insurance Statute of 1996) prohibit MFIs from providing their own insurance if they do not have an insurance license (McCord, Botero & McCord, 2005), in recent years some MFIs have discovered regulatory loopholes that are enabling them to effectively self-insure. Some MFIs are changing into small banks and deposit-taking institutions and, under these circumstances, are opting to self-insure. These MFIs often choose to underwrite only the "better" risks and try to have the "poorer" risks underwritten by AIG, a less than optimal situation from the insurer's perspective. These actions by MFIs are forcing AIG to extend their distribution network in Uganda to other organisations such as credit and savings cooperatives.

The Indian experience driven by regulation. In contrast, in India the Insurance Regulatory and Development Authority's (IRDA) *Obligations of Insurers to Rural or Social Sectors Regulations of 2002* forces insurers to meet certain targets on the sale of insurance policies to rural clients (Roth & Athreye, 2005). AIG was not allowed to obtain a license to do business in India unless it partnered with a local company. Consequently, a joint venture between the Tata Group, one of the largest corporate groups in India, and AIG was formed. In order to meet the government targets, the resultant joint venture, the TATA-AIG Life Insurance Company[66], partnered with The Bridge Foundation (a microfinance wholesaler) in 2001 to distribute insurance policies through the wholesaler's network of MFIs. Although partnering with MFIs enabled TATA-AIG to enter the microinsurance environment, it soon realised that distributing microinsurance through only MFIs would not enable it to reach the rural access targets set by the Indian government as MFIs in India are limited in both quantity and quality (Roth & Athreye, 2005). Furthermore, not all MFIs have the capacity/motivation to perform the critical roles required for distributing tailor-made voluntary products. Tata-AIG thus established a low-cost direct sales model in 2003. This low-cost model, built on Tata-AIG's learning from the field, uses a Community Rural Insurance Group (CRIG) strategy, whereby local opinion leaders are used to distribute and service the voluntary insurance products. Apart from cost advantages and local presence, the CRIG model, by virtue of using opinion leaders, is associated with social acceptability and access to local information on clients, both of which are very critical in selling, distributing and servicing microinsurance products.

Generally, MFIs are able to provide an environment in which trust (of the clients in the organisation) acts as social lubricant in the selling of financial services.

[66] Hereafter referred to as TATA-AIG.

However, the MFI-linked partner-agent model, especially in the distribution of *voluntary* products, suffers from a number of limitations, discussed in Box 8 below.

Box 8: Potential constraints on distributing voluntary insurance through MFIs

- *Lack of appropriate internal controls with many MFIs.* In several markets, microfinance clients are increasingly seeking tailor-made voluntary products (endowment-type individual policies), which require special expertise, skills and motivation. For MFIs, insurance is not their core business and distribution of voluntary insurance as a secondary/tertiary product will not work, as significant after-sales service and support is required. As the agency relationship for voluntary insurance involves decentralisation of critical roles traditionally performed by the insurer and, given that MFIs neither have the capacity nor motivation to perform such roles, they are unsuited to act as agents for such voluntary products. This is illustrated by the experience of Delta Life Insurance (Bangladesh) Tata-AIG (India) and GLICO (Ghana). Significantly, all are mainstream insurance companies that see a great business potential in servicing low-income clients with a range of choice (voluntary) products.
- *Insurance premium money can be adjusted towards loan delinquency*. The experience of Delta, CARD and Tata-AIG indicate that mixing credit risk with insurance is fraught with difficulties – loan delinquency can result in late payment of insurance premiums, as, for the client, there is very little to distinguish between the loan and insurance product, which are delivered through the same channel and managed by the same sales force. Where loan delinquency has been serious, loan officers have shown a tendency to collect these first, even at the expense of premium payments. In fact, there are cases in India where loan officers have used insurance premium payments made by clients towards loan repayments, as a result of which clients have become delinquent with regard to insurance payments.
- *Clients may view insurance premiums as an additional cost to accessing a loan*. especially, for voluntary products, whose premiums tend to be higher than the run of the mill social protection products traditionally distributed through MFIs. Some clients tend to view the higher premiums as an additional cost to accessing a loan – such a perception again has naturally worked against MFIs and their core business and hence, there has been a reluctance on the part of some MFIs to distribute voluntary products. Discussions with Tata-AIG and some MFIs in India reveals that this has been a problem as clients have tended to view loan repayments, compulsory savings deposits and voluntary insurance premiums as a serious financial pressure.
- *Limited insurer control and the absence of incentives for loan officers could lead to poor sales and post-sales performance.* The distribution of voluntary products through MFIs means that the insurer does not have control over the priorities of the agents. Consequently, insurance can become a secondary or tertiary product in the product range of the MFI. Furthermore, when MFIs take the role of insurance agents, the loan officers are the main channel for delivering information to clients on the value, costs, benefits, and need for voluntary insurance. Since insurance is not the loan officer's primary concern and they often receive no direct incentives for products sold, this could form a hindrance to insurance sales and the deepening of customer relationships (McCord, Botero & McCord, 2005).
- *Insurance clients often have to deal with untrained loan officers, not particularly knowledgeable about insurance*. Related to the point above, loan officers are often not interested in expanding their scope of knowledge on the insurance products as they do not view it as their primary responsibility within the MFI. In cases where loan officers do receive training, it is limited. This does

not contribute to the broadening of client knowledge on the policy claims procedures, e.g. what forms are needed to claim, etc (McCord, Botero & McCord, 2005).

- *Long delays with claims settlements.* An efficient claims settlement process is of great importance when dealing with low-income clients. However, long delays often rise from the insurer's side when processing and assessing claims. Claims can be rejected because of issues beyond the control of the MFI or client or due to complex or inappropriate exclusions. The actual payout can be delayed because of lack of access (on the client's side) to a bank account or simply due to the multiple links in processing the claim that can lead to lost information or other delays (Churchill, Ramm & Namerte, 2005).
- *Lack of coverage between loan cycles.* Although insurance linked to credit (credit life) can mitigate risks, it is generally only a temporary situation with cover ceasing when the loan or credit is repaid (Churchill, Ramm & Namerte, 2005).

Despite these limitations, MFIs and other organisations that have access to large numbers of potential low-income clients are likely to remain an important entry point into this market for commercial insurers for the foreseeable future[67].

6.2.2. MUTUAL INSURER: TUW SKOK, POLAND

The credit union movement in Poland was revived in the 1990s during the political transition, led by Solidarity, a former trade union turned political party. During this decade, Polish credit unions underwent very strong growth to the extent that at the end of 2002, the network of credit unions formed the third largest financial network in Poland (Churchill & Pepler, 2004). The revival of the credit union movement in Poland led to the realisation by the credit union apex body, the National Association of Cooperative Savings and Credit Associations (NACSCU), that soon insurance (for the provision of credit and to safeguard savings) would be required if the network was to be sustainable. NACSCU has to ensure the safety and survival of its credit unions through the provision of a credit risk mitigation mechanism. It realised that private insurance companies were not offering a competitive value proposition and that the products of other insurers were simply priced too high (Buczkowski, 2006). It therefore decided to self-provide insurance to the cooperatives (Buczkowski, 2006).

Phase 1 – Provision of mutual insurance through establishment of insurer. The initial drive to insure credit unions part of the NACSCU was launched in 1993, when the Foundation for Polish Credit Unions[68] (FPCU) and CUNA Mutual, an US credit union insurer, established Benefit, a life insurance company (Churchill & Peppler, 2004). The two organisations contributions' to the initial capital base

[67] … and for brokers if these service providers enter this market.

[68] The Foundation for Polish Credit Unions is a tax-exempt arm of the Polish credit union movement (Churchill & Peppler, 2004).

provided the FPCU with a 10% share, while CUNA Mutual held the remaining 90% share.

The basic development of the TUW SKOK models is shown in

Figure 5. As noted in the figure, Benefit provided three insurance products to the credit union market (Churchill & Peppler, 2004):

- loan protection insurance;
- life savings insurance (entitling the beneficiary to earn two or three times the savings of the depositor, in the case of the depositor's death); and
- funeral insurance.

Phase 2 – Broker added to extend product offering. In 1994, the FPCU also decided to establish Asekracja, a brokerage company, in order to provide insurance products that were not available from Benefit to the credit unions market. Although Benefit was generating surpluses, its financial position was undermined by the fact that the capital requirements for Benefit were Euro-denominated. Given high Polish inflation rates and the depreciating Polish Zloty, the capital requirements of Benefit had to be constantly replenished. This eventually undermined the success of the insurer and in 1997 CUNA Mutual bought out the FPCU's share in Benefit and sold the company to a foreign insurer attempting to enter the Polish market.

Phase 3 – Acquisition of insurers to continue underwriting union products and extend into underwriting of life insurance. After the sale of the share in Benefit, NACSCU and the FPCU evaluated their strategic position and decided to offer the insurance targeted at the credit unions themselves, while arranging for life insurance to be sourced from other insurance companies and distributed via their brokerage. NACSCU, TUW SKOK and the FPCU, consequently, purchased TUW Praca, a failing mutual insurer, in August 1997 and transformed it to TUW SKOK, the Cooperative Savings and Credit Union Mutual Insurance Company. TUW SKOK's insurance license only enabled it to provide insurance to meet the needs of credit unions and, to a limited extent, that of union members[69]. The personal insurance products sold via the credit unions to credit union members, include (Churchill & Peppler, 2004):

- accidental death and disability insurance;
- homeowners or tenant's insurance; and
- insurance providing cover against financial losses due to the unauthorised use of debit cards.

[69] The insurance license did not allow TUW SKOK to underwrite life insurance products.

Although credit union members were still able to buy life insurance via NACSCU's brokerage, TUW SKOK's inability to underwrite life insurance became increasingly problematic. In August 2003, Metropolitan Life Poland was purchased in order to obtain a life insurance license (Churchill & Peppler, 2004). Since the purchase of the life insurance license, the brokerage is no longer distributing the insurance products of other life insurance companies and only distributes motor insurance as this specific market is extremely competitive in Poland (Buczkowski, 2006). The motor insurance products can therefore be obtained at competitive rates from the rest of the insurance market.

At present, TUW SKOK utilises three main distribution channels, i.e. agents positioned in the credit cooperative branches (there are approximately 1,600 distributed across Poland), a call centre and the internet. Of these three channels, the credit cooperative branches are by far the most popular (Buczkowski, 2006). At the end of March 2006, the cooperative network had a total of 168,000 individual member policyholders (Buczkowski, 2006).

Negative impact of intermediary regulation mitigated by special clause. In 2004, intermediary regulation requiring self-employed insurance agents to undergo 200 hours of training, provided by the insurance companies whose products they sold, was implemented (Buczkowski, 2006). This regulation could potentially have had a very negative impact on the distribution of TUW SKOK's insurance products. However, a special clause contained in the legislation limits the training requirements for insurance agents distributing tied-products (e.g. credit life insurance) to 50 hours. As up to 90% of TUW SKOK's insurance products can be considered tied-products, the negative impact on the organisation was not as severe as it potentially could have been (Buczkowski, 2006).

TUW SKOK model characterised by two aspects which are not ideal for the South African environment. Despite its general lessons for low-income or other affinity groups considering becoming insurers, two factors militate against trying to make the TUW SKOK experience *directly* applicable to South Africa:

- *Premiums are not collected in cash*. All credit union members are required to have savings accounts. This substantially eases premium collection as monthly premiums are simply deducted from the savings accounts by the credit union and paid over to TUW SKOK (Churchill & Pepler, 2004).
- *A passive sales process, which is less than ideal when trying to extend insurance to the previously uninsured, is utilised*. Agents in the various credit unions do not go out to actively sell the policy, but wait for members to enquire after the products (Churchill & Pepler, 2004). In the South African environment, where many low-income individuals are not familiar with insurance and its benefits, this sales approach will not necessarily be successful.

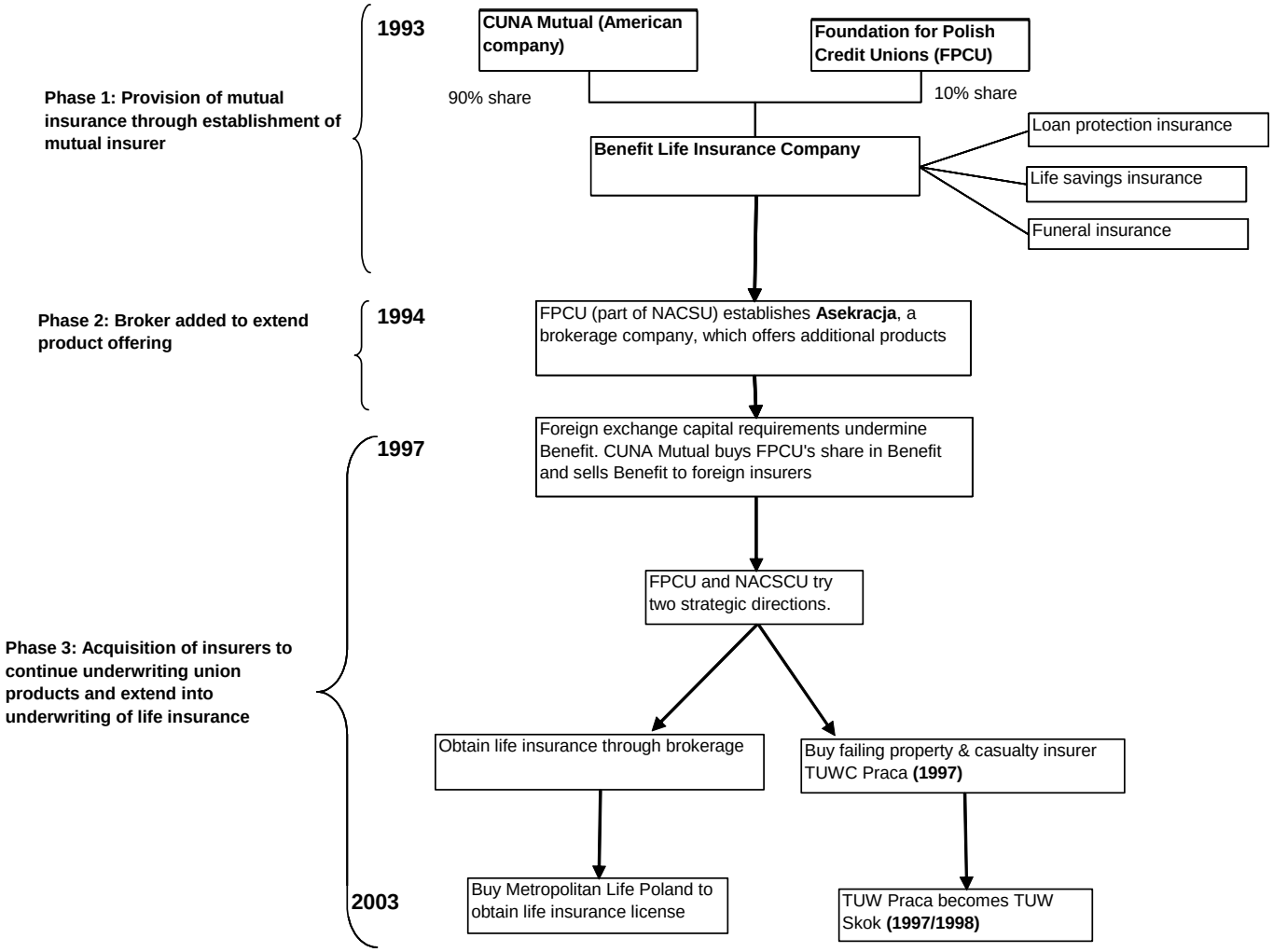

Figure 5: The history of the National Association of Cooperative Savings and Credit Unions (NACSCU) and the Federation for Polish Credit Unions' (PFCUs) insurance company, TUW SKOK

*Source :*Based on Churchill, C. & Pepler, T., 2004. *TUW Skok, Poland*. CGAP Working Group on Microinsurance, Good and Bad Practices, Case Study No. 2.

6.2.3. INDEPENDENT MULTI-FUNCTION INTERMEDIARIES: THE USE OF E-CHOUPALS AND SANCHALAKS BY ITC/MEGATOP

ITC/Megatop provides interesting lessons for South Africa in the utilisation of relatively simple technology to create a multi-function platform for the selling of insurance to the rural poor. The ITC/Megatop model consists of four components:

- the insurers
- the brokerage
- the e-Choupal; and
- the sanchalak

These four elements are discussed below.

ITC's diversification drive provides the basis for insurance distribution. ITC Limited is one of India's largest private companies. It has a market capitalisation of more than $13 billion and an annual turnover of $3.5 billion. Although it currently has business interests in a variety of products and sectors such as cigarettes, hotels and agri-business, it initially mainly focused on cigarettes and tobacco. It started diversifying its business in the 1970s when it purchased interests in the hotel industry (ICFA Centre of Management Research, 2002). However, ITC's diversification process gained new impetus in the 1990s when the Indian government started contemplating restrictions on smoking in public places and the advertisement of cigarettes and tobacco (ICFA Centre of Management Research, 2002). Today, ITC's agri-business division generates a substantial percentage of India's foreign exchange. During the last decade, it has earned more than $2 billion. The use of technology and, more specifically, e-Choupals, in the creation of a distribution network in rural areas has been central to ITC's success in the agricultural sector.

Technology facilitates a wide distribution network. An e-Choupal consists of a computer with an internet connection, strategically placed in rural villages or areas (Prahalad, 2005: 335). ITC initially developed this network of e-Choupals to assist in the distribution of information (in the local language) on weather and market prices, scientific farm practices and risk management. The e-Choupal network is also used to support the sale of farm inputs and to buy agricultural produce directly from farmers (ITC, 2006b). Currently, it serves more than 3.5m farmers in approximately 31,000 villages through 5,200 e-Choupal kiosks in six Indian states (ITC, 2006b).

In addition to the agricultural products such as herbicides, seeds, fertilizers, and soil testing services sold through e-Choupals, financial services, specifically insurance services and credit, has also been added to the products distributed. Investment-related products are yet to be launched (Arunachalam, 2006d). Initially

only simple endowment and moneyback insurance products were introduced. In the second year of operations, weather insurance was also launched. It is estimated that insurance sales total 10% of all marketing services conducted through the e-Choupals (Arunachalam, 2006d).

ITC uses a brokerage to serve the lower-income market. Megatop Insurance Services is a wholly-owned subsidiary of ITC. It is a brokerage that distributes the insurance products of a number of insurers through the sanchalaks (see below) and e-Choupals in rural villages. The provision of sufficient client choice is of central importance in Megatop's distribution approach and, hence, the choice of broking model. It is important to note that ITC, since it wanted the e-Choupals positioned as an independent distribution network for information and other products, purposefully did not extend into insurance provision itself and elected to establish a brokerage.

Table 8 details the participating insurers and their various products. By March 2006, 30,000 policies had been sold by Megatop via the e-Choupals (Arunahalam, 2006d). In contrast to South Africa where life risk products and, specifically, funeral insurance, are the most popular insurance products in the low-income market, the most popular products sold through the e-Choupals are simple endowment and money back products, while the weather and health insurance are becoming increasingly popular (Arunachalam, 2006d).

Insurance Company	Type of Product	Product Names
LIC of India	Unit-linked (savings product)	Bima Plus
		Future Plus
		Jeevan Plus
	Moneyback[70]	Jeevan Anurag
		Bima Gold
	Pension plan	Jeevan Nidhi
ICICI Prudential Life Insurance Co.	Educational risk plan	Smart Kid
	Money back	Cash Back
	Endowment	Save 'n Protect
ICICI Lombard General Insurance Co.	Accident	Personal Care
National Insurance Co.	Health	Family Health Care Product
	Package (consists 2 or 3 products)[71]	Multiple Cover Package Policy
TATA AIG life Insurance Co.	Term	Jan Raksha
	Whole Life Money Back	Mahalife
	Endowment	Subh Life
	Moneyback	MSP21

Table 8: Insurance products intermediated via Megatop e-Choupals.

Source: Arunachalam, R.S., 2006c. Personal communication. Insurance consultant. 06 June 2006.

The Sanchalak as representative of an insurance brokerage. The *sanchalak*, a specially selected and trained local farmer, is central to the success of the e-Choupals as distribution network and is responsible for all products and services distributed through the e-Choupal. The e-Choupal is placed in the living room of the sanchalak, eliminating the need for special infrastructure to house the e-Choupal (Prahalad, 2005: 336). The sanchalak is normally a well-trusted farmer from the community, able to read and write and neither rich nor poor (Prahalad, 2005: 337; Arunachalam, 2006c). After selection, the sanchalak receives training from the nearest ITC office and product training from the various product providers (Prahalad, 2005; 337). In India, it is required that insurance agents receive a certain level of training. In the case of ITC/Megatop, this training is provided by Megatop. The sanchalak is compensated according to the number and size of transactions processed through the e-Choupal (also the insurance transactions) and it can vary from e-Choupal to e-Choupal, depending on the specific mix of products and transactions (Arunachalam, 2006d).

[70] Moneyback products are risk products providing cover for a fixed amount. If no claims are made, the client receives 20% of the sum assured as the end of a 5 year payment period and at the end of the total policy term, receives a bonus accrued during the period.

[71] The Multiple Cover Package Policy, provided by the National Insurance Company, provides cover for household structures and content, cattle, cycles, tractors, two heelers, health and any commodities in the field during the harvesting process from damage.

It is important to note that the ITC/Megatop insurance model is not a passive sales model waiting for the clients to come to the sanchalak. The sanchalak actively meets with prospective clients, generates leads and closes sales (Arunachalam, 2006d).

Access impact. It is estimated that 40-45% of the individuals using the e-Choupals for agricultural services and products (and also insurance) are very poor, while another 15-20% can be classified as poor. (Arunachalam, 2006c). The majority of Megatop's insurance clients are first-time insurance users (Arunachalam, 2006c). Although ITC/Megatop initially focused on insurance sales to only captive clients like farmers and farmer groups, it has been requested by the Indian government to expand its focus to also include other marginalised groups such as women in self-help groups (Arunachalam, 2006c). Prospective clients do not need to be users of of the agricultural services and products provided through the e-Choupal in order to purchase insurance.

The role of advice. As Megatop is a broker with relationships with many insurers, the client is offered a choice of products. The sanchalak is mandated to offer product choice to the client and therefore introduces the client to the full array of insurance products available. During this process, the sanachalak will highlight the advantages and disadvantages of each product and try to relate it to the farmer's financial situation by matching client needs with the relevant products.

Premium collection and the distribution of benefits extend beyond bank accounts. Premiums have to be collected in cash as the majority of insurance clients are unbanked. The sanchalak collects all premiums in cash from insurance clients in the local village or area and then takes it to the nearest ITC office or centre, usually located within 15-20 kms of the sanchalak (Arunachalam, 2006c). Once a claim is lodged and verified, or the policy has reached maturity (in the case of an endowment or savings policy), the claim is processed in less than two weeks and sent to the nearest ITC centre or office, where the sanchalak or insurance client/recipient can then collect the benefit (Arunachalam, 2006c).

Success factors. Several factors have contributed to the success of the sanchalaks and e-Choupals as insurance distribution channel:

- *Multi-function nature of the intermediary*. Both the sanchalak and the e-Choupal fulfil multiple functions. The sanchalak is able to make a reasonable living because he not only sells insurance, but processes a variety of transactions for which fees are received. The cost of technology is justified (from a financial perspective) because it is used for more than one purpose and soon starts paying for itself[72]. Related to the multi-function nature of the

[72] It is estimated that each e-Choupal becomes financially self-sustaining after seven months (Arunachalam, 2006c).

intermediary is the fact that a *client concentration strategy* is utilised. Many farmers and other individuals interact with the sanchalak on a daily basis for other non-insurance purposes (e.g. the ordering of agricultural products). During these interaction processes, they are offered the opportunity of purchasing insurance.

- *Gradual introduction of technology*. Computer technology can be intimidating, even for well-educated and wealthy clients. Initially, ITC simply established the e-Choupals as "gathering spots" in rural villages where agricultural information was distributed to farmers by ITC representatives. This allowed them to gradually familiarise themselves with the ITC brand. After three months, a farmer asked for how long ITC representatives would still be sent out in person, as he was aware that a computer could provide the same type of services as the ITC representative (Prahalad, 2005: 336). ITC viewed this as an indication that it could start the rollout of information technology and it triggered the up-scaling of the e-Choupals (Prahalad, 2005: 336). ITC therefore used a gradual approach to roll out the technology. Furthermore, insurance was only introduced to the array of product offerings after farmers and other groups were already familiar with the e-Choupals. As the sanchalak acts as interface between the client and e-Choupal, illiterate clients are not directly exposed to an unknown technology.
- *Promotion of premium persistency.* In order to improve premium persistency, regular electronic premium reminders are generated before the premium due date and sent to the sanchalak via the e-Choupal. The sanchalak is then able to follow up and collect the premiums from the client(s) (Arunachalam, 2006a).

6.3. REGULATION SHAPES THE MARKET: THE EXPERIENCE OF THE UK

Relevance to South Africa. This section considers the experience of the UK market and, specifically, the impact that regulation has had on the intermediation of insurance. Although the UK insurance market is much more advanced than South Africa, similar regulatory approaches are utilised in South Africa and it would, therefore, be useful to consider the impact these regulations have had on the UK market.

Independent brokers only emerged from the 1950s. Distribution of insurance products in the UK changed markedly during the last half of the 20th century. Up to the 1950s, insurance products were distributed through captive agents, with each insurer (including mutual insurers) having a network of tied-agents selling their products exclusively, often on a doorstep basis. From the late 1950s onwards, independent brokers began to emerge. This distribution channel grew rapidly and by the 1970s, brokers held some 30% of the distribution market, rising to a peak of some 70% in the late 1980s and early 1990s.

Direct and captive channels encroaching on broker sales. Today, brokers[73] continue to comprise the largest distribution channel for all insurance products in the UK, particularly pension, life and other investment products. However, industry statistics for 2004 show that the proportion of general business being extended through brokers amounted to only 55% and is expected to fall further in future. By contrast, direct sales (telephone and Internet) as a proportion of total sales increased to 28% in 2004, particularly sales of general products (property and assets). Sales through banks and other financial institutions (credit life and mortgage linked products), which are also viewed as direct sales channels, have increased to 7%. The proportion of sales going through these two channels is expected to continue growing[74].

Brokers had role to play in provision of advice on complex products. Brokers emerged from the late 1950s onwards in response to the development of more complex investment assurance products (commonly linked to pensions and mortgages) and the demands of wealthier clients for independent advice. These clients traditionally consulted their legal advisers or accountants on insurance matters, but the newer products required a greater understanding of insurance matters than these traditional (financial) advisers possessed. Brokers did not charge for the provision of advice, this cost being covered by commissions. Indeed there has been a history of free advice in the insurance industry, which persists today, even among wealthy individuals and corporate customers[75]. There were no regulations governing the operations of brokers until 1977 when the Insurance Brokers (Registration) Act which set up a self regulated industry registration council and required all brokers to register with this industry body.

Technology has facilitated recent distribution developments. Technology, in particular the growth of and increasing low cost of communications and the continuous drive to reduce costs (primarily staff costs) has led to some significant developments in the distribution of insurance products in the UK over the past 15-20 years. Prominent among these are:

- *Growing direct sales (often telephonic and Internet sales)* as more cost-effective methods of reaching customers (in comparison to face-to-face

[73] Brokers in UK are defined as being independent of any particular insurer or product and able to offer advice. Although there may be small definitional differences, classification of brokers in UK, other countries and South Africa is basically identical. In the UK, this group comprises traditional independent brokerage businesses, Independent Financial Advisers (IFAs), mortgage advisers, and a wide range of retail and other service providers who now offer insurance products alongside and as a value addition to their core business proposition. Examples include white goods and furniture retailers and motoring organisations.

[74] Association of British Insurers (ABI) statistics.

[75] Some industry insiders argue that the quality of advice would be enhanced if clients were obliged to pay as a matter course.

encounters) originated. This development also led to the emergence of new insurers and brokers[76] who solely operate in this space.

- *Emergence of a form of the partner-agent model* through which banks and supermarkets (in particular) have sought to use their highly visible brands and large captive markets to sell insurance. In the case of banks, insurance has been sold in order to mitigate lending risks, particularly investment products associated with mortgages and life cover linked to personal loans. In the case of supermarkets, insurance has been confined to simple products such as life cover, and asset and property cover (investment products being considered as carrying potential reputational risk). This practice is known as "white labelling". The products are branded with the name of the business that is making the sale, but are actually vanilla products of and underwritten by mainstream insurers. Sales through these channels are cost-effective for the insurers concerned, as the agent is required to invest in promotion, selling, applications and (at least initially) premium collection. Equally, consumers appear not to be interested in the identity of the insurer that is carrying the risk, their relationship and trust are vested solely in the branded product distributor[77].

Stronger insurance regulations. The UK regulatory regime has been substantially strengthened over many years from the 1970s onwards. As of early 2005, the insurance is regulated by the Financial Services Authority (FSA) which supervises the entire financial sector. All insurance companies, brokers and intermediaries have to meet demanding new standards of professionalism and competence. Today, insurance providers, including broker and agent channels, are obliged to provide consumers with:

- clear minimum policy disclosure information, such as key fact-based documents setting out the premiums;
- commissions payable and other charges;
- terms of the policy, any exclusions and to notify and explain these to customers before completing the sale.

It is necessary to note that the above does not constitute advice in our view (see Section 5.5). Customers now have the right to cancel a policy within 14 days without penalty. Brokers are also obliged to undertake and pass professional examinations in order to undertake advisory work, the level of qualification determining the type of advice that can be offered.

Consumer protection regulation increasing compliance costs. Although the new regulation provides consumers with greater transparency, it is increasing costs for insurers. To comply with the new regulation, insurance companies have to update

[76] Direct Line, which is actually a broker, is perhaps the best known of this new wave of businesses.
[77] Statistically, these are considered to be direct sales.

computer systems, introduce new documentation, and retrain staff. It is unlikely that insurance companies will bear the full cost of these activities, but will pass the cost onto the consumer through increased premiums[78].

New regulations have larger impact on brokers than captive agents and direct channels. It is too early to assess the impact of these widespread changes on distribution channels, but industry opinion suggests that these new regulations will impact more on brokers and other intermediaries, particularly small businesses, offering a range of products and services to customers on a personal basis. The new regulatory regime is likely to further stimulate the growth of direct sales channels, particularly as insurers can better control and manage their sales and distribution networks.

6.4. KEY FINDINGS

6.4.1. MFI-LINKED PARTNER-AGENT MODEL

This model links with our low-income group category of intermediaries as described in Section 3. Although the case study is focused on the MFI sub-component of this group, we shall also highlight the relevance of findings for other low-income groups (e.g. cooperatives, NGOs, burial societies, etc.) where relevant. The key findings on this model are:

Successful models developed around compulsory credit life insurance. These models initially developed around *compulsory* credit life insurance tied to the credit provided by the MFIs. This model worked well as the product was embedded with the credit product, did not require much additional administration and did not require the MFI staff to 'sell' the product. The major appeal of this model was quick access to a large and captive client group that could be reached through existing MFI infrastructure. A drawback is that it does not allow for the intermediation of insurance to non-MFI members.

Experience with voluntary products not as successful. The next phase of development was where these models were extended to also intermediate *voluntary* insurance products that were not directly linked with or related to the credit products. The evidence on this, although not conclusive and dependent on the nature of the product sold (see below), suggests the experience with voluntary products has been less successful. There are a number of reasons mentioned for this:

[78] Some brokers and insurers have said the cost of regulation will increase premiums by up to 20%. Other experts maintain that competition will continue to keep prices down.

- Firstly, and most importantly, the voluntary sales process required additional effort and skills on the part of MFI staff and systems as it is not part of the credit process. The evidence suggests that the additional process does not fit well with the credit processes and that MFIs have had difficulty managing this. Special effort and skills relating to the microinsurance product is required through the whole lifetime of the product, especially for endowment/savings/health products. Consequently, MFIs typically do not want to engage in the sales of high transaction cost voluntary microinsurance products as returns are minimal, even more so in environments with capped commissions. In summary, MFIs are unlikely to be good intermediaries for voluntary microinsurance products that call for a great deal of effort.
- Secondly, the voluntary nature means that scale is more difficult to achieve and that there is a higher risk of anti-selection.
- Thirdly, there is a conflict of interest in an MFI distributing its own credit product as well as an insurance product of an insurer. If the client is under financial pressure, the MFI will tend to allocate premiums to the credit repayment rather than to the insurance, leading to lapses in policies (some other constraints of the MFI intermediation model are noted in Box 8).

The result is that the insurers have tended to explore other models for voluntary products.

Regulatory environment impacts on the exact relationship between insurer and MFI. This applies to both insurance and intermediation regulation.

- *In less stringent regulatory environments, the relationship between the MFI and insurer may be more difficult to maintain in the long-term.* In countries with weak insurance regulation, MFIs may utilise the room provided to underwrite themselves. In some instances, this has been the case in Uganda. While insurers may find benefit from an on-going distribution relationship with MFIs, in the case where regulation on underwriting is not as clear (or less onerous), MFIs may opt to self-insure (partly or fully) instead of partnering with the insurer. This is particularly the case where MFIs become more sophisticated and build up their own balance sheet. It is important to note that *choosing to self-insure is not in line with international best practice* and occurs because the MFI perceives the risk/reward balance to be in its favour[79]. This may not necessarily be an objective evaluation
- *In countries with limited intermediary regulation, the MFI plays a larger role in all functions of distribution* (selling, collecting premiums, administering the policies, paying claims, etc.). Where intermediaries are more regulated, this may limit the ability of the MFI to fulfil some intermediation functions without incurring potentially substantial regulatory compliance cost. The FAIS

[79] However, this perception is not always correct and in these instances, NGOs risk insolvency.

legislation in South Africa is an example of quite stringent intermediary regulation that requires intermediaries to be registered with minimum levels of education, conduct business in manner specified in the Act and report regularly on business conducted (see discussion in Section 5.3.2).

In summary, some of the direct implications for South Africa are:

- The distribution of *voluntary* insurance products (e.g. funeral insurance) through MFIs (e.g. SEF) may face some of the same constraints as found in other jurisdictions (noted above). Care should be taken to address these constraints in the proposed models.
- Insurers are not guaranteed a long-term willing distribution partner in MFIs as they may opt to become insurers themselves, could potentially access reinsurance as described above or may simply choose to remain independent (i.e. can move between insurers). To date, the discussions between insurers and MFIs (also other low-income groups) seem to focus on captive models (supposedly necessary to entice the insurer to adapt products to the needs of the MFI), but it may actually be in the interest of the MFI to retain independence to ensure that the on-going relationship with the insurer is mutually beneficial[80].

6.4.2. COOPERATIVE/MUTUAL INSURANCE

The international review found that the distribution of insurance through a network of financial cooperatives is a relatively common model and holds some lessons for emerging cooperative insurance movements in South Africa.

Insurers need to improve and demonstrate value proposition. The development of the TUW SKOK experience over the last 15 years highlights the risk insurers are facing of potentially large parts of their client groups opting to self-insure through cooperative structures. TUW SKOK explored the avenues of, firstly, owning their own insurance companies and, secondly, acting as intermediary for other insurers and eventually mainly opted for the first route rather than the second. The main reason for this was that, in terms of regulation, it was possible for them to do this (i.e. comply with insurance regulation). Relationships with other insurers would also not have ensured sufficient value for members. The establishment of a brokerage was, arguably, from the very beginning only seen as an *intermediary* step to the

[80] It must be noted that the nature of the product needs to be taken into account when considering the relative success of these models. Parametrically triggered insurance products (e.g. crop insurance which pays out a fixed amount if the rainfall varies by a specified amount and which does not require complicated claims investigation and management by the MFI) may be quite usefully distributed through MFIs. The main reason is that the risk of anti-selection is addressed by the basic nature of the product and that the MFI is mainly used to sell the product and possibly to collect premiums, but do not have to administer the product

eventual self-provision of all relevant insurance and allowed TUW SKOK to offer a value proposition to its members while achieving its final goal.

Insurance offerings may also facilitate growth of apex bodies. We already see some of the early signs of such considerations in South Africa where client groups are considering entering into the insurance environment (see Section 7.2.1). It has largely been attributed to the perceived lack of value that insurers have brought to the various client groups and the unwillingness of insurers to adapt models and products to suit the needs of the client. In addition, apex bodies see the provision of insurance as a way of building their own credibility and value proposition to their members, something that is still important to establish for these bodies. Although the introduction of insurance in the TUW SKOK example can not purely be ascribed to this factor, it has certainly contributed to the re-establishment of the credit cooperative movement in Poland under the National Association of Credit and Savings Unions (NACSCU).

6.4.3. E-CHOUPAL

The e-Choupal was included in the review because it presented an interesting example of an independent commercial distribution channel utilising new technology and existing commercial infrastructure. It, therefore, falls within the multi-function intermediary category (see Section 3.1.2.3). The key insights to note are:

Utilisation of existing infrastructure. The e-Choupal was not established purely for the distribution of insurance. Instead, the insurance distribution function was added to an existing commercial and technological platform. In addition, the overall technology model was gradually introduced with the sanchalak as ‘guide’ to interaction with the technology. Clients are not simply required to utilise the computer-based sales model to purchase insurance, but instead the sanchalak uses the platform to guide clients through options and eventually execute the transaction.

Active sales and marketing. The e-Choupal is not a passive sales model waiting for clients to approach the sanchalak for insurance. Instead, the sanchalak actively markets the products to potential clients.

Independent intermediary. The e-Choupal is set up as an independent intermediary. ITC/Megatop do not own their own insurance company and do not have ties to particular insurance companies whose products are intermediated through the e-Choupal. This was considered essential to ensure the e-Choupal’s credibility as information provider (its original primary purpose) and independent intermediary of insurance products.

Relevant for South Africa is to consider whether similar infrastructure exists that could be adapted to distribute insurance. Two examples can be noted:

- *Spaza shops:* Spaza shops provide a large distribution network that is already utilised for other commercial distribution. It is, however, not 'franchised' or centrally organised and, unlike the case with ITC/Megatop, negotiations would have to be done with individual spaza shops. Nonetheless, the increased introduction of point-of-sale (POS) devices (in effect, a communication network) in spaza shops for transaction purposes may present interesting opportunities and a more centralised point of interaction.
- *Airtime vendors:* Airtime vendors are probably closer to the e-Choupal model as they are already centrally organised through the various cellular networks and their airtime sales systems already provide an extensive and advanced communication technology platform. Also, the additional benefit is that all clients have cell phones that can be used in the interaction with the insurance provider (ranging from payment reminders to eventually cell phone-based premium payments)

6.4.4. DEVELOPMENT OF UK REGULATION AND IMPACT ON MARKET

The need for advice vs. disclosure. As described in Section 5.5, we distinguish between advice and disclosure. This is essential as there is a much greater cost and effort attached to providing advice than there is to providing product disclosure. The question that arises, therefore, is whether disclosure is sufficient to ensure informed sales and consumer protection or whether this requires advice. The experience of the UK suggests that, while advice is not necessary, at least full disclosure and a cool-off period are required to prevent misselling and also to ensure that premium persistency is improved as clients understand what they are buying.

6.4.5. OTHER GENERAL CONCLUSIONS

Integrate technology to enhance efficiency of front-end processes. Technology has been integrated into processes close to the customer so as to reduce costs. Such a strategy has helped channels to overcome disadvantages of distance, remoteness and high transactions time/effort and ensure greater and timely responsiveness to customers. Several examples exist and these include Megatop, Tata-AIG, TUW SKOK, Servi Peru, and CARD.

Access captive markets to lower costs. Existing platforms/clients, such as MFIs, NGOs and SHGs have been tapped to reduce initial search, information,

screening, promotion and marketing costs. Insurers in all the major models[81] have accessed existing captive markets or existing client bases.

Transfer management of front-end processes closer to customers. Specifically, insurers have shifted management of front-end business processes to staff closer to the customers, to ensure better service, both in terms of speed and quality. This shift of front-end business processes has been backed-up by use of technology, standardisation and simplification of processes and capability building. Some of the key processes which have been shifted include: initial client selection; awareness creation/education; marketing and promotion; proposal filling and support documentation; premium collection, and initial claims assistance and follow-up.

Use existing market infrastructure to access selected markets. Local people have been engaged as staff/agents to reduce costs, and gain access to local information because they are already accepted and trusted within their various communities. The most significant examples are in the direct sales model - Delta, Tata-AIG and now GLICO. Megatop has likewise used sanchalaks, local farmers/opinion leaders, in the same manner, as have other cooperative/mutual insurers, such as COLUMNA. In addition, there are many benefits associated with using individuals' part of the relevant organisational structure, e.g. the use of members of credit unions as agents by TUW SKOK.

81/ While Tata-AIG has clearly moved away from the partner–agent model, the CRIGs sell to established self-help groups and other such captive markets that may be available locally.

7. MARKET AND REGULATORY TRENDS SHAPING MICROINSURANCE INTERMEDIATION IN SOUTH AFRICA

This section combines the analysis presented in the preceding sections, to construct and describe three trends that will shape the intermediation of microinsurance going forward.

- Opposing regulatory forces are increasing the cost of intermediation, bifurcating the market into advice and non-advice components and risk closing down emerging microinsurance intermediation models;
- Controllers of client groups are entering into intermediary and insurance markets; and
- Broker domination will delay introduction of new models in high-income markets, but new captive models and independent microinsurance intermediation models may undermine broker power and relegate brokers to high-income niche markets.

These trends are described in more detail below.

7.1. TREND 1: OPPOSING REGULATORY FORCES ARE INCREASING COSTS, BIFURCATING THE MARKET AND RISK CLOSING DOWN INTERMEDIATION TO LOW-INCOME MARKETS

The regulatory changes described in Section 5 are dramatically impacting on the intermediation of insurance and is leading to three key trends in the market:

Trend one: The cumulative impact of regulation, especially since the introduction of FAIS, is increasing the costs of entering and operating in the market, especially for low-income brokers, while the looming National Treasury proposals are decreasing incentives.

The harsher regulatory environment is reducing, or will reduce, the number of intermediaries in the market. Basic economic theory suggests that in a market where barriers to entry climb, costs of operation increase and incentives to remain fall, a number of suppliers will be either barred from entering the market or will choose to exit it. We expect both to occur in the intermediary market. Some moderate exclusion of intermediaries has already taken place (630 applicants out of 14,500 have been declined a licence by the FSB[82]). This represents 4.3% of

[82] This does not take into account the number of brokers w ho simply did not apply for a license and decided to exit the market with the promulgation of FAIS.

applications. However, many more will soon be excluded - the intermediaries who have applied for registration are largely those who expected to be approved and there are likely large numbers of weaker candidates who are simply ignoring FAIS.[83] A pattern of wholesale exit is not yet evident in the market for two reasons:

- *FAIS (and other laws) are not strongly enforced, yet:* The FSB has a small inspectorate with limited capacity. Where it does locate and report offences, the report is handed to the authorities for criminal prosecution and they are generally not well informed about financial legislation. Where prosecutions have been successful, the court sanction has also been small (as little as a R500 fine). However, with the FAIS registration processes drawing to a close, the FSB is preparing to move the bulk of FAIS staff from the registration department into compliance and enforcement. This will improve enforcement. Moreover, as the new regulatory regime gains acceptance the market will begin to self-regulate. Insurers will simply refuse to sell business through intermediaries who are not FAIS compliant. At this point, most unlicensed intermediaries will be forced to exit the market.
- Grace periods are still running: Moreover, grace periods concerning minimum education requirements for Category A applicants (those who sell funeral insurance only) are still running and anecdotal evidence suggests that large groups of these providers will not be sufficiently skilled by the expiry date in September 2007 to retain a licence. Unless grace periods are extended, they will also be obliged to exit the market.84

The harsher regulatory environment impacts more on lower-income and smaller intermediaries than on upper-income and larger intermediaries. FAIS is generally gaining acceptance in the market and, in many quarters, is seen as a welcome development, particularly by intermediaries serving the upper-end of the insurance market, most of whom have no trouble passing the fit-and-proper requirements, meeting compliance duties and paying the FSB levy. They see FAIS as a good way to “clean up” their profession. Given the more sophisticated nature of the market that higher-income brokers have been serving, they have already been forced to follow procedures and disclosure requirements similar to that which FAIS has now formalised. At the bottom end, the brokers would have followed substantially less formal procedures and would have to make the biggest adjustments to their systems and processes to comply with FAIS.

The small and emerging brokers serving the lower-end of the market may find it comparatively difficult to comply with the fit-and-proper educational requirements, to pay for a compliance officer and auditor, and to carry out financial needs

[83] Interview with Warren Neale, Head of FAIS registration on 09 February 2006.

[84] When FAIS were announced in 2002 an appeal was made by funeral insurance intermediaries (Category A applicants) for more time to comply. According to the FSB, nearly 30% of brokers that applied for Category A licenses required exemption on these grounds. The FSB agreed to provide a three year grace period, which is due to expire in September 2007. Interview with Warren Neale, Head of FAIS registration, on 09 February 2006.

analyses. The increased compliance costs may, in some cases, be enough to undercut the narrow margins they make. What options do such intermediaries have? They could:

i) Exit the market.

ii) Try to move up the income chain to increase revenue (this will be difficult owing to their narrow skills and marketability base).

iii) Try to increase turnover – this will lead to the emergence of more group selling to burial societies, stokvels, trade unions etc and a greater use of client concentration strategies. However, this may also be limited for less sophisticated and emerging brokers as they will be competing with the better resourced agency forces of large insurers.

iv) Try to migrate to a tied-agency, or direct marketing sales force to take advantage of the assistance an insurer can provide in complying with regulation. This is unlikely to be an attractive option for most brokers.

v) Cope with heightened regulatory costs by consolidating into networks or groups or by joining compliance support service bodies. These already exist - some are intermediary-led type bodies e.g. Luasa, while others are insurer-led and sponsored e.g. Masthead. Typically, these bodies offer support from around R100 p.m. for basic compliance assistance up to R2,500 p.m. for a full compliance service including an external compliance officer.

Of the above-mentioned options, only the last has been observed at any scale. It, therefore, looks like the first-order coping strategy of brokers is to organise themselves into networks to reduce compliance costs. This may change once the enforcement of the FAIS Act kicks in.

Trend two: The increased regulatory cost of providing advice, will lead to the bifurcation of the market into two types of distribution: advice-based selling and non advice-based selling.

Regulated advice-based selling limited to high-income market. The placing of additional regulatory requirements on the provision of advice means that, in effect, providing advice has become more expensive (both in direct cost and in terms of the heightened risk). This can be recovered in high premium business, but in low-premium business the provision of advice may not be feasible (unless conducted at very high volumes which, in turn, is biased against individually-tailored advice). The result is that the market is being bifurcated into two camps: one formed around advice-based sales and focussed mostly on upper-end, higher-premium sales, and one formed around non-advice based sales at the lower-end of the market.

New models emerging in the low-income market to exploit regulatory space for non-advice based selling; these are unlikely to make use of traditional brokers. A further result of the separation of advice-based and non-advice-based selling is that brokers are unlikely to play in the advice-less (and low-income) market for three reasons:

- Brokers tend to see their core value proposition as the provision of advice[85] and would not want to move to advice-less selling.
- In the mind of the client, the broker is someone that advises. Even advice-less sales by a broker would, therefore, be perceived as advice-based by the client, which would lead to regulatory risk.
- A broker who incurs the cost of being regulated as an advice-provider, would not be interested in selling lower-value advice-less policies.
- Most importantly, brokers will have to compete with low-cost no-advice models.

Models that can rely on not providing advice will be adopted by insurers for the lower-end market. For example, a client will be sold insurance by being asked if they wish to purchase insurance, and simply being asked to "tick a box" or indicate in the affirmative. No advice is given with this sale. This method is increasingly used by retailers to sell credit and other forms of insurance. The obvious advantage to the supplier is that no advice (as defined in FAIS) is being offered, and consequently, there is no need for the staff member to be registered as a representative.

Trend three: Regulatory rulings against non-advice selling may close down the only channels operating at the lower-end of the market.

With the introduction of the FAIS Act and the concomitant increased regulation of advice-based selling, a number of questions have been raised on what exactly constitutes advice, when a financial needs analysis is required and in what form, and who needs to be registered under FAIS as intermediaries. Specifically, questions have arisen on the legality of so-called "tick-of-the-box" selling, which emerged in reaction to the increased costs of advice-based selling and in an attempt to avoid the regulatory cost incurred under FAIS. In order to guide the market on these issues, the FSB has issued guidance notes. In addition, legal interpretations of the FAIS Act are also provided through the rulings of the FAIS Ombud. However, these two interpretations of the FAIS Act are not always aligned and in some cases, we argue, are contradictory. This not only leads to confusion in the market, but risks undermining the intermediation of insurance to the lower-income market.

FSB: Needs analysis only required when providing advice and advice is not required in all insurance sales transactions. Read to the letter of the law, it is. The

[85] In fact, this document argues that the broker business model is defined by its independence and the provision of advice (see Section 3.1.2.1).

General Code to FAIS is clear that a needs analysis is only required where advice is being furnished (see Part VII (8)). Advice, as defined in the Act, means giving a recommendation, guidance or proposal of a financial nature, but it excludes merely factual information given about the procedure for entering into a transaction, or in relation to the description of a financial product, or in answer to routine administrative queries, or factual, objective information given about a particular financial product.

Thus, an "intermediary" who makes no recommendation or provides no guidance to lead the client one way or the other, is not providing advice (and is not required to do so under FAIS) and would not need to carry out a needs analysis. Put practically, an intermediary who asks a client "Would you like to buy funeral insurance?" and allows the client to decide without guidance whether he wants the insurance or how much cover would be appropriate or even which of two competing products is the better for the client's needs and so forth, would not be giving advice (and is not required to do so under the FAIS Act). The intermediary will therefore not need to conduct a needs analysis or be registered as an intermediary.

This begs the question: would the intermediary need to be registered as a *representative* on the grounds that "selling" a policy, collecting cash and so forth constitutes an intermediary service? The answer is, arguably, again no because the definition of representative in the FAIS Act specifically excludes a person who acts only in a clerical, administrative or subordinate capacity and who does not use judgment. As long as the person offers no guidance or recommendation, and acts only in an administrative or clerical or subordinate role which does not require the application of judgement *or* does not lead the client into any specific transaction, the person will not be acting as a representative, as defined, and will not have to be registered as a representative.

This is also the view presented in a recent FSB guidance note.[86] The guidance note not only provides an attractive gap for the retailer tick-of-the-box model but, for such sales, explicitly removes the need to register intermediary staff as representatives or to conduct a needs analysis – effectively manoeuvring around two costly parts of FAIS. It is important to note that the fact that no advice is provided does not necessarily mean that no information or disclosure is provided to the client. The non-advice activities noted in the guidance note allows the intermediary (who is not required to be registered as representative) to provide full product disclosure to the client.

FAIS Ombud: Whether advice is required or not is determined by the need of the client rather than the nature of the transaction. The FAIS Ombud may take a different view on that presented above. In a recent case[87], he took what, in effect

[86] Undated guidance note on Intermediary Services and Representatives, available at http://www.fsb.co.za .

[87] The case in point was resolved without a formal hearing so was not published. It was reported by the Ombud in Cover Magazine, May 2006, Volume 18, Number 12, at page 24

translates into an anti-tick-of-the-box position. The facts were as follows: The complainant purchased a VCR at a furniture store, and discovered later that credit life insurance had been taken out and added to the purchase price. He alleged he was unaware of the insurance purchase and had not wished to purchase credit insurance. It became apparent that he had, in fact, signed the insurance form, but at the time no effort had been made to explain to him that he was purchasing credit life insurance or to question whether it was appropriate in the circumstance. The Ombud found that the store's behaviour was in contravention of FAIS and pointed out that the implication is that any sale of insurance, even if bought via tick-of-the-box, must be accompanied by a needs analysis (and hence advice) to clarify at least if the purchaser already has insurance or wishes to purchase insurance. Other anecdotal evidence also suggests the Ombud favours needs analysis (and hence advice) even on tick-of-the-box products. The Ombud has been quoted as saying:

> *"The insurer cannot spend two minutes talking about insurance cover exclusions over the phone — can the consumer really get to grips with the complexity of the product in this time?"*
>
> and
>
> *"When we ask a complainant if he knows what he has signed off, it becomes clear he didn't in fact know what he was signing off. Making sure the client understands is the way to go."* [88]

Market entry into non-advice space. Whether the tick-of-the-box model is in compliance with FAIS is, therefore, still a moot point but a number of players have taken a view that it is and have rushed to launch tick-of-the-box models. The matter will be eventually be decided by the Ombud (whose rulings will supersede the position of the FSB on the FAIS Act) and his pronouncements on tick-of-the-box selling both formally and anecdotally have not been positive towards non-advice selling. If he were to rule that a needs analysis must be done for every sale of insurance, it would in effect remove the regulatory space for non-advice selling and will throw the viability of the tick-of-the-box selling in serving the low-income market into disarray.

In combination with the fact that advice-based models may be forced out of the low-income market (through increased regulatory cost of providing advice and competition by no-advice models) the potential closure of non-advice selling in the low-income market may leave this segment of the population completely unserved.

The regulatory impacts described above are depicted visually in Figure 6.

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[88] Sunday Times, 02 April 2006

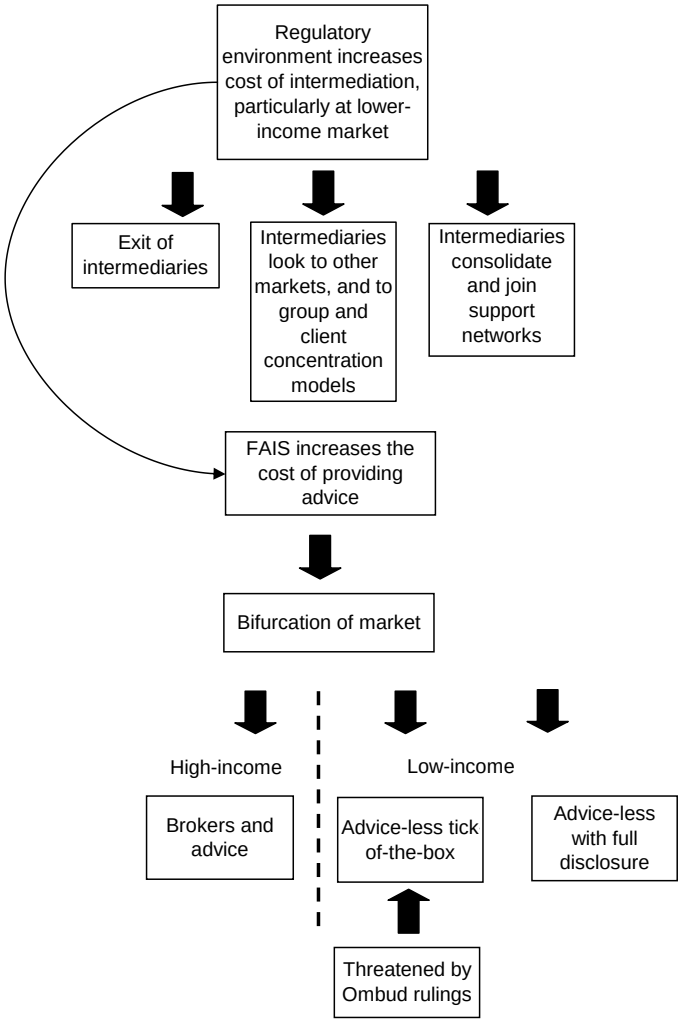

Figure 6. Trends in the market caused by regulatory environment

Source: Genesis

7.2. TREND 2: CONTROLLERS OF CLIENT GROUPS ARE ENTERING INTO INTERMEDIARY AND INSURANCE MARKETS

Based on the interviews and interactions we have had, three issues are clear in trying to distribute insurance to the low-income market:

- The needs of the low-income market have largely not been met;
- Insurance is an unfamiliar product and is, by and large, provided by institutions that are not well trusted in low-income communities; and

- Distribution of insurance to groups of customers is essential in lowering/limiting costs.

As a result, in order to notably reach and serve the low-income market, a force is emerging that will be fundamental in shaping the distribution of insurance going forward: ***client ownership will determine the position of providers in the low-income market***.

Client ownership can either mean actually *controlling* access to a group of low-income customers (e.g. SEF) or, given the nature of the interaction of the institution with a group of customers, providing a point of *concentration* to effectively access a group of low-income customers (e.g. PEP):

- Controlling access to client groups is important as it provides an immediate advantage to the controlling institution over and above other players. The controlling institution may come in a number of forms and has the power to negotiate the terms of the relationship (see discussion on SEF in Section 3.1.2.5) and may even have the potential to become insurers themselves (see discussion on Lesaka in Section 3.1.2.5) if they control sufficient numbers to support this step. Finally, as a result of the lack of insurer control, it forces insurers to offer a greater value proposition through more suitable products and services for low-income customers.
- Concentration of low-income customers is important in that it will allow the targeting of groups.
    - This may be through customer databases or merely through the general interaction of the individuals with the group and, will in turn, provide a non-Greenfield/volume proposition for insurers in entering the low-income market.
    - Group distribution is easier and often provides more cost effective access to the low-income market, which is beneficial for both the provider and the customer. For the provider, group distribution allows the opportunity to drive down costs and improve the viability of serving the low-income market. Where the group is formulated around the provision of another service/good, it will allow for sharing of infrastructure and cross-subsidisation of costs. Although the lower costs arising from shared infrastructure and cross-subsidisation will not necessarily be passed through to the client, group distribution does facilitate access to a largely underserved low-income market.
    - The unfamiliarity and insecurity of low-income consumers towards insurance may be overcome by presenting solutions through groups that are both familiar and trusted in the market. Given the discussion in Section 7.1, it seems like adviceless/tick of the box models will be used predominantly in targeting the low-income market. These models will have

a better chance of take-up/success if they are offered through either trusted groups or a trusted brand.

There is already evidence of this force in the market. Players are already making moves to gain or cement their ownership of a low-income client base in order to realise the benefits of control and/or concentration.

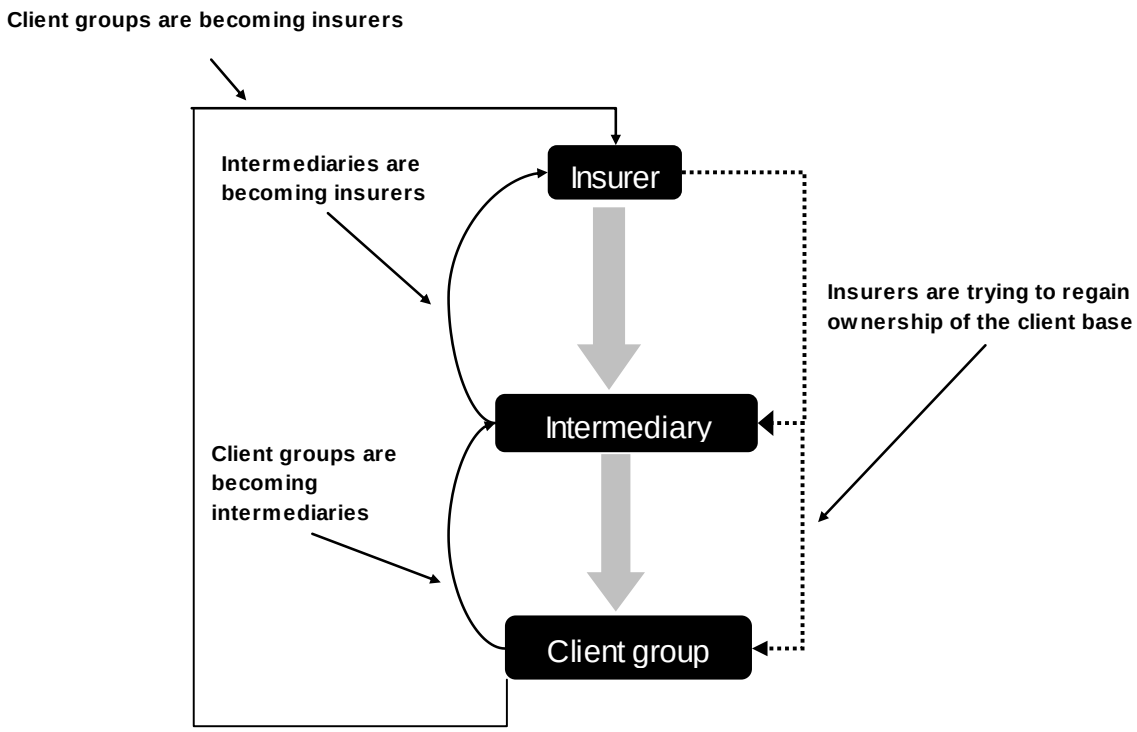

Figure 7: Movements of players to gain or reinforce low-income client ownership

Source: Genesis Analytics

As shown in Figure 7, there is, on the one hand, the movement of client groups and intermediaries up into positions of intermediation or provision of insurance. On the other hand, there are insurers acting against this in trying to move down into intermediation and/or gain control of client groups.

7.2.1. CLIENT GROUPS AND INTERMEDIARIES MOVING UP OR INTO INSURANCE VALUE CHAIN

There are three sources of evidence for the movement of client groups and intermediaries up or into positions where they are reinforcing and trying to benefit from their ownership of low-income client groups. These are:

- The rising of organised low-income groups
- Players with existing infrastructure and low-income client concentration entering the intermediation market
- Institutions applying for short-term and long-term insurance licenses

Rising of organised low-income groups. Low-income groups refer to the phenomenon where low-income groups are aggregated through client-facing networks (i.e. mutuals, cooperatives, NGOs or developmental MFIs). Such groups include large microfinance institutions[89] (e.g. SEF), co-operatives (e.g. SACCOL), burial society groups and associations (e.g. Great North Burial Society), stokvel associations (e.g. SACCOL) and unions and union-owned institutions (e.g. Lesaka).

On the one hand, a number of these low-income groups are realising that there is a need amongst members for insurance, particularly funeral insurance, and coupled with their significant numbers, have decided to become insurance intermediaries. On the other hand, certain of the low-income groups already have experience intermediating insurance and have the potential to reach really significant numbers of low-income customers, are going a step further and registering for their own insurance license.

A point to note is that although a number of these groups are member-owned and for member benefit, the intention to enter the formal insurance sector, either through intermediation or as an insurer, has allowed the opportunity for profit institutions to enter with the support of such institutions.

Players entering the intermediation market. Beyond organised low-income groups, there are other players entering the insurance value chain. These are players with an existing infrastructure that penetrates geographically quite widely and who already have low-income client ownership or concentration. At this stage, these groups tend to play an intermediary role, but down the line there is the possibility of these groups obtaining insurance licenses.

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[89] These are institutions that exist explicitly to make loans to poorer households, in order to help households start or pursue income generating activities with the ultimate goal of assisting such households in their path out of poverty. As a result, these organisations are not 'loan sharks' and have a broader social mandate than just trying to make a profit out of loaning money.

At present such players include the retailers (e.g. Shoprite, Edgars and Pep) who have opted to either maintain total ownership, and use the insurer to provide underwriting, or share ownership by entering joint ventures with the insurer. Cellular providers have a strong potential to also enter this space.

It is important to note that the impending Privacy Bill will make it difficult for databases to be acquired by the third party, thereby, further empowering these client owners over insurers.

Institutions applying for short-term and long-term insurance licenses. Recently there has been an increase in institutions applying for both short-term, e.g. CIB (a brokerage), Legalwise (a UMA) and Kaizer Chiefs (an affinity club), and long-term (e.g. a micro-lender called Real People Life) insurance licenses. Some of these institutions have previously played a role in intermediation and others are trying to benefit from their large group of members/clients who are un- or underserved.

Pressure on current formal providers – intermediaries and insurers. As a result of client groups and other players moving up or into the insurance value chain there is a potential loss of market share for insurers (to those players applying for insurance licenses) and for intermediaries who face greater competition from other players moving into the intermediation space. The ultimate result is a loss of control over distribution channels to those who are carefully moving to reinforce or gain ownership.

Consequently there will be pressure on both current providers (intermediaries and insurers) to develop an appropriate value proposition in order to access the low-income market. This value proposition must be both in terms of appropriate products for the needs of low-income consumers and provide sufficient benefit for owners of these customers.

Insurers are, however, not accepting this loss of control and are themselves employing strategies to regain ownership of the client.

7.2.2. INSURERS MOVING DOWN INSURANCE VALUE CHAIN

Four strategies employed by insurers. Insurers are employing four strategies to try and regain client ownership:

- *Buying distribution channels*. This will allow insurers direct ownership of the distribution channel through the purchase of an agency force (e.g. Momentum buying Sage) or alternative channels (e.g. Sanlam buying Channel Life).
- *Reconsidering agencies through franchising and call centre supported agents*. An agency force provides the insurer direct ownership of the channel. The franchised agent is a model that falls somewhere between a broker and a

traditional agent. This model allows agents greater independence and attracts brokers who are struggling on their own to cope with compliance and other costs. In both instances, the insurer either maintains ownership (e.g. a more independent agent does not move to a totally independent broker position) or regains ownership of the distribution channel (e.g. a previously independent broker coming back into the net). Call centre-supported agents is a move to maintain/increase the effectiveness of the agent model given the increased regulatory burden created by FAIS (see Box 3). It allows agents the opportunity to get on with the business of selling, whilst compliance is to a large extent managed by a call centre.

- *Developing broker support systems*. As discussed in Section 7.1, the broker model is under, and will be under, increasing pressure to operate in the post-FAIS regulatory environment. As a result of this, and the necessity to maintain the broker channel, certain insurers have developed broker support systems – one of these being the Masthead initiative launched by Old Mutual. Such an initiative will help maintain the small/independent brokers who find it difficult to operate with increased compliance and other costs. At the very least, broker support systems will retain the goodwill of brokers who are supported and may even allow the insurer the opportunity to exercise some control over broker distribution channels. By offering a very reasonable service such an initiative will also discourage the formation of broker networks, which in themselves would take away some channel control from the insurer.
- *Changing client focus from brokers to customers*. There has been mention, particularly in the short-term industry, of insurers changing their client focus from brokers to customers. Although the customer has always been recognised as important to the business of insurance, in most cases these customers could only be accessed through the broker. As a result, the client focus of the insurer was on the broker who had the ability to link insurers with customers. With the advent of new technologies, insurers are realising that they no longer have to depend on brokers to access and serve the customer. Instead they are able to reach the client directly without the broker and as a result the value of the customer is now recognised as key. One example of this is the use of call centre operations by insurers, as a direct link between the insurer and the customer. Now the insurer is able to retain control of clients and client information without the need for a broker.

Regulations favouring insurers re-gaining control. Although the Privacy Bill makes it difficult for databases to be acquired, certain regulations are favouring insurers in re-gaining ownership over distribution channels:

- The first of these is FAIS and the impact it will have on small/independent brokers (see Section 7.1). As these brokers feel the squeeze of FAIS, they will welcome the broker support systems or the potential franchised agent opportunities. In addition, FAIS imposes an increased level of disclosure

regulation which makes the insurer more visible in the selling process. As a result, customers will be more aware of the product provider, which may to an extent strengthen ties between the insurer and customer.

- The PPR allows the insurer to regain control over outsourced administrator channels. At the very least, this entails obtaining client information and, similar to the increased levels of disclosure imposed by FAIS, allows more clarity about the actual identity of the product provider.
- Finally, commission capping still protects the smaller and, to an extent, larger insurers from the more powerful and lager brokerages and broker networks.

7.2.3. IMPLICATIONS FOR DISTRIBUTION TO THE LOW-INCOME MARKET

As discussed, there are client groups and intermediaries moving up or into insurance value chain, while insurers are simultaneously moving down the insurance value chain. The ultimate goal of both these movements is to try to re-gain or reinforce and benefit from a position of client ownership.

At this stage, it is uncertain who may come out on top and have access to the low-income client base. What we can say, however, as the implications for low-income insurance distribution is that:

- Firstly, there has been a fundamental shift in the way the market operates which will be in favour of those who own the client base.
- Secondly, there is greater competition in the low-income market, which will be positive for both affordability and access to current and potential low-income clientele.
- Finally, the models that the insurer can own, however, generally rely on serving banked and formally employed clients. Keeping in mind the discussion in Section 4, a large majority of potential low-income clients are not banked nor formally employed. As a result, the insurer will ultimately be dependent on other client owners for significant low-income market penetration.

Putting this all together, it is clear that increased competition for insurers and more demanding client groups will mean that insurers will have to offer a clear and appropriate value proposition in order to play a role in the low-income market. Insurers will ultimately not be able to control distribution channels to the extent they may hope and will need to, through other client groups, develop partnerships or joint ventures in order to penetrate the low-income market.

7.3. TREND 3: BROKERS ARE RETREATING TO HIGH-INCOME MARKET

This section presents a story on the changing position of brokers in the intermediation of microinsurance.

7.3.1. ESTABLISHMENT OF BROKER DOMINANCE

Move towards broker distribution. During the initial stages of the South African insurance industry's development, brokers and agents were the only distribution channels available to insurance companies. Insurers realised that the broker represented a lower cost channel than the agent as the company did not need to invest in the development of the broker, nor provide him/her with additional financial support. Brokers were remunerated with sales commission effectively paid by the client, although hidden as part of the total premium. As this realisation became stronger, insurers gradually started to migrate their sales force from a predominantly agent force to a predominantly broker force. The lower distribution costs benefited insurers, but were accompanied by a gradual loss of control over the client base. This was an inevitable consequence of the migration from agent- to broker-distribution.

Current position of broker dominance. As already mentioned, a 2003 report estimates that independent brokers *and* tied-agent sales forces are responsible for more than 90% of total new insurance business production (Uys, 2003: 14). Although the exact level is debatable[90] and may vary for different companies and different market segments, it is clear that currently the majority of all long-term and short-term insurance business is written through brokers[91] and particularly large brokerages that control access to the client and, consequently, have substantial power over insurers.

Commission capping under the current regulation provides some protection for the insurer against the market power of the brokers. This creates a situation where, although the insurer controls the price, the broker effectively owns the client.

The gradual establishment of broker dominance (in terms of proportion of premiums intermediated) is depicted in Figure 8.

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[90] A research report by Swiss Re (2004) estimates that brokers' share of personal lines non-life (i.e. short-term) distribution in South Africa was only 50%.

[91] In 2004, short-term insurance companies were selling their products through a total of 24,280 brokers, while long-term insurance companies had a total of 26,598 brokers (PricewaterhouseCoopers, 2004). It is important to note that these numbers are not addable as overlap is possible.

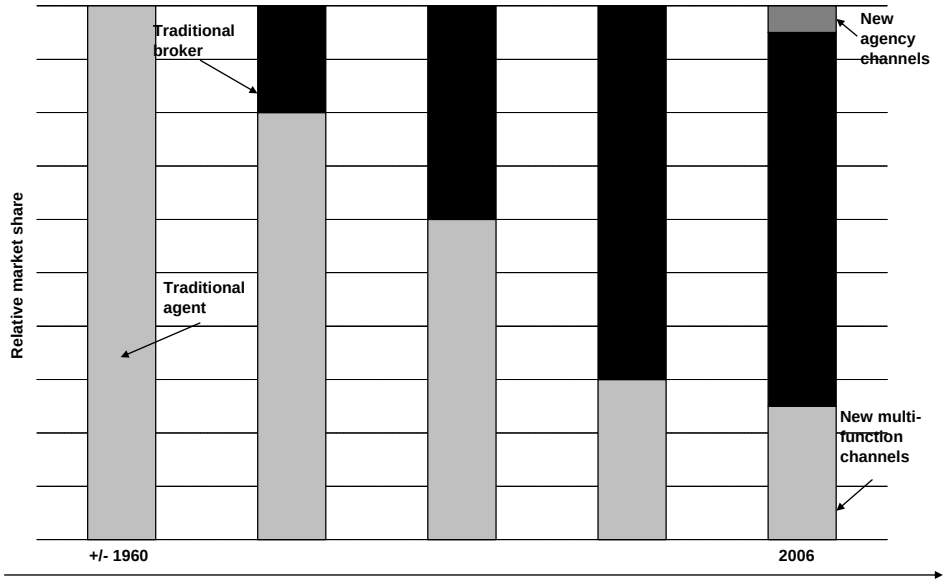

Figure 8: The establishment of broker dominance[92]

Source: Genesis

Dependence on broker distribution may delay the passing on of lower costs (in the form of lower premiums) to clients. Given the fact that the majority of short- and long-term insurance clients are effectively controlled by brokers, insurers cannot simply start utilising alternative distribution channels. Furthermore, some brokerages are part of large financial services groups where it is not in the interest of the group to cannibalise its broker channel[93], even though it has other distribution channels available. The above argument is evidenced by the fact that a large South African short-term insurer cannot sell its short-term products at lower premiums through its direct call centre channel as it will sour the relationship with its broker channel. The insurer is therefore selling its short-term products through its call centre at the same premiums its brokers are selling it at. Although the short-term insurer is not necessarily complaining about the situation as it is earning broker-level commissions on products sold directly, cheaper products could have led to an increase in products sold and, depending on the elasticity of demand, greater revenue and profit.

[92] It is important to note that the figure is not based on actual statistics, but merely serves to illustrate the increasing market share of brokers relative to agents over recent decades.

[93] Insurers may prefer hedging their sales risk through utilisation of a multi-channel distribution strategy.

7.3.2. NEW MODELS EMERGING

Technological innovation and distribution model innovation have led to reduced intermediation costs and the introduction of an array of new (captive and multi-function) intermediary channels (as discussed in Section 3).

Agency intermediary models serving the higher-income market. The new agency intermediary models that are emerging include contact centre supported sales agents and direct call centre sales agents (inbound and outbound calls). These channels offer insurers lower cost distribution strategies than traditional agents and brokers, while being able to compete with broker sales as they can serve the traditional broker's market, e.g. the educated, high-income individual. Since the new channels are captive (owned by the insurer), it enables insurers to regain control over clients, while also cutting costs. However, it is important to note that these models might not be able to serve low-income clients, as they:

- do not allow for cash collection of premiums;
- have limited geographic reach; and
- mostly target employed banked individuals that receive regular income flows, or employer groups that provide the option of payroll deduction.

Multi-function intermediary models serving the low-income market. Rather, it is the new, multi-function intermediary models that allow individuals in the low-income market to be sold insurance. These models include insurers partnering with retailers (through joint ventures, or other arrangements) such as the Pep/Hollard and Edcon/Hollard initiatives. These models generally rely on the power of at least one retailer brand and the trust that it instils. Due to infrastructural capacity of low-income retailers, the models often have vast geographic reach. The extensive infrastructure also implies lower distribution costs, while enabling the final link in the distribution chain (e.g. the retailer) to collect premiums in cash. In addition, client concentration forms a key feature of the models.

7.3.3. IMPLICATIONS OF BROKER DOMINANCE AND NEW MODELS FOR INSURERS

Given brokers' control over clients and their position of power over insurers' choice of distribution channel, insurers would want to employ strategies that allow them to regain client control while slowly mitigating broker power. The emergence of two new types of distribution models, due to technological and model innovation, provides insurers with two possible strategies to achieve the above goals, while also lowering distribution costs.

Insurers may reduce premium values of products sold through lower-cost channels (or price discriminate) if certain conditions are in place. In order to reduce the

premiums of products sold through lower-cost channels, insurers need to be able to *price discriminate*[94]. If it is assumed that the insurer contemplating such a strategy does have market power (whether by lack of competition or simply the complex nature of the product), it means that price discrimination can be quite easily implemented by selling the same product at different premiums to different markets through different average cost distribution channels. This would allow the insurer to not jeopardise existing channels while it is gradually regaining control over or access to its existing client base (currently under broker control). If price discrimination is successfully achieved, it will not only allow insurers to generate client volumes not otherwise attainable, but also aide in the establishment of lower-cost distribution channels that can eventually start to eat into the broker channel's market share.

Insurers may adopt lower-cost channels without decreasing premiums. However, rather than attempting to price discriminate, a first-order strategy for incumbents is to adopt new agency distribution channels to reduce the distribution costs (and increase insurer profitability), *but retain premiums at broker levels*. Cost savings are thus not passed on to the client. The appeal related to non-price aspects of the new distribution channels (e.g. the convenience of telephone sales), may allow the insurer to initially increase its client base without reducing premiums.

[94] Price discrimination is defined as "the ability to set prices so that the difference between average prices and average costs varies between different sales of either the same good or closely related goods" (Church & Ware, 2000: 160). Price discrimination in an insurance context would simply mean that an insurer is able to sell the same product at different prices through distribution channels with different average costs. Two preconditions are required for a strategy of price discrimination to be successfully implemented. Firstly, the insurer needs to have market power and, secondly, resale or arbitrage of the sold product should not be possible (Church & Ware, 2000: 160). Whether the first condition holds for all insurers is obviously debatable. What is, however, clear is that insurance, due to the fact that it is a credence good, is not a product that can be easily arbitraged.

7.3.4. HIGH- AND LOW-INCOME MARKET BEHAVIOUR

Depending on the markets which insurers choose to target, insurers will select one of the two strategies discussed above. The implementation of both discussed strategies hold implications for the continued dominance of brokers as a distribution channel in the insurance market. Whatever strategy selected, the new agency channels and multi-function intermediary channels will gradually encroach upon brokers' market share, as depicted in Figure 9, below.

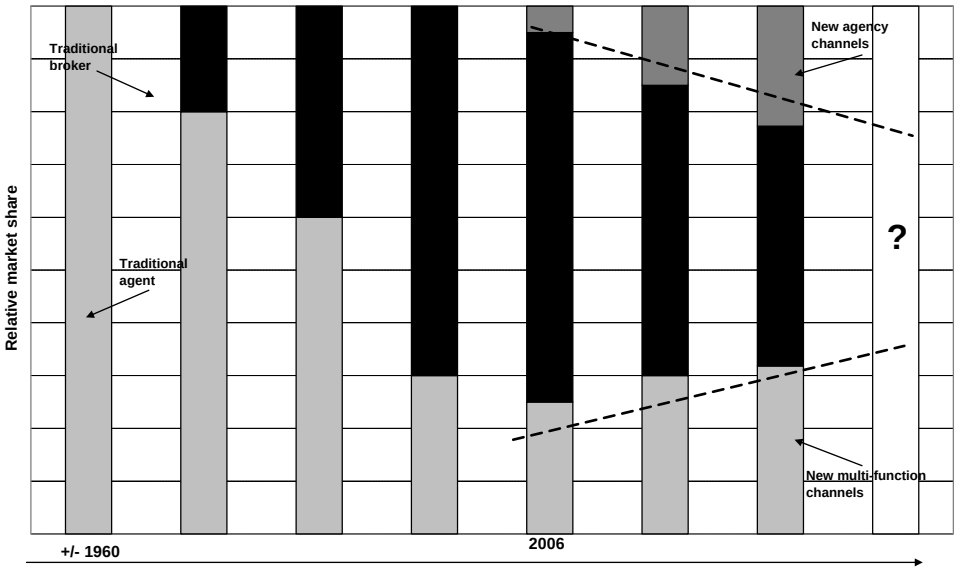

Figure 9: The rise of new intermediary models

Insurers choosing to focus on higher-income clients will generally select the second strategy discussed. This will allow them to increase client share (see Figure 9) without reducing premiums and also to sell products through lower-cost distribution channels (in addition to its broker channel).

However, if insurers choose to actively target *both* the low- and high-income markets, the price discrimination strategy would be more appropriate. These insurers will be able to price discriminate by charging lower premiums in the low-income, non-broker dominated market by distributing through the new lower cost, multi-function intermediaries. As brokers are currently not actively serving the low-income market, there will be no real resistance to the use of the new multi-function intermediary channels.

The regulatory separation of advice and non-advice markets (see Section 5) also supports the strategy of price discriminations, as it naturally excludes brokers from

the low-income market, where advice-less selling takes place. Brokers are unable to compete in the market for advice-less insurance. Not only do they not want to (they actively choose to be in the advice business), but the premium levels of advice-less insurance products do not facilitate individual or face-to-face selling. Furthermore, brokers have already invested in being able to provide advice during the sales process (through the purchase of their FSP licenses, educational qualifications obtained and other skills learned in the industry). Due to these restrictions, brokers will be forced to focus on serving the high-income market as they cannot sell advice-less products. This implies that the low-income market will have to be served by channels utilising advice-less selling processes, while the high-income market will be served by brokers, able to provide independent advice to their clients.

7.3.5. MARKET OUTCOMES

New entries will overtake broker-dependent insurers due to lower pricing. The entry of more insurers and other players into the low-income market is forcing incumbents to utilise low-cost models and pricing. The rise of branded players, such as the Pep/Hollard initiative, is also hastening the negative impact on broker-dependent insurers and increasing the need for reaction by incumbents as higher brand trust facilitates faster take-up of new products. While broker-dependent market players (such as Santam and Old Mutual) are constrained in terms of their pricing (i.e. cannot simply decrease premiums), the new entrants are able to sell products at the lowest possible premiums.

Low-income models could prove to be a Trojan horse. While it seems as if new models in the low-income market do not really pose a threat to brokers in the high-income market, the entry of insurers and other new players into the low-income market could in fact prove to be a Trojan horse for the high-income market. Initially, entry into the low-income market provides insurers a chance to perfect their low-cost distribution models and strategies before also targeting the high-income market. If this proves to be true, the broker's market share will be encroached upon from all sides (see Figure 9).

Some advice will continue to be provided by brokers in the high-income market. Insurers serving the high-income market are constrained to their traditional behaviour by the phenomenon of broker power. Although the impact of new, non-traditional distribution channels, such as retailers, on premium levels will occur slowly, broker market share will eventually be encroached upon by new players and the expanded scope of initial lower-income entrants. It is very likely that South Africa will be following the United Kingdom experience, where brokers, due to the entry of new players, are now only serving a small, quite specialised segment of the high-income market.

Broker market share is decreasing and will continue to do so. The above trends imply that the proportion of insurance business sold by brokers will gradually decrease. Although part of this change will be attributable to the creation of a bifurcated insurance market through the unintended consequences of regulation, decreasing broker market share is an international and inevitable trend.

This trend actually forms part of a broader development around the blurring of lines between client groups, intermediaries, insurers and re-insurers. Particularly, insurers are experiencing the same pressure with entry by client groups and intermediaries into the insurer environment while at the same time re-insurers are finding ways of accessing client groups directly.

8. OPPORTUNITIES AND THREATS TO INSURANCE INTERMEDIATION

Given the discussion in the preceding sections, this section will present some of the opportunities and threats to insurance intermediation in South Africa.

8.1. OPPORTUNITIES TO MICROINSURANCE INTERMEDIATION

8.1.1. EXISTING CLIENT TOUCH POINTS PROVIDE ACCESS TO SIGNIFICANT MARKET

A number of distribution opportunities for both insurers and intermediaries were highlighted in Section 4. Table 7 showed the number of LSM 1 to 5 individuals who do not have formal insurance, but who are accessible through existing relationships with the formal sector and/or other networks. These include:

- 4.2m people who have bank accounts;
- 3.3m people who have a pre-paid cell phone;
- 1.4m people who have store cards/accounts; and
- 2.2m people who are members of burial societies.

Importantly, both banks and retailers will have databases with extensive client information, including financial information (e.g. behaviour, card/account payment persistency) about their customers. This information can be used by providers in the design of suitable products for low-income clients.

Retailers, airtime vendors (to purchase airtime) and potentially burial societies will be in a position to collect cash premiums. This is especially important for the substantial numbers in LSM 1 to 5 who are not banked or employed in a company where premiums could be respectively debited or deducted.

And burial societies remain a key point through which to access the 1.2m individuals who are not banked and do not have a pre-paid cell phone or a store card/account. In addition, the overall use of burial societies by people in LSM 1 to 5 who have no form of formal insurance is a good indicator of the need for, particularly, funeral insurance and, potentially, their propensity for other forms of insurance.

The significant numbers of people accessible through existing client touch points shows that the FSC targets are well within ‘distribution’ reach.

8.1.2. NEW DISTRIBUTION MODELS EMERGING

A number of new models are emerging that extend beyond banked and employed and are able to serve LSM 1-5. These models fall in the multi-function and low-income group categories and share a number of characteristics:

- *Ability to collect cash premiums*. A key advantage of the new models is that they are able to collect cash or collect premiums through alternative means (to bank account or salary deduction). The result is that these models are able to serve the unbanked and those that fall beyond payroll deduction.
- *Reliance on tick-of-the-box selling*. The new models rely on tick-of-the-box selling without advice.
- *Utilising brand trust and/or group affinity to facilitate sales*. The new models all utilise some form of brand or affinity power to facilitate an easier introduction of its insurance products to the lower-income market.
- *Intermediary control over distribution channel*. The nature of the relationship with the distribution partner means that access to the client in most of the new models is beyond insurer control.
- *Simple but effective use of information technology*. A further key aspect of the new models is their simple, but effective application of technology for communication purposes.

8.2. THREATS TO MICROINSURANCE INTERMEDIATION

The threats highlighted here are threats to access to microinsurance rather than to the market share of any particular models.

8.2.1. CONSUMER PROTECTION OVERRIDES ACCESS OBJECTIVES

The combination of the increased regulatory cost of advice-based models and the introduction of less expensive non-advice models is forcing traditional advice-based models out of the low-income market. The retailers and other emerging low-income intermediaries are relying on tick-of-the-box selling. However, there are indications that the legality of this practice could be questioned and eventually closed down by rulings of the FAIS Ombudsman. Uncertainty around tick-of-the-box selling thus poses a very real threat to the ability of existing models utilising this practice to serve low LSM categories.

If tick-of-the-box selling is indeed shut down, it could leave a large un(der)served gap in LSM 1-5. Many of the low-income models in Section 3.1 only work because of their ability to sell policies using a tick-of-the-box method (with some models only offering advice or disclosure on demand) and because they are able to utilise unregistered sales staff. A very real risk exists, therefore, in the possibility that the FAIS Ombudsman may move against non-advice selling.

Even if the Ombud does not extend rulings on non-advice-based sales explicitly to the lower-income market, the uncertainty and potential brand risk may be a sufficient deterrent to firms considering entering these markets.

8.2.2. NON-ADVICE MODELS DO NOT ACHIEVE TAKE-UP OR RESULT IN ABUSE

If regulatory space for tick-of-the-box selling remains, there are two other remaining risks:

- *Passive sales models do not achieve take-up.* The success of new low-income models is yet to be proven. These models employ passive sales methodologies which rely on the client approaching the distribution point rather than the other way around. Although the new models will place the products within reach of low-income customers, it is not clear whether they will achieve take-up. This will have a double impact. It will push market makers (brokers/agents) out of the market, but cannot replace the market making function previously fulfilled by brokers/agents.
- *No advice models result in mis-selling and regulatory backlash*. The emerging low-income models are relying on the absolute lowest cost methodologies, selling insurance (in some cases) without even the most basic disclosure. Some of these models offer no advice or disclosure or only disclosure on request. The absence of even minimum levels of disclosure in some of the models is at risk of resulting in mis-selling and, as a result, a potential regulatory backlash. If the models currently providing no advice are allowed to continue operating in this manner, it could have negative repercussions for the market as a whole, especially for those models currently providing policy disclosure, but no advice.

8.3. CAN THE BROKER RE-INVENT THEMSELVES TO SERVE THE LOWER-INCOME MARKET?

A key question in the terms of reference to this study was whether brokers (independent intermediaries conducting advice-based sales) could re-invent themselves as intermediaries of microinsurance. In considering this question, this study has shown that:

- The bifurcation into advice and non-advice selling will result in non-advice selling in the low-income market and advice-based selling in the higher-income market. Regulatory costs are increasing on advice-based models and, going forward, regulatory and policy changes are likely to increase this divide.
- While the complete absence of disclosure will not be in the long-term interest of the market, the study has argued that advice may be too costly relative to the benefit provided in the low-income market. Instead, it is argued that disclosure should be set as the minimum standard rather than advice.

- The cost modelling exercise showed that brokers will find it difficult serving the LSM 1-5 market. Although there are some avenues to consider in improving the efficiency of the broker distribution model, these are unlikely to allow it to extend to any significant degree in the LSM 1-5 market.
- Broker models are not playing a major role in the intermediation of microinsurance internationally.

The counter question emerging from these findings is whether brokers **should**, in fact, try to re-invent themselves as intermediaries of microinsurance?

If the definition of a broker as an independent, advice-based sales model is used, this document argues that advice-based sales are not necessary and not feasible for the largest part of LSM 1-5. Our view is, therefore, it is not necessary for brokers to reinvent themselves to serve this market and that there are more promising avenues to pursue in other independent or captive disclosure-based models.

9. CONCLUSIONS

This document presented a review of the threats and opportunities for the intermediation of insurance to low-income households in South Africa. Intermediation is simply defined as all the interactions, processes and flows required to establish the relationship between the risk carrier and the client.

9.1. SUMMARY OF FINDINGS

Opportunity: The horse is at the water trough. The review finds that a large number of unreached clients are within reach of existing formal and informal client touch points. For a large proportion of LSM 1-5, premium collection is, therefore, not the main constraint to reaching the uninsured as they are already accessing other formal and informal networks that could serve as a payment collection system.

Growing focus on the provision of microinsurance. In addition, both formal insurers and other organisations are actively targeting the low-income market. This is not only driven by the Financial Sector Charter (which only applies to formal insurers), but by perceived opportunities for profit in this market. It is thus an increasingly competitive environment and multiple delivery models are emerging. This leads to growing pressure on insurers to produce better value propositions and gain ownership of customer groups.

New cost-effective models are emerging, but have yet to show results. A number of new intermediary models are emerging that are able to reach LSM 1-5. These models are able to collect cash premiums, rely on passive, tick-of-the-box selling and, therefore, do not provide advice. The emergence of the tick-box approach points towards the commoditisation of insurance. This means that the insurance product is no longer sold within a relationship, especially a relationship with a broker. It is sold as a commodity, i.e. a standardised product. In addition, there is a move to multiple contact points to deal with the distribution of the same product – personal contact, cell phone, contact centre, retail or other point of contact. This trend to client-centric rather than broker-channelled communication has been facilitated by low-income consumers coming “on grid”, especially via cell phone uptake. The ability to communicate directly and immediately via a very popular medium (SMS) has increased the viability of non-debit order premium collection. Experience shows that significantly better payment performance can be achieved by sending SMS reminders, which can be generated at very low cost. However, despite all of these improvements and innovations, little penetration has been achieved beyond funeral insurance and the new models have yet to show results.

Major risk for market players to generalise observable trends in funeral insurance to hold for non-funeral insurance products. There is an innate culturally-driven

demand for funeral insurance in South Africa, particularly amongst the low-income market, where it is by far the largest category of insurance being used. Unlike other types of insurance, funeral insurance is, therefore, bought not sold. Products such as credit life insurance have achieved penetration based on compulsion and by being bundled with other products. It is unlikely to have achieved the same penetration if it had been sold on a voluntary basis. Funeral and non-funeral products, consequently, requires very different intermediation approaches to succeed in the low-income market. Whereas the former can rely on some form of passive selling, the latter requires active selling.

Regulation has placed the cost of advice beyond the level which can be afforded in the low-income market. Even before the introduction of FAIS, traditional advice-based intermediation models had not been able to extend significantly into LSM 1-5. Given the cost of conducting advice-based intermediation, there has been little commercial incentive for advice-driven intermediaries to pursue this market and the introduction of FAIS combined with the debate on commission restructuring is likely to remove the little incentive there was. Cost modelling conducted as part of this review suggests that it is unlikely that advice-based sales models like of brokers will be able to profitably serve any significant proportion of LSM 1-5.

Does active selling mean the same as providing advice? We argue that it does not and that this distinction is necessary to allow intermediation in the low-income market. The regulatory review suggests that guidelines issued by the FSB implicitly also differentiate between “selling” and providing advice. However, given the lack of clarity on this distinction (due to conflicting regulatory signals from the FSB and FAIS Ombud), the market has effectively bifurcated into active, advice-based selling or completely passive, advice-less selling. The result is, therefore, that the only active selling models operational in the market are ruled out of the low-income market by the increased regulatory cost of providing advice (noted above). Given the conflicting regulatory views on the requirement of advice, the regulatory space for non-advice models may be closed down.

This leads to a conundrum: To go beyond funeral insurance in the low-income market requires active selling (proactive human interaction – e.g. E-choupal). Yet regulation, by combining active selling with advice, is making it too expensive and beyond the reach of the low-income market. Unless some agreement can be reached on a definition of “active sales”, which does not equate to providing advice, this study concludes that it is unlikely that any take-up beyond funeral insurance will be achieved in the low-income market.

International microinsurance experience does not provide easy solutions but yields some insights.

- It confirmed that multi-function models are essential to achieve scale and viability at low premium levels. Specifically, existing infrastructure such as airtime vendors and spaza shops may present opportunities.
- It showed that models depending on MFI distribution have not achieved success in distributing voluntary insurance and that only a limited range of insurance products have been successfully distributed to the poor. Successful products have been limited to simple life insurance products and asset insurance categories where the claims are parametrically triggered (e.g. weather insurance) or simple to assess.
- Furthermore, international experience suggests that insurers are not guaranteed a permanent distribution mechanism through MFIs and other client/affinity groups. Other options are becoming available to these groups to mitigate credit risks, including becoming insurers themselves. In particular, reinsurers are finding new ways of linking directly with microinsurance client groups placing further pressure on the insurer to establish its value proposition.
- Significantly, few of the international intermediation models reviewed relied on passive sales methodologies but employ various means and mechanisms to actively sell products to potential clients.

9.2. DRIVERS OF SUCCESFUL INTERMEDIATION OF MICROINSURANCE

Based on the above analysis, we propose that there are three drivers that determine the success of microinsurance distribution.

1. The ability to cost-effectively collect premiums, especially cash premiums, and pay benefits. This is facilitated through the “touch points” referred to in the report. The facilitators here are two-fold:

- the proliferation of point-of-sale (POS) infrastructure in low-income areas (retailers, airtime vendors, spaza shops with POS devices etc) where payments can be made; and
- cell phone infrastructure through which regulatory compliance can be administered and regular client interaction can be facilitated at low cost (e.g. reminded to make premium payments).

Both of these are critical and all of these touch points are multi-functional, which helps to reduce costs by piggy-backing on existing infrastructure. However, the touch point by itself is not sufficient to ensure success.

2. Active selling through trusted personal interaction. Even more so than in the high-income market, insurance in the low-income market (with the possible exception of funeral insurance) has to be sold. This requires:

- *Active selling* of some form sufficient to create the market for the insurance product.
- *Trusted intermediary:* These are likely to be some form of affinity group, trusted brand or a trusted individual as part of a multi-function channel (as per the e-choupal).
- *Calibrated information requirement to allow the distinction between advice and selling/disclosure:* In trying to ensure consumer protection, FAIS has placed a definition (and thereby a cost) on advice which is beyond the reach of low-income customers. This is not dissimilar to the experience with prescribed minimum benefits under the regulation of medical schemes. To allow the active selling required, the information to be provided as part of the sales process needs to be defined in calibrated packages related to the complexity (see below) and value of the product. This will require providing regulatory clarity on the definition of advice as opposed to other information provided during the sales process. **Caveat:** There is a risk that attaching a regulatory definition to selling/disclosure as differentiated from advice, may in fact impose regulatory cost on this activity as in the same way as has been done for advice. It may, therefore, be better to define advice accurately and to leave what is not advice unregulated.
- *The right incentives:* Those doing the selling need to be driven by the right incentives, i.e. some form of commission or performance related bonus. Interestingly, individual airtime vendors or spaza owners may be easier to incentivise than retail store clerks conducting insurance sales as part of their general responsibilities.

3. Appropriate product. While perhaps beyond the definition of intermediation, the nature of the product cannot be completely removed from the debate about intermediation. In particular, three aspects of the product will impact on the ease and effectiveness of intermediation.

- **Cover that reflects needs.** The product must meet a relevant need and be competitive in how it meets it. There are alternative risk mitigation mechanisms to insurance (e.g. savings and credit). Accepting that the poor face certain risks does not necessarily translate into wanting or needing insurance. Related to the requirement for active selling, the value of the product and how it relates to risks faced by the poor need to be effectively communicated as part of the intermediation process.
- **Manageable risk.** As a counterpoint to meeting the needs, it must be noted that some low-income risks cannot be insured simply because it is not possible for the insurer to manage within the low premium value. The intermediary often

has to play a role in selecting and managing the risk underwritten by the insurer and the extent of risks to be managed is often inversely related to the size of the premium. Moral hazard is particularly difficult to manage for low-income products and the successful products have been those where the client has little incentive to abuse it (or strong disincentives for abuse) and/or the risk could be managed at low cost. Beyond life insurance, there are relatively few examples of such products. Parametrically triggered products such as weather insurance present a classic example as the risk event is beyond the control of the client and it is easy to assess. Other general insurance products (e.g. household content insurance) present significant challenges in this regard.

- **Sufficiently commoditised and/or simplified.** The structure and complexity of products directly impact on the nature of intermediation required. Essentially, it is argued that a simplified product with appropriate (calibrated) disclosure can substitute for advice. Three issues are at stake here:
  - Firstly, the ability to sell with ease a product which is universally understood. Airtime is a good example. The development of CAT standards is a move in this direction, as is the Mzanzi account in the banking arena. This standardisation generally reduces the need for advice. It also means that many stakeholders are reinforcing the same marketing message, which contributes to consumer education.
  - Secondly, the ability to pay benefits with ease. The triggers for payment are standardised making it easier to understand as well as to assess.
  - Thirdly, a standardised product which is also regulated in some form (regulation of the "what") presents an alternative or complimentary approach to consumer protection where control of the process (the "how" regulation referred to in the regulatory review) is very difficult or prohibitively costly in a particular market.

9.3. CAN THE BROKER RE-INVENT THEMSELVES TO SERVE THE LOWER-INCOME MARKET?

A key question in the terms of reference to this study was whether brokers (independent intermediaries conducting advice-based sales) could re-invent themselves as intermediaries of microinsurance. In considering this question, this study has shown that:

- The bifurcation into advice and non-advice selling will result in non-advice selling in the low-income market and advice-based selling in the higher-income market.
- While the complete absence of disclosure will not be in the long-term interest of the market, the study has argued that advice may be too costly relative to the benefit provided in the low-income market. Instead, it is argued that disclosure should be set as the minimum standard rather than advice.

- The cost modelling exercise showed that brokers will find it difficult serving the LSM 1-5 market.
- Broker models are not playing a major role in the intermediation of microinsurance internationally.

This raises the question of whether the broker model is at all relevant in the low-income market. If the definition of a broker as an independent, advice-based sales model is used, this document argues that advice-based intermediation is not necessary and not feasible for the largest part of LSM 1-5. We conclude, therefore, that it is not necessary for brokers to reinvent themselves to serve this market and that there are more promising avenues to pursue in other independent or captive advice models.

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GLOSSARY

BEE	Black Economic Empowerment
FAIS	Financial Advisory and Intermediary Services
FICA	Financial Intelligence Centre Act
FNA	Financial needs analysis
FSB	Financial Services Board
FSC	Financial Sector Charter
FSP	Financial Services Provider
GNBS	Great North Burial Society
IBC	Insurance Brokers Council
LOA	Life Offices Association
LSM	Living Standards Measure
MIA	Micro Insurance Agency
MFI	Microfinance institution
NGO	Non-governmental organisation
OTC	Over-the-counter
REI	*Retail Enhancement Initiative*. A Metropolitan Life initiative aimed at the provision of intermediary support during the sales process.
SACCOL	Savings and Credit Cooperatives League of South Africa
SAIA	South African Insurance Association
SBIB	Standard Bank Insurance Brokers
SHG	Self-help group
UMA	Underwriting management agent

APPENDIX A: A BRIEF DESCRIPTION OF THE CURRENT REGULATORY ENVIRONMENT FOR INSURANCE INTERMEDIARIES

There are three main acts that impact on the activities of insurance intermediaries. They are the Long-term Insurance Act (the Long-term Act) and PPR, the Short-term Insurance Act (the Short-term Act), and the Financial Advisors and Intermediary Services Act (FAIS). Also of relevance are the Medical Schemes Act and the Friendly Societies Act.

In this appendix, we provide a description of the pertinent terms of these acts.

THE LONG-TERM AND SHORT-TERM INSURANCE ACTS, 1998

The Long-term and Short-term Acts are virtual mirrors of each other, so we consider these together. Both the Long- and Short-term Acts principally regulate the activities of insurers rather than intermediaries; however both contain terms of relevance for intermediaries.

Where an intermediary sells long-term products[95], the insurer is obliged to furnish the intermediary with a written mandate to act as an intermediary.[96] In addition, an independent intermediary selling long-term products may only be remunerated by way of commission in monetary form and commission must be capped at a statutory limit calculated on a sliding scale contained in the regulations[97] which depends on the type of insurance sold. At present, the commission on an individual life product or health and disability product is capped at 3.25%; funeral products have been left unregulated and commission on such products is, in effect, uncapped.[98]

Commissions on long-term products are paid on an “upfront” basis. The value of the policy over its full term is calculated and the commission is paid at the start of the policy, usually in two instalments: one payment of up to 85% on signing and the remainder after one year.

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[95] According to section 1 of the Long-term Act, long-term products include life and assistance (funeral) policies, as well as disability policies, fund policies, health policies and sinking fund policies.

[96] Rule 5 of the Policyholder Protection Rules issued under the Long-term Act

[97] See Section 49 of the Long-tern Act , and Part 3 (2) of long-term regulations

[98] During the course of our research no policymaker or official could explain from a policy perspective why assistance business has been left uncapped. It may be that there is lower risk of consumer abuse in this market because benefits are strictly limited (a maximum of R10, 000) and premiums are relatively small. It may also be because policymakers recognised that funeral insurance is widely and enthusiastically used by lower-income consumers and they did not want to remove the intermediary incentives to go out and provide a socially and culturally important insurance.

If a life or health or disability policy is terminated during the first two premium periods of the policy (24 months in total), part of the commission must be refunded by the intermediary to the party from whom it came (usually the insurer).[99] This is colloquially known as “claw-back”. The claw-back is calculated on a sliding scale worked out on the term that has elapsed from the start of the policy.

A short-term intermediary must have a written agreement with the short term insurer. The Short-term Act governs the level and structure of the commission that can be paid to insurance intermediary selling short-term products.[100] Presently, commission on the sale of personal lines insurance i.e. insurance sold to a natural person is capped at 12.5% while motor insurance is capped at 20%. The Act does not stipulate *how* commission must be structured but by custom almost the entire industry pays short-term commission on an “as-and-when” basis, that is, commission is collected on each premium payment as it is made. There is no statutory right of claw-back on short-term insurance, although if it is agreed that the premium on a short-term policy is payable in advance, a right of claw-back may be agreed contractually. The statutory caps for various long- and short-term insurance are summarised in Table 9.

[99] Regulation 3.5.2.a

[100] See Section 48 of the Short-term Act, and regulations to the Act. A short-term policy means an engineering policy, guarantee policy, liability policy, miscellaneous policy, motor policy, accident and health policy, property policy, or transportation policy (section 1).

Product	Commission Cap	Limit on primary commission (Upfront, max of total premium payable)	Secondary payment allowed (after one year)	Claw-back applies?
Funeral insurance	Not regulated (uncapped)	Not regulated	Not regulated	Not regulated
Individual life products (multiple premium policy)	3.25%	85%	Yes	Yes – within first 24 months
Health and disability (multiple premium policy)	3.25%	85%	Yes	Yes – within first 24 months
Short-term personal lines	20%	Not regulated (usually as and when payments)	Not regulated (usually as and when payments)	N/A if as and when. If premium is payable in advance, claw back may be agreed by contract
Short-term motor	12.50%	Not regulated (usually as and when payments)	Not regulated (usually as and when payments)	N/A, if as and when. If premium is payable in advance, claw back may be agreed by contract

Table 9: Statutory controls over intermediary commission

Source: Long-term Insurance Act, Short-term Insurance Act

FINANCIAL ADVISORY AND INTERMEDIARY SERVICE ACT

The Financial Advisory and Intermediary Services Act (FAIS), was introduced to regulate the financial advice industry. It is a piece of consumer protection legislation that seeks to ensure that persons rendering financial advice and intermediary services are properly qualified to discharge the responsibility and that they act in a professional manner.

WHO MUST REGISTER AS A FSP UNDER FAIS?

Any person, natural or juristic, who (i) gives advice or who (ii) provides an intermediary service to the public in respect of a financial product, is a financial services provider and must be licensed as a Financial Services Provider (FSP) with the Financial Services Board (FSB). A financial product includes any short- or long-term insurance policy.

The definition of “advice” and “intermediary service” are defined in section 1 of FAIS.

Advice means:

- "…any recommendation, guidance or proposal of a financial nature
- furnished, by any means or medium,
- to any client or group of clients
- in respect of the purchase of or investment in any financial product."

Expressly excluded from the definition of advice, is *factual* advice given merely:

- on the procedure for entering into a contract; or
- in relation to the description of a financial product; or
- in answer to routine administrative queries; or
- in the form of objective information about a particular financial product; or
- in the display or distribution of promotional material.

Also excluded from the definition of advice is an analysis or report on a financial product that is made without any express or implied recommendation, guidance or proposal that any particular transaction in respect of the product is appropriate to the particular investment objectives, financial situation or particular needs of a client. In other words, an intermediary who gives purely factual or administrative information to the client is not giving advice as defined, but as soon as the intermediary starts to offer an opinion or recommendation on the suitability of a financial product for the needs of the client, s/he is providing "advice" as defined in the Act.

Where the action of an intermediary does not constitute advice *per se*, it may still constitute an intermediary service, in which case the intermediary would also need to be registered as a FSP.

An **intermediary service** is defined as:

"Any act other than advice, performed by a person for and on behalf of any client or product supplier, the result of which is that the client enters into a transaction."

The definition expressly *in*cludes any act performed on behalf of any client or product supplier, with a view to, buying, selling, administering, keeping in safe custody, managing or otherwise dealing in a policy purchased by the client from a product supplier. It also includes collecting or accounting for premiums payable by the client, and receiving, submitting or processing the claims of a client. (It does not include the collecting of premiums by a bank where the bank acts merely as a conduit between a client and product supplier – a bank would presumably have to be registered in terms of the Banks Act or Mutual Banks Act).

The definition of intermediary service is very broad and without limitation would cast the FSP net over almost any person involved in the administration of insurance no matter how innocuous the activity. The Act does in fact limit the scope of intermediary service but not directly. It does so in an indirect fashion, by limiting the definition of "representative", as set out below.

A "**representative**" is defined as a person who renders a financial service, i.e. gives advice or provides an intermediary service, to a client for or on behalf of a financial service provider, either as employee or as a contractually bound agent of the FSP. In other words, any employee of a registered FSP who is providing advice or an intermediary service must be registered as a representative with the FSB.

A representative does not hold a licence in his or her own right but is registered under the licence of an FSP who must hold an up-to-date register of its representatives' names, addresses and the categories in which its representatives are competent to render financial services. It is thus incumbent on an employer to carefully assess the functions of its staff members or agents acting on its behalf, to determine whether or not they should be registered for FAIS purposes. Incidentally, an individual cannot be a representative of another representative, only a representative of a FSP.[101]

The very wide definition of intermediary service means that the employee of a FSP who collects premiums, processes claims and so forth would at some point be conducting an intermediary service as defined in the Act. To limit this very wide application, the Act goes on to exclude from the definition of representative any person who:

- Renders only clerical, administrative, legal, accounting or other service in a subordinate capacity,
- which service does not require judgement, *or*
- does not lead a client to any specific transaction in response to general enquiries (our underlining).

Put another way, administrative staff who do not make any judgements in their role are not classified as representatives of the FSP. This view can be challenged through the exact wording of the Act, but it is one that has been supported in a guidance note issued by the FSB.[102] It is also an indirect means of limiting the overly-wide interpretation of intermediary service set out above.

Let us consider the obligations on a person who must be registered as an FSP, both in terms of entry into, and activity in, the market.

ENTRY REQUIREMENTS

To register as a FSP, application must be made to the Financial Services Board.[103] The application procedure is not insignificant and considerable information must be supplied to show that the applicant complies with the "fit-and-proper" requirements

[101] Telephone interview with Warren Neale, FSB Head of FAIS registration, 17 February 2006
[102] Undated guidance note on Intermediary Services and Representatives, available at www.fsb.co.za
[103] Section 7

laid out in the Act. These requirements were fleshed out in a FSB Board Notice put out in 2003.[104] In short, the applicant must demonstrate:

- ***Personal character qualities of honesty and integrity:*** For example, the applicant should not have been found guilty of fraud or dishonesty in the five years prior to the application.
- ***Financial soundness:*** The applicant must not be an un-rehabilitated insolvent.
- ***Operational ability:*** The applicant must have basic operational infrastructure in place.
- ***Competence:*** The applicant must demonstrate a level of experience appropriate to the complexity of the products s/he wishes to sell, as well as obtain minimum educational standards measured by a knowledge-based credit point system. The required credits differ according to the complexity of the product, the lowest categories being funeral insurance (Category A business). Category A applicants are required to have at least a Grade 10 (Standard 8) *or* must have attained a National Qualifications Framework Level 2 translating into at least 12 credits. In addition, the Category A applicant must within two years of being licensed, complete an appropriate skills programme at the level of a National Qualification Framework Level 2 of at least 30 credits.[105]

A once-off licensing fee is also payable. For general FSPs the fee is around R900.

INFRASTRUCTURE REQUIREMENTS

An FSP is obliged to satisfy the following infrastructure-related requirements:

- The FSP must have a fixed business address, communication facilities including a full time phone or cell phone service, typing and photocopying service, adequate storage and a filing system, and a bank account with a registered bank, together with a separate bank account for client funds.[106]
- The FSP must have in place systems to record all verbal and written communications relating to a financial service rendered to a client and to maintain these records for a minimum of five years.[107]
- The FSP must maintain records in respect of money and assets held on behalf of clients, brought up to date monthly.
- The FSP must keep funds separate and operate a separate banking account designated for client funds only, and must within one business day deposit such funds into the account. The FSP's auditor must confirm in an annual report that client money was kept separate from the FSP's funds throughout the financial year.

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[104] Board Notice 91 of 2003
[105] See Board Notice 91 of 2003
[106] Part III (4) of Board Notice 91 of 2003 (Determination of Fit-and-proper Requirements for FSPs)
[107] Section 18 of FAIS, and General Code of Conduct Part II (3)

- The FSB must display signs that it holds a licence issued by the FSB.

COMPLIANCE AND REPORTING REQUIREMENTS

- All FSPs are obliged to pay the FSB an annual levy.
- Any FSP with more than one key individual or one or more representatives must appoint a compliance officer to monitor compliance with FAIS by the provider and its representatives. The compliance officer is responsible for understanding the Act and for putting in place systems to ensure compliance. He or she also acts as the contact point with the FSB.[108] A provider can also appoint an external compliance officer and there are a number of FSB-approved officers available to assist with compliance. Sole proprietors are exempt from complying with the compliance officer requirements.[109]
- The FSP must maintain full and proper accounting records, brought up to date monthly, and prepare annual financial statements to be submitted annually to the FSB. An external auditor must be appointed to audit the annual financial statements.[110]

TRANSACTIONAL DUTIES

- There is a duty on the FSP to supply factually correct information to the client, confirmed in writing upon request and provided timeously. The FSP should also disclose the existence to the client of any personal interest or conflict of interest in the service being rendered.[111]
- There is also a duty to supply information to the client about the product or service concerned, including the name and type of the product, the monetary obligations assumed by the client and the nature and extent of any commission payable to the FSP. All amounts, sums, values, charges, fees, and remuneration must be disclosed. Any personal interest or non-cash incentives which could be viewed as a conflict of interest must be disclosed.[112]
- Where the transaction is recorded in writing the FSP must ensure that the original agreement is delivered to the client for safekeeping.[113]
- *Where furnishing advice*, the FSP is obliged to conduct an analysis of client's financial needs. According to the Act, this means that the FSP, prior to providing the advice in question, must first:
    - Take reasonable steps to seek from the client information about the client's financial situation, his financial product experience and objectives,
    - must then conduct an analysis of the information;

[108] Section 17 of FAIS
[109] See Board Notice 99 of 2004
[110] Section 19 of FAIS
[111] See Part II (3) of the General Code of Conduct, Board Notice 80 of 2003
[112] Ibid
[113] Part VIII (2) of the General Code of Conduct, Board Notice 80 of 2003

- should identify the products that will be appropriate to the client's risk profile and needs; and
- must also take reasonable steps to ensure that the client understands the advice given and is in a position to make an informed decision.[114]

Non-compliance with FAIS constitutes a criminal offence. Section 36 sets the maximum penalty for contravention at R1million and/or 10 years imprisonment. In addition the Ombud for Financial Service Providers can make awards in favour of aggrieved consumers of up to R800,000.

MEDICAL SCHEMES ACT

In terms of FAIS, the definition of financial product includes a health service benefit provided by a medical scheme (as defined in the Medical Schemes Act). In other words a person selling a medical scheme product must register as a FSP.

In terms of the Medical Schemes Act no person may act as an intermediary or broker for a medical scheme unless the Council for Medical Schemes has granted accreditation upon submission of an application and payment of the prescribed fees[115] (currently R1000). In other words, an intermediary wishing to "cross-sell" both insurance and medical scheme products to clients would need to be registered both with the FSB under FAIS, and with the Council for Medical Schemes under the Medical Scheme Act.

The application procedure for medical schemes is not as onerous as that under FAIS. The applicant must demonstrate to the Council that s/he has a matric and a minimum of two years experience as a health care broker. New applicants without the necessary experience can apply as long as they have a matric and can show they will serve two years apprenticeship under a fully accredited and willing broker.

A medical schemes' broker can earn for each member he introduces to the scheme and continues to service or advise a maximum of R50 per member per month or 3% of contributions per member per month, whichever is the lesser.[116] This is paid on an as-and-when basis.

[114] Part VII (8)(1) of the General Code of Conduct, Board Notice 80 of 2003
[115] See section 28B of Medical Schemes Act
[116] Section 28 of the regulations to the Medical Schemes Act, No 131 of 1998

THE FRIENDLY SOCIETIES ACT

Certain friendly societies, particularly those constituted by large burial societies provide funeral insurance policies to their members. These are often underwritten by a registered insurer; in effect, the society acts as an insurance intermediary. In such a case, the society is governed by the Friendly Societies Act, and the insurer by the Long-term Insurance Act.

An inconsistency arises between the operation of societies and insurers. In terms of the Friendly Societies Act, a society can offer benefits (including those in respect of funeral assistance) of up to R5,000 to each of its members. Where a society seeks to pay more it is obliged to register as long-term insurer.[117] In reality, R5,000 is not enough to cover the cost of a decent funeral. Societies find that the maximum benefit they can offer by law is not sufficient to meet the needs of their members. As a result, friendly societies report[118] they are losing members to insurers who by contrast are able, in terms of the Long-term Insurance Act, to pay up to R10,000 benefits for a funeral policy.

To remedy this it would be necessary to increase the benefits payable under the Friendly Societies Act to R10,000.

THE FINANCIAL SERVICES BOARD

The Financial Services Board (FSB) was created in terms of the Financial Services Board Act (Act 97 of 1990). It is an autonomous, statutory, public body regulating and supervising the business of non-banking financial services. The Executive Officer of the FSB is ex officio the Registrar of Long-term Insurance in terms of the Long-term Act, the Registrar of Short-term Insurance in terms of the Short-term Act, and the registrar of FSB under FAIS.

THE OMBUDSMAN FOR FINANCIAL SERVICES PROVIDERS

The Ombusman for Financial Services Providers was established in terms of Section 20 of FAIS. The role of the Ombudsman is to protect consumers from bad or inappropriate advice from intermediaries. His office will consider complaints from the public that alleged that a FSP or representative failed to comply with the provisions of the Act and, as a result thereof, the complainant has suffered or is likely to suffer financial prejudice or damage. The Ombud's powers are extensive. Where a complaint is upheld he may award compensation of up to R800, 000 to be

[117] Section 7 (2) of the Long-term Act

[118] Interview with Daniel Masemola, Vice-president, Great North Burial Society on 3 February 2006

paid by the respondent. Moreover, the Ombud is able to make any other order that a court may make.[119] Effectively, he is a judge.

The current Ombud, Charles Pillai, has embraced his role enthusiastically and as of 1 April 2006 had received 3,068 complaints from the public. He has upheld many complaints, and it is reported that in two years of operation he made awards of R6 million rand to consumers.[120]

[119] See section 28 (1) of FAIS

[120] *"FAIS Ombud hands R6m to customers… and counting",* Sunday Times, 02 April 2006.

APPENDIX B: EVALUATION OF INTERMEDIARY MODELS

EXPLANATION OF CRITERIA USED TO ASSESS INTERMEDIARY MODELS

Each model shown in Table 3 is evaluated on its performance relative to each of 5 criteria. These criteria are explained below.

Ability to accept cash premiums: The "cash" criterium is focused on whether a specific model is able to collect premiums in cash, or whether other means of premium collection have to be employed. Other means, such as debit order collection, normally rely on the client to be banked or, alternatively, to be formally employed by an organisation that allows payroll deductions. The "cash" criterium directly relates to the ability of a model to successfully serve the low-income market as many low-income individuals do not have bank accounts.

Use of tick-of-the-box method of selling. The "tick-of-the-box" criterium indicates where the model utilises a simplified sales process of simply 'ticking' the option if insurance is required. The sale is conducted without advice. In a few cases disclosure and/or advice is available on request of the client, but it is not part of the standard sales process. It often implies that the sale is completed (i.e. the client indicates that she wants to purchase the product) before any disclosure or advice on the product is provided (if any disclosure/advice is provided at all). One benefit of the "tick-of-the-box" method to the intermediary is that the sale can be conducted by a non-FAIS registered employee (see Section 5.3.2).

The expected impact of FAIS on cost and the nature of advice provided. The impact of the FAIS Act is assessed relative to both its cost impact and impact on the model's selected approach to the provision of advice.

Cost. The FAIS Act not only has upfront cost implications, e.g. licensing and registration costs, but also have an ongoing or transaction cost impact, e.g. reporting and general compliance, on the intermediary. The impact of these cost components is determined by issues such as whether:

- The intermediary was already able to comply with fit-and-proper requirements at the time when FAIS was initially implemented and if not, the additional education that was required;
- The intermediary was required to make many changes to internal systems and processes in order to become FAIS compliant;
- The above changes required large investments.

The larger the cost impact of the FAIS Act on a specific intermediary, the less able that intermediary will be able to successfully serve the low-income market.

Advice. The "advice" criterion relates to whether the intermediary, under the FAIS Act, is still able to provide advice (indicated by a tick in the relevant column in Table 3) or whether the requirements of FAIS have pushed the intermediary out of the advice space (indicated by a cross in the relevant column in Table 3).

Advice, according to our definition, includes the conduct of at least a simple financial needs analysis (FNA) to determine the needs of the client, followed by product comparisons within the product range of one provider (e.g. advice provided by the agent) or a product comparison across the product ranges of a number of product providers (e.g. advice provider by brokers). In contrast, we define disclosure to be more limited. Disclosure, according to our definition, entails (at a minimum) an explanation of product terms and features. This should at least be written disclosure but in many cases verbal disclosure in addition is necessary (see Section 5.5).

It is possible that although an intermediary may be certified to provide advice, the impact of FAIS on their business model may be of such a nature that they opt not to provide advice to the client.

Likely LSM reach. A model's "LSM reach" assesses how low the model can reach in terms of serving low-income clients. This is not based on data on actual penetration but our assessment of likely reach based on model characteristics. The LSM reach is dependent on both a model's ability to collect premiums in cash and its geographical or infrastructural reach. The darker shaded squares in Table 3 represent the LSM categories a model would have been able to serve in a pre-FAIS environment, i.e. an environment with less onerous regulations and compliance requirements.

Access score. The "access" criterion is a combined rating based on how a specific insurance model scores on the promotion of access to insurance to low-income individuals. The score was allocated based on whether cash collection is offered, whether the model provides advice and how low within the LSM groups the model or intermediary can successfully sell insurance, was used.

NOTES ON CALCULATION OF SPECIFIC SCORES

Model	Example	Cash	Tick-of-the-box	FAIS Impact				Access		Likely LSM Reach
				Cost				Advice		
				Upfront	Ongoing	Total *a*	Total *b*			
Independent traditional broker		No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	Good skills in pre-FAIS environment, generally able to comply with fit-and-proper requirements, low cost impact. Score: 1	Independent, have to manage the reporting and compliance themselves - expensive. Score: 2.5	Score: 3.5	⭘	Advice (FNA and recommendation) provided	Although advice is provided, does not utilise cash collection and not operating below LSM 6. ⭘	LSM 6-10. Pre-FAIS also LSM 5
Independent emerging broker		No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	Worse off than the traditional broker. Score: 2	Worse off than the traditional broker. Score: 3.5	Score: 5.5	⭘	Advice (FNA and recommendation) provided	Although advice is provided, does not utilise cash collection and not operating below LSM 6. ⭘	LSM 6 and 7. Pre-FAIS also LSM 4 and 5
Shared brokerage	Masthead	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	Shared brokerage is mainly the domain of traditional type brokers - thus similar fit-and-proper costs to independent traditional brokers. Score: 1	Ongoing FAIS costs are subsidised by the insurer. Score: 0.5	Score: 1.5	⭘	Advice (FNA and recommendation) provided	Although advice is provided, does not utilise cash collection and not operating below LSM 6. ⭘	LSM 6-10. Pre-FAIS also LSM 5
Networked emerging broker	Small Brokers	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	Upfront costs similar to that of independent emerging broker, as they have similar costs for upskilling and fit-and-proper requirements. Score: 2	Ongoing costs can be shared. Smaller impact than for independent brokers, but bigger than for shared broker (free with insurer) and traditional agent (support from insurer). Score: 1.5	Score: 3.5	⭘	Advice (FNA and recommendation) provided	Although advice is provided, does not utilise cash collection and not operating below LSM 6. ⭘	LSM 6-10. Pre-FAIS also LSM 5
Traditional agent		No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	May need to upgrade skills (fit-and-proper, registration). Higher cost impact than for the traditional broker who, as a result of having most likely been in the industry for a longer period, is possible better skilled already. Score: 1.5	Low ongoing costs as supported by the insurer. Similar to the shared brokerage. Score: 0.5	Score: 2	⭘	Advice (FNA and recommendation) provided	Although advice is provided, does not utilise cash collection and not operating below LSM 6. ⭘	LSM 6-10. Pre-FAIS also LSM 5

Direct sales (telephone only): LT	1Life	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	May need to upgrade skills (fit-and-proper, registration). Higher cost impact than for the traditional broker who, as a result of having most likely been in the industry for a longer period, is possible better skilled already. Score: 1.5	Centralised compliance systems. No extra reporting from agents. Thus, cheapest or lowest cost impact. Score: 0	Score: 1.5	○○	Advice (FNA and recommendation) provided	Provides advice and serves up to LSM 5, but does not collect premiums in cash. ○○	LSM 5-10
Direct sales (telephone only): ST	Outsurance	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	May need to upgrade skills (fit-and-proper, registration). Higher cost impact than for the traditional broker who, as a result of having most likely been in the industry for a longer period, is possible better skilled already. Score: 1.5	Centralised compliance systems. No extra reporting from agents. Thus, cheapest or lowest cost impact. Score: 0	Score: 1.5	○	Advice (FNA and recommendation) provided	Although advice is provided, does not utilise cash collection and not operating below LSM 6. ○	LSM 6-10.
Direct sales and network marketer: LT	Clientele	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	May need to upgrade skills (fit-and-proper, registration). Higher cost impact than for the traditional broker who, as a result of having most likely been in the industry for a longer period, is possible better skilled already. Score: 1.5	Centralised compliance systems. No extra reporting from agents. Thus, cheapest or lowest cost impact. Score: 0	Score: 1.5	○○	Advice (FNA and recommendation) provided	Provides advice and reaches up to LSM 5, but does not collect premiums in cash. ○○	LSM 4-10
Franchised agency	Liberty	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	Similar experience and skills to that of the traditional broker - ability to be more independent. Score: 1	Comply on their own with linited insurer support. Thus, smaller cost impact than traditional broker and bigger impact than traditional agent. Score: 1.5	Score: 2.5	…	Advice (FNA and recommendation) provided	Not currently serving LSM 1-5.	LSM 8-10
Agent + CC compliance and admin	Metropolitan (REI)	No, generally collects premiums through debit orders or payroll deduction.	No, intermediary/model provides advice before product is sold.	May need to upgrade skills (fit-and-proper, registration). Higher cost impact than for the traditional broker who, as a result of having most likely been in the industry for a longer period, is possible better skilled already. Score: 1.5	Centralised compliance systems. No extra reporting from agents. Thus, cheapest or lowest cost impact. Score: 0	Score: 1.5	○○	Advice (FNA and recommendation) provided	Provides advice and serves up to LSM 5, but does not collect premiums in cash. ○○	LSM 5-10. Pre-FAIS also LSM 4
Tiered agency force	HTG	Yes, able to collect premiums in cash.	Yes, sale is closed before advice/disclosure is provided.	Will be required to spend some money on attaining fit-and-proper requirements. Score: 2	Low ongoing costs as supported by the insurer. Score: 0.5	Score: 2.5	○○○○	Advice (FNA and recommendation) provided	Able to collect premiums in cash, provides advice and serves down to LSM 2. ○○○○	LSM 2-7

Independent funeral parlour (multi-function)	Small parlours	Yes, able to collect premiums in cash due to infrastructural capacity and geographic reach.	Yes, sale is closed before advice/disclosure is provided.	FSP registered representatives. Insurance is not the core business. Significant expense. High cost impact as parlour staff will mostly not be sufficiently skilled and current sales operations likely do not comply with FAIS regulations (particularly where there is element of cash-based self-insurance). Score: 3	Reporting on their own. Lack proper systems as it is not core business. Significant expense. Score: 3.5	Score: 6.5	⭘⭘	No advice or disclosure provided	Able to collect premiums in cash and serves down to LSM 2, but provides no advice or disclosure. ⭘⭘	LSM 2-6
Cash retailer/OTC plus LTD CC support (independent)	HTG/ Shoprite	Yes, able to collect premiums in cash due to infrastructural capacity and geographic reach.	Yes, sale is closed before advice/disclosure is provided.	Not registering as representatives as following no advice-retailer model where sales staff are exempted (do not have to register as representatives or comply with FAIS standards). Score: 0	Some reporting required on the side of Shoprite, which may create additional costs. Score: 0.5	Score: 0.5	⭘⭘	No advice or disclosure provided	Able to collect premiums in cash and serves down to LSM 2, but provides no advice or disclosure. ⭘⭘	LSM 2-8
Bank counter/broke r	Std Bank	No, collects premiums through debit orders.	No, intermediary/model provides advice before product is sold.	Good skills in pre-FAIS environment, generally able to comply with fit-and-proper requirements, low cost impact. Score: 1	Centralised compliance systems. No extra reporting from agents. Thus, cheapest or lowest cost impact. Score: 0	Score: 1	⭘⭘	Disclosure provided	Unable to collect premiums in cash, but provides advice and serves down to LSM 4. ⭘⭘	LSM 4-10
Cash retailer/OTC plus CC support (captive)	Pep/Holl ard	Yes, able to collect premiums in cash due to infrastructural capacity and geographic reach.	Yes, sale is closed before advice/disclosure is provided.	Not registering as representatives. As following no advice-retailer model where sales staff are exempted (do not have to register as representatives or comply with FAIS standards). Score: 0	Centralised compliance systems. No extra reporting from agents. Thus, cheapest or lowest cost impact. Score: 0	Score: 0	⭘⭘⭘⭘	Disclosure provided	Able to collect premiums in cash, can serve down to LSM 2 and provides policy disclosure. ⭘⭘⭘⭘	LSM 2-6
Union owned low-income group	Lesaka	No, generally collects premiums through debit orders or payroll deduction.	Yes, sale is closed before advice/disclosure is provided.	Better trained agents already selling and advising - similar to the traditional agent impact. Score: 1.5	Large operation with good systems in place to manage these costs. Score: 0.5	Score: 2	⭘⭘⭘	Disclosure provided	Unable to collect premiums in cash, but can serve down to LSM 3 and provides policy disclosure. ⭘⭘⭘	LSM 3-7
MFI	SEF	Yes, collects premiums in cash.	Yes, sale is closed before advice/disclosure is provided.	Have registered loan officers as representatives, hus the upfront costs will be significant as they are complying at the individual level. Score: 3	Ongoing costs will be significant as they have not got the systems in place to report and will be doing something quite different from their current operation. Score: 3	Score: 6	⭘⭘⭘⭘	Disclosure provided	Able to collect premiums in cash, can serve down to LSM 1 and provides policy disclosure. ⭘⭘⭘⭘	LSM 1-3

APPENDIX C: ASSUMPTIONS FOR BROKER COST MODEL

COST ASSUMPTIONS

In this section, the basic cost components, assumptions behind these components and how we arrived at actual costs, are discussed. We provide an overview of the basic model's cost components, but also indicate where it varies slightly for different variants of the emerging broker (i.e. the lone emerging broker, the emerging broker in a small brokerage, the emerging tiered-broker and where limited group selling is included).

We have distinguished between three main cost categories:

- direct costs per sale (excluding a professional fee);
- direct costs per service of an existing client; and
- overhead costs.

Where appropriate, we disaggregate these costs on a monthly basis. The basic direct costs per sale are presented in Table 10.

Direct costs/sale	Total (Rand)
Travel cost	110
Telephone, internet, postage	20
Stationary	50
Professional hours	0
Total/sale	**180**

Table 10: Emerging broker's monthly direct costs per sale

Source: Genesis calculations based on submissions of industry players and Genesis assumptions

Direct costs per sale. The joint submission of the Insurance Brokers Council (IBC) and the Association of Black Insurance Brokers (ABIB)[121] (IBC & ABIB, 2005) contains a table titled "realistic intermediary acquisition cost illustration". Basic costs for a number of direct and overhead cost items (as well as assumptions underlying these costs) are presented. We utilise this information as a starting point for calculation of the emerging broker's costs. Travel cost, telephone, internet and postage and stationary are assumed to total 25% of the cost values in the IBC and ABIB (2005) submission (see Table 10), as we are of the opinion that the submission drew on the average costs of a broker servicing high-income clients and did not try to model the lowest costs (e.g. the submission calculated the travel costs of a broker based on a motor vehicle value of R200,000). We did not allocate the cost of professional hours spent with the clients as a direct cost per sale, but

[121] In response to a submission by the LOA, during 2005, to the National Treasury on costs and commissions in the long-term savings industry.

rather incorporated this as a basic monthly salary under overhead costs. According to our estimates, the emerging broker's direct costs will total R180 per sale.

Note: We also model the costs of an emerging broker who utilises "runners" to sell insurance policies – a type of tiered brokerage. A runner is an assistant to a emerging broker who merely sells policies (through a tick-of-the-box approach) and is not licensed to provide advice. It is important to mention that if an emerging broker utilises runners to sell policies, it will add an additional R20 per sale to the direct costs per sale as the runner will receive a fee of R20[122] for each policy sold.

Direct costs per service of an existing client. According to the LUASA (2006) response to the statement of intent by the National Treasury and the LOA in December 2005[123], the costs associated with servicing an existing policy are 8.5 times less than (or 11.76% of) the costs associated with selling a policy[124]. We also assume that approximately 5%[125] of the emerging broker's existing funeral/life policyholders will need to be serviced in a month, while 10% of Mzansi (short-term) policyholders will need servicing in any given month[126].

Overhead costs. Our estimates of the various overhead cost components and also the total overhead cost are shown in Table 11. Going down the various line items in Table 11:

- Rather than allocating the cost of professional hours spent with a client to the category of direct costs, we assume that the emerging broker receives an average monthly salary of R3,000.
- We also assume that monthly rent is 10% of the monthly rent value used in the IBC/ABIB (2005) submission.
- Equipment, telecommunication and line rental costs were estimated at 50% of the monthly value used in the IBC/ABIB (2005) submission[127].
- It is assumed that the emerging broker does not have short-term insurance on equipment used and therefore does not pay a monthly short-term premium
- The emerging broker does not have any employees (however, this assumption was modified for the emerging broker-runner model, discussed below).
- Professional indemnity insurance was estimated to be 50% of the insurance value used in the IBC/ABIB submission[128].
- The information technology and maintenance cost is assumed to be R229 per month for the payment of a computer purchased on credit[129].

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[122] This is the same amount that Wizz Kids earn per Wizzit Bank account sold.

[123] The statement of intent captured remedial actions which will be taken by the life-insurance industry to address the low values of retirement annuities and other savings products that are terminated early.

[124] The problem of this assumption is that it refers to brokers selling endowment/savings products and it may not be directly comparable with the sale of life products. However, it was the best available estimate or assumption.

[125] This means that the whole book will be serviced over 20 months or that each policy will be serviced approximately every 20 months.

[126] According to Mohlaping (2006), the amount of servicing required is double for short-term policies as opposed to funeral and life policies.

[127] It was assumed that the average emerging broker would not have an ADSL and switchboard, as included in the IBC/ABIB submission.

[128] The IBC/ABIB submission assumes that the monthly premium for professional indemnity insurance providing R3m cover is R500.

- The lowest possible monthly cost of software licenses for financial packages and other software packages (Spotlight, Pastel and Office) is assumed[130].
- The annual FSP levy will not cost more than R125 per month and forms the only component of regulatory costs.
- The cost of compliance services were estimated to be R375 per month, but could be even less if the emerging broker was part of a shared brokerage (discussed in Section BLA).
- Fit-and-proper (training) costs for the emerging broker will not likely exceed R166 per month[131].
- Training costs associated with the Spotlight financial software package (used for FNAs) will cost R99 on a monthly basis[132].
- The additional general cost category refers to other overhead expenses and is estimated to be R200 per month or 10% of the value used in the IBC/ABIB (2005) submission.

The various overhead cost components amount to a monthly cost of R6,219 (Table 11).

Overhead costs/month	Total
Required earnings (emerging broker)	3000
Rent	400
Equipment, telecom and line rental	750
Insurance	0
Total salaries	0
Professional indemnity	250
I.T. and maintenance	229
Software licenses	625
Regulatory costs	125
Compliance services	375
Fit-and-proper costs (training)	166
Training to use the Spotlight package	99
Additional general costs	200
Total/month	**6219**

Table 11: Emerging broker's monthly overhead costs

Source: Submissions of industry players and Genesis assumptions

Contribution of FAIS costs to total overhead cost per month[133]. Based on the above estimates, total FAIS fixed costs (the purchase of the Spotlight package, regulatory

[129] Although the FAIS Act does not make it mandatory for FSPs to own or have access to a computer, FSPs who do not have access to a computer will be disadvantaged in dealing with FNAs and will not easily be able to conform to acceptable accounting practices, as required by the Act (Francis, 2006).

[130] Part of this calculation is based on the most basic Spotlight package sold by Advicenet.

[131] This is according to Francis (2006) and would include training for FAIS levels one to four.

[132] According to Advicenet, the total cost of training to use the Spotlight package is R2,600. R99 is, thus, the monthly cost of paying for this training over a 36 month period at 22% per annum.

[133] Please note that these figures are merely indicative and are not based on a detailed cost-benefit analysis of FAIS.

costs, compliance services, fit-and-proper costs and training to use the Spotlight package) contribute 20% or R1,242 to total monthly overhead costs. If the Spotlight package is removed, FAIS fixed costs contribute 11% or R666 to total monthly overhead costs.

Costs for individual vs. group selling. The above cost items are for an emerging broker selling to *individuals*. If the same broker decides to focus on group selling (and assuming a group size of 30 individuals[134]), all overhead costs will remain the same, but direct costs per sale will change. It is assumed that travel costs will be five times greater (i.e. R550) than if the client is an individual (the broker may need to visit the group more often than when making an individual sale). Telephone, internet and postage usage is also assumed to be five times greater than in the case of an individual sale (i.e. R100). Stationary is considered to cost the same amount for the stationary cost of an individual sale multiplied by the number of individuals in the group (i.e. R1,500).

PRODUCTS

Products sold. Two specific low-income insurance products were used to model the costs and financial sustainability of an emerging broker serving the low-income market (see Table 12). The first product is a short-term product which provides cover for household structure and content at a monthly premium of R45. This product was selected to represent a mid-range premium value of possible Mzansi short-term products developed by SAIA.

The second product is a funeral insurance product with a monthly premium of R75 (based on suggested maximum premium values by the LOA). It is a member and family product for a main member younger than 55 and provides cover to the value of R10,000 for the main member and spouse and less for children. Relative to other funeral products available in the market, this product can be considered *a moderate to high premium funeral product*. As such we are not modelling the lowest cost funeral product.

For both products, it is assumed that the emerging broker sells an average of 15 policies per month or, given the selected broker business model, sells policies to one group (consisting of 30 individuals) every two months.

Short-term product commission structure. It is assumed that the emerging broker earns an as-and-when (monthly) commission of 20%, the maximum legislated rate on personal lines insurance. On a R45 policy, this will equate to R9 commission per month per policyholder. The total commission on 15 policies sold in a month will thus equal R135 (of course, commission will be earned on a cumulative basis as the emerging broker builds up his/her book of clients).

Funeral product commission structure. In the case of the funeral insurance product, commission is earned on an up-front basis at the rate of 3.25% per policy sold.

[134] According to Mohlaping (2006), this is the average size group that an emerging broker sells to.

Although the commission on funeral insurance is uncapped and it is thus theoretically possible to earn commission at a higher rate, we decided on this commission level as it is the maximum commission that can be earned on long-term risk insurance products. In addition, we also did a sensitivity analysis by adjusting this commission rate upwards, as will be discussed.

The commission is calculated on an assumed term of 25 years and will be calculated on a total premium paid of R15,000 over 25 years (in present value terms). Given the assumed commission level of 3.25%, this implies that the emerging broker will earn a total of R487.50 on each funeral insurance product sold. The total value of the commission is paid to the broker within the first two years after the policy sale according to the following structure:

- Half of two-thirds of the total commission is earned in the first month (i.e. R162.50), while the second half of two-thirds of the commission is earned in the seventh month (i.e. R162.50) after the policy sale.
- Half of the remaining third of the commission (R81.25) is earned in the first month of the second year (the 13th month), while the second half of the remaining third (R81.25) is received in the seventh month (the 19th month) of the second year.

	Funeral/life product	Short-term product
Premium	R 75	R 45
Item covered	Life of main member, spouse and children	Household structure and content
Type of commission	Up-front (within first two years)	As-and-when (monthly)
Commission level	3.25%	20%

Table 12: Product and commission assumptions

Source: SAIA, LOA

BROKER MODEL VARIANTS USED IN THE COST ANALYSIS

A number of broker model variants are used to assess cost sensitivities to different structural changes.

Different selling approaches[135]. The **first model** we will test is the emerging broker selling to only individuals and selling, on average, 15 insurance policies per month. The **second model** we will test is the emerging broker selling to both individuals and groups. In this model, it is assumed that the emerging broker sells to one group (consisting of 30 individuals) every two months and to 15 individuals per month (thus a total of 30 policies per month).

Varying business models. Apart from the standalone emerging broker selling to both individuals and groups, we modelled a few variants to see if emerging models

[135] The assumptions of number of individual and group policies sold are based on discussions with Mohlaping (2006).

will resolve some of the cost constraints impacting on the emerging broker. These models and their various assumptions are:

(i) ***Multiple broker/small brokerage model***. For this category of the emerging broker, we used a scenario of 3 brokers sharing certain infrastructure costs (rent, equipment, telecommunications and line rental, information technology and maintenance, software licenses, training to use the Spotlight package and additional general costs). All other assumptions and cost items are similar to that of the broker selling to both groups (i.e. 0.5 groups per month) and individuals (i.e. 15 individuals per month). It is important to note that costs and income are modelled per broker in the brokerage (i.e. each broker's costs and income are modelled individually taking into account the shared costs).

(ii) ***Runner model***. This model assumes a scenario of 3 runners (runners can be viewed as assistants to the broker who only sell policies through a tick-of-the-box approach and who are not allowed to provide advice) who work for a single broker. It is assumed that the runners sell 10 policies each per month and that due to greater availability of time, the broker is able to sell policies to one group per month. It is further assumed that the runners earn R20 per policy sold, and:

- For the Mzansi product, 10% of total commission earned by the broker (on an as-and-when basis).
- For the funeral/long-term product, 10% of total commission earned by the broker (in the same time structure as the broker).

(iii) ***Mixture of multiple brokers/small brokerage and runner model***. This model combines the multiple broker and runner models. It is assumed that the 3 brokers share the same infrastructure costs and that each broker also employs 3 runners. As before, it is assumed that each runner sells 10 policies per month, while the broker, due to the greater availability of time, sells policies to one group (consisting of 30 individuals) per month. Once again, the runner earns R20 per policy sold and commission on the Mzansi product and funeral/long-term product as discussed. Finally, it is important to note that the costs and income are once again modelled for an individual broker in the brokerage.

OTHER ASSUMPTIONS

A few other assumptions also underlie our models and the conclusions derived from these models:

- There is no lapsing or surrendering of policies and no policyholders die during the period for which costs and income flows were modelled. We thus present the best possible case for each model.
- Cumulative losses do not include interest payments on the obtained loan or overdraft to finance the losses.

- Brokers will tend to specialise and sell only the funeral/life product or the short-term product.

APPENDIX D: THE FINANCIAL SERVICES MEASURE (FSM)

FinMark through FinScope has developed the Financial Services Measure (FSM), a segmentation device classifying individuals into tiers based on a variety of measures related to financial services.

The model has four main dimensions or measurements:

- Financial Penetration of services (take-up)
- Attitudes to money, consisting of two subscales:
  - financial knowledge and control"; and
  - financial discipline.
- Physical access to banks
- Connectedness and optimism

These four subscales are used to create an aggregate FSM score, based on which an individual is classified into one of eight possible FSM tiers. FSM 1 is seen as the lowest possible tier or score (and denotes low financial services usage and knowledge), while FSM 8 is the highest possible tier or score.

APPENDIX E: EXPLANATION OF DISTRIBUTION ASSESSMENT

		Easy to Reach	Flexible Premium Group	Innovative Distribution Group	Hard to reach
y "receptiveness" to insurance		●●●	●●	●●	●
ent insurance usage	**Formal**	42% has formal insurance (●●●)	17% has formal insurance (●●)	18% has formal insurance (●●)	5% has formal insurance (●)
	Informal	22% belong to burial society (●●●)	14% belong to burial society (●●)	22% belong to burial society (●●●)	10% belong to burial society (●●)
ncial sophistication (FSM distribution)		29% below FSM 3 (●●)	31% below FSM 3 (●●)	98% below FSM 3 (●)	99% below FSM 3 (●)
nt of informal contact		27% has informal contact (●●●)	24% has informal contact (●●●)	24% has informal contact (●●●)	12% has informal contact ((●●)
nt of formal contact		99% has formal contact (●●●)	100% has formal contact (●●●)	17% has formal contact (●)	16% has formal contact (●)
ty of distribution strategies available		●●●	●●●	●●	●
lity of individual sales		●●	●●	●	●
lity of group sales		●●●	●●●	●●	●
lity of OTC/client concentration strategy		●●●	●●●	●●●	●●●

Definition/calculation of line items:

- "Receptiveness" to insurance: average of current insurance usage (formal and informal) and financial sophistication.
- Current formal insurance usage: percentage of group that has any form of formal insurance (funeral, life, medical or short-term).
- Current informal insurance usage: percentage of group that belongs to burial society.
- Financial sophistication: percentage of group in FSM 3 or below (the greater the proportion, the lower the financial sophistication).
- Extent of informal contact: percentage of group that either belongs to a burial society or stokvel.
- Extent of formal contact: percentage of group that has a bank account, or store card/account or prepaid cell phone.
- Distribution strategies available: receives one dot for every distribution strategy available. A distribution strategy is considered to be available for a specific group if that distribution strategy received two or three dots.
- Likelihood of doorstep broker/agent sales succeeding: subjective evaluation based on income and "receptiveness" to insurance.
- Likelihood of group sales succeeding: subjective evaluation based on income and "receptiveness" to insurance.
- Likelihood of client concentration strategy succeeding: subjective evaluation based on income and "receptiveness" to insurance.

APPENDIX F: MEETING LIST

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