Ref: Directive 159.A.i (LT&ST)

FINANCIAL SERVICES BOARD

REPUBLIC OF SOUTH AFRICA

LONG-TERM INSURANCE ACT, 1998 (ACT 52 OF 1998)

SHORT-TERM INSURANCE ACT, 1998 (ACT 53 OF 1998)

Addressee:	Long-term and Short-term insurers		File:	10.41.1.5.2 & 10.41.2.5.2	
Edition	**Issue date**	**Effective date**	**Directive**	**Status**	**Withdrawal date**
1st	12 April 2012	12 April 2012	159.A.i (LT&ST)	Issued	-
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3rd	-	-	-	-	-
Subject:	Compliance with sections 9(3)(b)(i) read with sections 12(1)(c) of the Long-term Insurance Act and Short-term Insurance Act, respectively: Outsourcing				

1. PURPOSE

The purpose of this Directive is to, under sections 4(4) of the Long-term Insurance Act No. 52 of 1998 and the Short-term Insurance Act No. 53 of 1998 ("the Acts"), read with sections 9(3)(b)(i) and sections 12(1)(c) of the Acts, respectively, direct long-term and short-term insurers ("insurers") to comply with the requirements set out in this Directive when outsourcing an aspect of their long-term or short-term insurance business ("insurance business") to another person.

2. BACKGROUND

2.1 Outsourcing may materially increase risk to insurers or materially adversely affect their ability to manage risks and meet regulatory obligations.

2.2 International standards[1] require an appropriate legislative framework that mitigates the potential adverse effect referred to in paragraph 2.1.

3. APPLICATION AND SCOPE OF DIRECTIVE

3.1 This Directive applies to all insurers (including, subject to paragraph 3.6, reinsurers).

[1] Insurance core principles (October 2011), specifically ICP 8.7, of the International Association of Insurance Supervision (IAIS).

3.2 This Directive applies in respect of all aspects of the insurance business[2] of insurers that are or may be outsourced to another person, but does not apply to intermediary services[3].

3.3 This Directive applies irrespective of the person to whom an aspect of the insurance business is outsourced being a related party or inter-related party of the insurer as defined in section 1 of the Companies Act No. 71 of 2008, and irrespective of that other person being located outside of South Africa.

3.4 This Directive also applies to –

3.4.1 the outsourcing of any insurance business conducted by a branch of an insurer located outside of South Africa; and

3.4.2 the outsourcing of any insurance business conducted by a subsidiary of an insurer located in or outside of South Africa.

3.5 This Directive does not apply to functions or activities performed by an insurer on behalf of another person, i.e. it does not apply where functions or activities have been outsourced to the insurer.

3.6 This Directive applies to any outsourcing (such as pricing and actuarial services) by an insurer to a reinsurer or by a reinsurer to an insurer, whether under a reinsurance contract or not, but does not apply to the actual insurance provided under a reinsurance contract.

3.7 This Directive sets out the general and overarching requirements that an insurer must comply with when outsourcing any aspect of its insurance business. This means that it applies in addition to the existing regulatory framework. An insurer must therefore, in addition to this Directive comply with the specific regulatory requirements set out in the regulatory framework, such as the requirements relating to nominee business, binder agreements and assistance business group schemes (under the Long-term Insurance Act).

4. LEGISLATIVE FRAMEWORK

4.1 Sections 9(3)(b)(i) of the Acts provide that an application for registration as an insurer may not be granted by the Registrar if the applicant does not, *inter alia*, have the organisation or management that is necessary and adequate for the carrying on of the business concerned.

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2 This includes not only the functions or activities that constitute the provision of policy benefits as per the definition of long-term insurance business and short-term insurance business in the Acts, but includes all functions or activities that enable the insurer to provide such policy benefits such as IT systems, asset management and records / database administration.

3 Means the "rendering services as intermediary" as defined in Part 3A of the Regulations issued under section 72 of the Long-term Insurance Act and "services as intermediary" as defined in section 1 of the Short-term Insurance Act.

4.2 Sections 12(1)(c) of the Acts provide that the Registrar may prohibit an insurer from carrying on insurance business, *inter alia*, if an insurer is not able to satisfy the Registrar as to the matters referred to in section 9(3)(b)(i).

4.3 This means that an insurer must at all times –

4.3.1 be able to demonstrate that it has the organisation or management that is necessary and adequate for the carrying on of the business concerned; and

4.3.2 have an appropriate governance framework relating to outsourcing in place to ensure that it effectively manages risks and meets regulatory obligations.

5. CLARIFICATION AND APPLICATION OF TERMINOLOGY USED IN DIRECTIVE

5.1 For purposes of this Directive, any word or expression to which a meaning has been assigned in the Acts has the meaning so assigned to it, and -

5.1.1 **"control function"** means the risk management function, the compliance function, the actuarial control function and the internal audit function;

5.1.2 **"management function"** means a function usually performed by a managing executive;

5.1.3 **"material function"** includes any function that has the potential, if disrupted, to have a significant impact on the insurer's insurance business operations or ability to manage risks effectively, including risks to the fair treatment of customers; and

5.1.4 **"outsourcing"** means an arrangement of any form between an insurer and another person, whether that person is supervised under any law or not, in terms of which that party performs a function or an activity, whether directly or by sub-outsourcing, which would otherwise be performed by the insurer itself.

5.2 An insurer, in respect of every outsourcing to another person, must determine if the outsourcing constitutes the outsourcing of a control, management or material function for purposes of this Directive. In making the determination as to whether a function is a material function, an insurer must, amongst others, consider -

5.2.1 the potential impact of the outsourcing on the policyholders, finances, reputation and insurance business operations of the insurer, or a significant part of the insurance business of the insurer, particularly where the other person may fail to perform over a given period of time;

5.2.2 the ability of the insurer to maintain appropriate internal controls and meet regulatory requirements; and

5.2.3 the degree of difficulty and time associated with replacing the other person or performing the function or activity "in-house".

6. KEY PRINCIPLES INFORMING OUTSOURCING

General principle

6.1 The board of directors and managing executives of an insurer remain responsible for the insurance business of the insurer, regardless of any outsourcing.

Principles with which any outsourcing must comply

6.2 An insurer may not outsource any function or activity if that outsourcing may –

6.2.1 materially increase risk to the insurer;

6.2.2 materially impair the quality of the governance framework of the insurer, including the insurer's ability to manage its risks and meet its legal and regulatory obligations;

6.2.3 impair the ability of the Registrar to monitor the insurer's compliance with its regulatory obligations; and

6.2.4 compromise the fair treatment of or continuous and satisfactory service to policyholders.

6.3 An insurer must when outsourcing any function or activity avoid, and where this is not possible mitigate, any conflicts of interest between the insurance business of the insurer, the interests of policyholders or the business of the other person that performs the outsourcing.

6.4 Remuneration paid in respect of outsourcing must –

6.4.1 be reasonable and commensurate with the actual function or activity outsourced;

6.4.2 not result in any function or activity in respect of which commission or a binder fee is payable being remunerated again;

6.4.3 not be structured in a manner that may increase the risk of unfair treatment of policyholders; and

6.4.4 not be linked to the monetary value of insurance claims repudiated, paid, not paid or partially paid.

6.5 The principles referred to under paragraphs 6.1 to 6.4 also apply to any sub-outsourcing of an outsourcing by another person, where that other person is authorised to sub-outsource under the outsourcing contract between the insurer and that other person.

7. KEY REQUIREMENTS FOR OUTSOURCING

Outsourcing policy

7.1 An insurer that outsources any aspect of its insurance business must have an outsourcing policy approved by its board of directors.

7.2 An outsourcing policy must, at least –

7.2.1 give effect to the principles referred to in paragraph 6 above;

7.2.2 set limits on the types and overall level of outsourced functions or activities at the insurer and the extent to which activities can be outsourced to the same person;

7.2.3 provide guidance on the contractual risks and any other risk issues to be assessed, monitored and managed in outsourcing (Annexure A provides guidance on the types of risks that could be considered);

7.2.4 provide for the internal review and approval of any outsourcing of a control, management or material function in a manner consistent with that set out in paragraph 7.5 below; and

7.2.5 provide for the appropriate management and regular review of any outsourcing of a control, management or material function, in particular to assess the impact on operational risk, if any, and any issues that may arise from such arrangements with respect to market conduct and fair treatment of customers consistent with that set out in paragraphs 7.9 to 7.11.

7.3 The outsourcing policy of an insurer must be reviewed at least annually and be adapted in view of any significant changes.

7.4 An insurer must ensure that all its affected business units and staff are aware of, and comply with, the outsourcing policy.

Internal review and approvals

7.5 An insurer must prior to outsourcing any control, management or material function -

7.5.1 assess the costs and benefits and potential risk to its insurance business inherent in the proposed outsourcing;

7.5.2 identify potential persons to undertake the outsourcing through objective procurement and selection procedures;

7.5.3 consider the potential impact of multiple outsourcing arrangements by the insurer and those provided by the person to a number of insurers;

7.5.4 assess whether the other person is fit and proper in terms of meeting qualities of competence and integrity;

7.5.5 assess the person's governance, risk management, and internal controls and its ability to comply with applicable laws;

7.5.6 assess whether the person's operational capability or financial position pose a material risk to the person's ability to deliver the proposed outsourced function or activity;

7.5.7 develop appropriate management and monitoring procedures for the proposed outsourcing consistent with that set out in paragraphs 7.9 to 7.11;

7.5.8 develop appropriate contingency plans to ensure the continuous functioning of the insurance business of the insurer in the event that the outsourcing arrangement is terminated or ineffective; and

7.5.9 secure the necessary approvals for the outsourcing in accordance with the outsourcing policy.

Written contracts

7.6 Any outsourcing of a control, management or material function (other than a binder function[4]) must be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities, and service-level requirements of all parties.

7.7 A written contract must, at least, -

7.7.1 specify the duration of the contract;

7.7.2 specify the type and frequency of the function or activity to be performed;

[4] The binder functions referred to in section 49A(1)(a) to (e) of the Long-term Insurance Act and section 48A(1)(a) to (e) of the Short-term Insurance Act. Binder functions are covered by specific provisions dealing with the requirements to enter into a written agreement, and the minimum requirements for such agreements.

7.7.3 specify the level and standard of service that must be rendered to a policyholder, where relevant, and to the insurer;

7.7.4 require that the other person have appropriate governance, risk management, and internal controls in place to perform the outsourced function or activity;

7.7.5 require that the other person comply with applicable laws;

7.7.6 specify the Rand value of the remuneration or consideration payable by the insurer to the other person, or, if the Rand value is not fixed or determined on entering into the contract, the basis on which the remuneration or consideration payable will be calculated;

7.7.7 provide for the type and frequency of reporting by the other person on the function or activity performed under the contract;

7.7.8 provide that an insurer must monitor the other person's performance under and compliance with the contract and the manner in and means by which that monitoring will take place;

7.7.9 provide for periodic performance reviews of the other person and the regular review of the contract;

7.7.10 specify that the insurer has continued access to information relating to the outsourced function or activity, including access to any information the insurer may require to monitor the treatment of policyholders, where relevant;

7.7.11 address confidentiality, privacy and the security of information of the insurer and policyholders;

7.7.12 address sub-outsourcing;

7.7.13 address ownership of intellectual property;

7.7.14 provide for business contingency processes, including the continuity of function or activity if the other person is placed under curatorship, business rescue, becomes insolvent, is liquidated or is for any reason unable to continue to render the function or activity in accordance with the contract;

7.7.15 specify that the other person will take the necessary steps to allow the Registrar access to its business and information in respect of the outsourced function or activity;

7.7.16 specify the circumstances under which the insurer may terminate the contract;

7.7.17 include indemnity and liability provisions;

7.7.18 set out any warranties or guarantees to be furnished and insurance to be secured by the other person in respect of its ability to fulfill its contractual obligations;

7.7.19 provide for a dispute resolution process; and

7.7.20 provide for a reasonable termination period, irrespective of the circumstances under which the agreement is terminated (including the lapsing or non-renewal of the agreement) that will allow the insurer's contingency plans to be implemented.

7.8 Where an outsourcing contract allows another person to sub-outsource any part or the full function or activity outsourced to it, that sub-outsourcing must also comply with paragraphs 7.6 and 7.7.

Management and regular review

7.9 An insurer must ensure that the risks associated with any outsourcing of a control, management or material function are appropriately assessed, monitored and managed, and regularly reviewed.

7.10 An insurer must ensure that the level and standard of service to the insurer and its policyholders, where relevant, in terms of any outsourcing are appropriately monitored, managed, and regularly reviewed.

7.11 An insurer must regularly assess the other person's –

7.11.1 governance, risk management, and internal controls (including fit and properness);

7.11.2 ability to comply with applicable laws; and

7.11.3 operational and financial capability.

8. REPORTING

Notification of outsourcing of control, management or material functions

8.1 An insurer must timeously, but no later than one month, prior to the effective date of an outsourcing contract relating to the outsourcing of a control, management or material function, notify the Registrar of –

8.1.1 the proposed outsourcing (subject to any requirements under the Acts);

8.1.2 the details of the other person to whom the insurer will outsource that function; and

8.1.3 the key risks associated with the outsourcing and the risk mitigation strategies that will be put in place to address these risks.

8.2 An insurer must immediately notify the Registrar of any material developments (such as pending termination, material non-performance and the like) with respect to the outsourcing referred to in paragraph 8.1, during the duration of the outsourcing contract.

9. COMPLIANCE

9.1 Any outsourcing on or after the date on which this Directive takes effect must comply with this Directive.

9.2 Any outsourcing undertaken prior to the date on which this Directive takes effect must comply with this Directive when the contract relating to that outsourcing is extended, renewed or amended, but by no later than 1 January 2013.

9.3 Any non-compliance with this Directive may be referred to the enforcement committee in accordance with the section 6 of the Financial Institutions (Protection of Funds) Act No. 28 of 2001.

10. AVAILABILITY AND INFORMATION SHARING

This Directive is available on the website (www.fsb.co.za) of the Financial Services Board. Insurers must bring this Directive to the attention of their appointed auditors and statutory actuary (where one has been appointed).

REGISTRARS OF LONG-TERM AND SHORT-TERM INSURANCE

Annexure A

GUIDANCE ON RISKS

An insurer should assess, monitor and manage the following types of risks in respect of any outsourcing:

Contractual Risk:	The insurer should be able to enforce the contract with the other person.
Strategic Risk:	The totality of the other person's activities should be consistent with the overall strategic goals of the insurer and the insurer should have the expertise to oversee, manage and monitor the other person.
Reputation Risk:	The other person's conduct should be consistent with the overall standards of the insurer or the stated practices (ethical or otherwise) of the insurer.
Compliance Risk:	The other person should comply with applicable legislation and have adequate compliance systems and controls in place.
Operational Risk:	The potential for technology failures, fraud or other errors should be minimised.
Exit Strategy Risk:	Appropriate exit strategies (termination clauses), should be in place.
Country Risk:	The political, social and legal climate should be appropriate where the other person is situated outside of South Africa.
Access Risk:	The insurer, at all times, should have access to timely data and other information.
Concentration and Systemic Risk:	The insurer should not be over-reliant on a single other person. The insurer should ensure that the other person does not provide the same or similar function to a significant number of other insurers.