RETAIL DISTRIBUTION REVIEW (RDR): STATUS UPDATE ON PROPOSAL TT - SPECIAL REMUNERATION DISPENSATION FOR THE LOW-INCOME MARKET

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FSCA
Financial Sector
Conduct Authority

1 BACKGROUND

The former Financial Services Board ("FSB")'s Retail Distribution Review published in November 2014 ("the initial RDR proposals") put forward several proposals to reform the regulatory framework for distribution of financial products by ensuring that these financial products are distributed in ways that support the delivery of fair customer outcomes. Among the initial RDR proposals is Proposal TT which recognised that certain of the other RDR proposals could have unintended consequences in the low-income sector and that a specific remuneration dispensation would be appropriate in this sector. Proposal TT is therefore aimed at balancing the need to promote financial inclusion and access to advice against the particular information asymmetry and customer vulnerability risks in this sector. A dispensation is needed that will ensure that intermediaries are adequately remunerated so as to encourage them to service the low-income market whilst ensuring access to fair and affordable advice and products that deliver fair outcomes for financial customers in the low-income market.

RDR Proposal TT provided as follows:

Proposal TT: Special remuneration dispensation for the low-income market

Additional consultation and technical work will be undertaken to determine an appropriate remuneration dispensation for product suppliers and intermediaries serving low income customers, in respect of life insurance risk products and investment products. Elements to be considered include:

- *Product standards to allow products to qualify for this dispensation, including in relation to: Benefit types, premium / contribution limits, product terms and charges. In particular, such product standards will either prohibit or significantly reduce the extent to which product supplier may recover any up-front commissions payable from product values in the form of early termination charges.*
- *Inter-relationship between this dispensation and policy proposals in respect of microinsurance and tax-free savings products.*
- *The types of intermediary and advice services qualifying for this dispensation.*
- *Permissible commission limits.*
- *Permissible product supplier / intermediary relationships.*

In addition, comment is invited on the extent to which a special remuneration dispensation is required for the low-income market in respect of personal lines short-term insurance products.

All commentators on Proposal TT were in support of a different dispensation for the low-income market in order to avoid any "advice gap" that could potentially result from the introduction of an advice fee-based remuneration structure or other changes to current commission structures. The majority of commentators were of the opinion that the low-income sector should not be defined based on customer demographic segments (such as "LSM" levels) or income levels but favoured a product definition approach which ties in with the approach to developing the enhanced Financial Advisory and Intermediary Services ("FAIS") Act competency model.

In subsequent RDR communications, the FSB and Financial Sector Conduct Authority ("FSCA") have confirmed that Proposal TT would be developed and implemented as part of our broader strategies for financial inclusion and transformation of the financial sector. These strategies have since been elaborated on in the FSCA's published Regulatory Strategy.

The purpose of this document is to provide an update on regulatory reforms that have been undertaken to implement Proposal TT within the broader inclusion and transformation context, and to elicit stakeholders' inputs on the FSCA's thinking on outstanding issues. The paper will in particular take into account –

- the microinsurance and funeral policy product standards introduced through amendments to the Policyholder Protection Rules ("PPRs") made under the Long-term Insurance Act No. 52 of 1998 ("LTIA") and the Short-term Insurance Act No. 53 of 1998 ("STIA"); and
- the related remuneration dispensation introduced through amendments to the Regulations under the LTIA and STIA.

2 PROGRESS – IMPLEMENTATION OF PROPOSAL TT

2.1 Microinsurance and funeral policy product standards

The initial RDR proposals highlighted the importance of product standards in defining the criteria for products to qualify for a low-income remuneration dispensation in respect of life insurance risk products. In this regard the FSCA has introduced the microinsurance and funeral policy product standards through amendments to the PPRs made under the LTIA. The introduction of this framework was pre-empted by a policy document titled "The South African Microinsurance Regulatory Framework" ("NT Policy Document")[1] that the National Treasury published in 2011. The NT Policy Document proposed that product standards must be developed for microinsurance policies to ensure that products are designed in an appropriate and simplified way to support an improved understanding of insurance products by consumers in the market. Consideration was also given to the fact that funeral policies are generally not complex and in many instances are also taken up by low income earners and therefore the product standards were extended to apply to funeral policies provided by traditional insurers.

2.2 Life (long-term) insurance commission regulations - Remuneration dispensation for life insurance risk products

For product simplicity envisaged in the product standards to translate into meaningful financial inclusion, the product standards should be supported by a remuneration regime appropriate for the selling of products to the lower-end of the market. Life insurance risk products sold in this market generally have low premiums and if premium-related commission caps are imposed, the selling of these products by intermediaries would not be financially viable resulting in intermediaries essentially being disincentivised from selling these products.

To promote access to appropriate advice to the lower-end of the market and to encourage the selling and on-ongoing servicing of microinsurance and funeral policies by intermediaries as well as to ensure that microinsurance and funeral policy distribution is viable for intermediaries, the regulatory framework (as introduced through recent amendments to the Regulations under the STIA and LTIA) provides that commission payable on these policies are uncapped, with the exception of commission in respect of credit life policies. Previous industry practices in assistance business (where commission was also uncapped) signalled that competition will serve to keep commission levels in check and that uncapping commissions will not undermine consumer protection. This position will, however, be reviewed on an ongoing basis to assess whether any undesirable market practices develop with regards to the offering and payment of commission in this market.

[1] The NT Policy Document aims to create a legal framework for microinsurers to promote financial inclusion and encourage entry of new providers into the market. The legal framework for microinsurers has been given effect to through the Insurance Act No.18 of 2017.

For purposes of RDR Proposal TT, the FSCA does not currently propose any additional remuneration interventions in respect of life insurance risk products.

2.3 Non-life (short-term) personal lines commission regulations - Remuneration dispensation for non-life microinsurance products

As noted above, RDR Proposal TT invited comment on whether a special remuneration dispensation is required for the low-income market in respect of personal lines short-term insurance. Comment provided did not motivate a clear need for such a dispensation. However, given that the microinsurance product standards also apply to non-life microinsurance policies, consideration was given to introducing a remuneration dispensation that will encourage and support the selling of these policies by intermediaries. In this regard, amendments were made to the Regulations under the STIA to provide for a remuneration dispensation for policies underwritten by a microinsurer. According to this dispensation commission is uncapped on all non-life insurance policies underwritten by a microinsurer, with the exception of non-life insurance policies underwritten under the "Motor" class of non-life insurance business where the aggregate value of the policy benefits exceeds R120,000.[2]

2.4 FAIS fit and proper dispensation for life insurance risk products

Advisers in the low end of the market play an important role by assisting clients in identifying products that are appropriate for their needs and objectives, financial situation and risk profile. It is therefore important to ensure that adviser competency requirements do not create inappropriate barriers to entry into the advice market. In light of this, microinsurance and funeral policy product standards have been drafted in such a way that all microinsurance policies will fall under the FAIS Tier 2 products (simple products) making persons who provide advice or intermediary services on these products eligible for proportionally less onerous competency requirements. The FAIS Determination of Fit and Proper Requirements for Financial Services Providers, 2017 has been amended accordingly.

3 REMAINING ISSUES

3.1 Remuneration dispensation for savings and investment products targeted at the low-income market

RDR Proposal MM stipulates that no remuneration may be paid to any intermediary for selling or servicing investment products, other than advice fees agreed to by the customer. However, an exception was made to this proposal under Proposal TT by providing that a special commission dispensation on investment products aimed at low-income earners would be developed. This exception was intended to ensure that advisers continue to advise on investment or savings products that meet appropriate standards of simplicity and value.

As indicated above, proposal TT is being considered as part of the FSCA’s holistic approach to financial inclusion. This includes striking a balance between introducing a remuneration dispensation for investment products targeted at low-income customers that will encourage sustainable advice models for these products and ensuring that these products are in fact appropriate to the needs of the market and offer good value. Put differently, the question that the FSCA seeks to answer is - how do we ensure that any regulatory remuneration dispensation we introduce for investment products in this market will in fact support fair customer outcomes? We

[2] Policies underwritten by a microinsurer under the "Motor" class of non-life insurance business where the aggregate value of the policy benefits exceeds R120,000 is capped at the normal commission rates applicable to policies written under the “Motor” class.

have realised that, before we can decide how best to strike this balance, we need a deeper understanding of the value proposition of products currently available to these customers.

In this regard, the FSCA will be engaging with product suppliers in the first quarter of 2019 to gather in-depth information on current savings and investment product offerings targeted at the low-income market. Products to be reviewed will include a mix of insurance products, collective investment scheme products, bank products and hybrids of these – including tax-free investments. The focus of these engagements will include:

- Product features
- Minimum and average premium or contribution sizes, including lump sum and recurring contribution products
- Charging structures
- Returns vs. effective annual costs
- Target market identification (i.e. why is the product considered suitable for the low-income market?)
- Sales volumes / take-up rates
- Lapse rates / periods for which products are held
- Distribution models, including intermediary remuneration models
- Successes and challenges experienced in designing or distributing good value products for low income customers
- Specific suggestions in regard to the RDR Proposal TT dispensation

3.2. FAIS fit and proper dispensation for savings and investment products

The product review exercise outlined above will also help the FSCA to determine whether any further adjustments to the FAIS fit and proper requirements are necessary to ensure that they support access to advice for low income customers on fair and appropriate savings and investment products. In particular, the review will inform a decision on whether there are any changes required to the types of savings or investment products categorised as Tier 2 products for FAIS competency purposes.

4 WAY FORWARD

Stakeholder engagements that the FSCA will be embarking on will inform the FSCA's policy decision on how to strike a balance between encouraging intermediaries to provide advice on investment products to the low-income market through an appropriate remuneration dispensation and ensuring that these products are appropriate to the need of the lower income earners.

Product suppliers that offer saving and investment products targeted at low income earners that would like their product offerings to be specifically included in this review are invited to contact the FSCA on FSCA.rdrfeedback@fsca.co.za. Stakeholders with comments and questions relating to this status update are also invited to send them to the same email address by **no later than 15 February 2019.**

Once these engagements are concluded, if it is found necessary, the subsequent policy decision will be translated into subordinate legislation. The draft subordinate legislation will follow the consultation process as prescribed for the type of regulatory instrument concerned.