



EXECUTIVE SUMMARY

This report contains an overview of the key findings of the Binder Regulations Thematic Review conducted by the Insurance Division of the Financial Services Board (“FSB”) during 2014.

The thematic review focused on 4 main areas, namely:

- Compliance of binder agreements with regulatory requirements;
- Governance and oversight of binder arrangements;
- Reporting systems and access to information; and
- Binder fees paid to non-mandated intermediaries (“NMI’s”)¹.

The main body of this report contains details of the specific findings from the thematic review, as well as an overview of the expectations of this Office regarding the manner in which insurers are required to manage their binder relationships.

The following general concerns were identified during the thematic review:

Compliance of binder agreements with regulatory requirements

- i. Information Letter 3 of 2013 emphasised that binder functions, and the activities incidental thereto, should be clearly described in all binder agreements. It was further explained that if a binder agreement does not contain a fee breakdown for each different binder function and/or activity related thereto, an insurer should at least be able to report to this Office as per the Annexures that formed part of the Information Letter. Information Letter 3 of 2013 allowed for a 90 day alignment period (from 1 July 2013).
- ii. Of concern is that the thematic review found that many binder agreements still do not comply with these regulatory expectations. Some of these agreements were also not compliant with the Binder Regulations, as they do not make provisions for the requirements as set out in Regulation 6.3 (a) – (t) of the Binder Regulations.

¹ Non-mandated intermediary means a representative or an independent intermediary other than a mandated intermediary or an underwriting manager.

- iii. Some binder agreements that were sampled included provision for intermediary functions (specifically the collection of premium) and provided for the payment of commission, administration fees and/or outsourcing fees. It was not always clear what proportion of fees is linked to which particular type of function or activity.
- iv. Regulatory action is being taken in instances of non-compliance.

Governance and oversight of binder agreements

- v. While most insurers appear to employ appropriate levels of due diligence prior to commencing business relationships with binder holders, there were significant disparities in the quality and effectiveness of the on-going monitoring of existing binder arrangements.
- vi. The management of conflicts of interest was generally not considered as part of the due diligence process prior to entering into a binder relationship. This issue was also not addressed in some of the sampled binder agreements.

Reporting systems and access to information

- vii. There were wide inconsistencies in the manner in which the data required in terms of binder agreements is shared by binder holders with insurers, ranging from manual submissions to various automated mechanisms. In many instances, the regulatory requirements relating to the sharing of data were not being adhered to in a satisfactory manner.

Binder fees paid to NMI's

- viii. Fees being paid to binder holders ranged from 0% to 100% of Gross Written Premium ("GWP"). In some cases insurer costs, and not the actual costs incurred by binder holders, served as a basis for the calculation of the fees². In most cases there was little or no assessment of the actual costs incurred by binder holders in performing the functions in question.

Overall, the findings of the thematic review are that in many cases the manner in which the sampled insurers are managing their binder arrangement falls well short of regulatory expectations.

² Remuneration in relation to outsource arrangements is addressed in detail in the Retail Distribution Review ("RDR") Discussion paper published in November 2014 and the RDR Phase 1 Status Update published in November 2015.

There was little to no evidence indicating that insurers are continuously assessing and/or addressing market conduct risks relating to the distribution and servicing of policies through binder mandates. The outsourcing of insurer functions under these circumstances can significantly increase the risk of poor outcomes to customers. Alternatively, the absence of robust oversight processes increases the likelihood of insurers not being aware of the potential risks to customer outcomes that arise as a result of the chosen distribution model.

This report outlines a set of supervisory steps and regulatory proposals designed to ensure that the conduct of insurance business through binder arrangements does not undermine sound risk management or fair treatment of customers.

DETAILED REPORT

1. Background and scope of the review

On 1 July 2013, the Registrar of Long- and Short-term Insurance (“the Registrar”) issued Information Letter 3 of 2013, which provided guidance to insurers on activities that constitute binder functions and activities that are incidental thereto. The Information Letter also outlined an activity-based fee model for binder functions and a standardised reporting format for binder functions and binder fees.

On 12 September 2013, the Registrar issued Information Request 7 of 2013 directing all insurers to furnish information to this Office relating to binder functions and binder fees in the standardised reporting format.

The Insurance division analysed the submissions that were received in response to Information Request 7 of 2013 to ascertain the range of fees being paid by insurers for the various binder functions. This exercise assisted in identifying 12 insurers (long- and short-term) most active in the binder holder space that became the focus of a thematic review in order to assess the level of compliance with the Binder Regulations.

2. Methodology and scope of the thematic review

The thematic review consisted of an off-site and on-site component.

As a first step, an off-site analysis was undertaken on the data that was submitted in response to Information Request 7 of 2013. Long-term insurers reported that a total of 590 binder agreements had been concluded, compared to 1 778 binder agreements reported by short-term insurers.

We determined that 90% of the total number of binder activities was outsourced within the short-term industry, with only 10% of the total number of binder activities being outsourced by long-term insurers.

The number of responses we received per binder activity was as follows:

(a) Long-term industry

Activity (a)	Activity (b)	Activity (c)	Activity (d)	Activity (e)	Total
108	43	41	23	64	279

(b) Short-term industry

	Activity (a)	Activity (b)	Activity (c)	Activity (d)	Activity (e)	Total
Personal lines	643	214	222	317	335	1 731
Commercial lines	358	136	146	218	253	1 111
Total	1 001	350	368	535	588	2 842

Activities (a) and (e), namely “enter into, vary and renew” and “claims settlement”, constitute 55% of all binder functions being outsourced to NMI’s by short-term insurers for personal lines business. During the on-site review, insurers confirmed that insurers would only in exceptional circumstances allow an NMI to perform binder functions (b), (c) and (d) - namely determining of policy benefits, premium and policy wording.

The fees paid for activity (a) varied from 0% to 100% of Gross Written Premium (“GWP”). The mean for activities (a) and (e), respectively, were determined to be in the region of 5% for both personal lines and commercial lines in the short-term industry.

Most of the explanations provided in respect of the manner in which the fees were determined were unsatisfactory and lacked substance. The FSB wrote to those insurers requesting further information on how the actual binder fees were determined in order to assess whether these fees were reasonably commensurate in relation to the activity(ies) performed by the binder holder.

For the 12 insurers identified for the thematic review, sample binder agreements were requested to enable an analysis of the fees being paid to NMI’s and to assess the extent to which the agreements complied with the requirements of the Binder Regulations.

This off-site analysis was followed by on-site visits at each insurer, during which detailed discussions were held covering the following focus areas:

- Compliance of binder agreements with regulatory requirements;
- Governance and oversight of binder arrangements;

- Reporting systems and access to information; and
- Binder fees paid to non-mandated intermediaries (“NMI’s”).

The on-site visits also included a run through of the system(s) being used for receiving data from binder holders to determine the format, security, frequency and integration of the data into the insurer’s system.

In instances where the thematic review revealed significant concerns in respect of individual insurers, these insurers received specific feedback subsequent to the on-site visits highlighting those areas that required immediate corrective action by management.

In addition, the FSB engaged with certain insurers who were not visited during the review, but where it later became apparent that such insurers were not adequately complying with the requirements of the Binder Regulations. In these cases, insurers were requested to undergo independent reviews, at their own cost, to demonstrate the adequacy and effectiveness of their control environments in respect of compliance with the Binder Regulations.

3. Specific findings

Paragraphs 3.1 to 3.4 below contain details of the specific findings and observations from the thematic review.

3.1 Compliance of binder agreements with regulatory requirements

Despite Information Letter 3 of 2013 allowing for a 90 day alignment period (from 1 July 2013) for binder agreements, of great concern was that the thematic review revealed that many binder agreements still did not meet the requirements of the Binder Regulations. Specifically, they did not make provision for the matters listed in Regulation 6.3 (a) – (t) of the Binder Regulations.

Many insurers were using long-standing legacy remuneration arrangements as the basis for their current binder fees. For example, one insurer indicated that they pay a binder fee of 10% of GWP in total for all 5 binder functions, and they would therefore “guess” that each separate function amounts to a binder fee of approximately 2% of GWP. This insurer was unable to provide an accurate methodology to substantiate how the fee was calculated for each binder activity. Most insurers sampled were not able to provide an adequate explanation as to how the binder fees for each binder activity were determined.

3.2 Governance and oversight of binder arrangements

3.2.1 Take-on processes

The thematic review examined the processes and procedures followed by insurers when taking on binder holders to render binder functions on their behalf. The following practices were noted at most insurers:

- It appears that an appropriate level of due diligence is performed at the outset of the business relationship with binder holders. Due diligence exercises usually cover the integrity and operational capability of binder holders as well as an assessment of risk (including jurisdictional, regulatory, operational, legal and financial risk);
- However, in most cases it was clear that the due diligence exercise did not cover beneficial owners and/or shareholding to test possible conflicts of interest, particularly in cases where there was evidence of profit sharing and/or “associate” relationships between the relevant parties; and
- Portfolio and/or client managers run accounts and conduct audits on binder holders. The audits generally include the following: assessment of roles, control requirements, systems and accountabilities that are essential to the business of the binder holder.

3.2.2 On-going monitoring and oversight

While most insurers have oversight structures in place, the evidence provided during the thematic review pointed to varying levels of effectiveness in respect of the continuous and ongoing monitoring of binder relationships.

On-going monitoring of binder holders by insurers appeared to be conducted in the following ways:

- Some insurers monitor the performance of binder holders on a monthly basis to monitor loss ratios;
- In some cases, operational meetings are held with binder holders on a monthly basis (if required);
- Occasionally NMI’s are visited on-site to assess their performance; and

- Some monitoring of binder holders is done through risk-based desktop reviews.

There was little evidence to demonstrate that detailed records are being kept of the types of monitoring mentioned above, especially in cases where the monitoring is limited to monthly meetings or on-site visits.

It was further noted that the focus of the monitoring tends to be limited to prudential issues and financial performance. There was little to no evidence indicating that insurers are continuously assessing and/or addressing market conduct risks relating to the distribution and servicing of policies through binder mandates. The outsourcing of insurer functions under these circumstances can significantly increase the risk of poor outcomes to customers. Alternatively, the absence of robust oversight processes increases the likelihood of insurers not being aware of the potential risks to customer outcomes that arise as a result of the chosen distribution model.

Our review confirmed that insurers, in general, do not consider the potential market conduct risks when binder arrangements are concluded.

Some insurers place an over-reliance on audits conducted at the binder holder as opposed to having the appropriate internal controls in place to detect and/or pre-empt the potential for poor customer outcomes. In instances where the scope or quality of the audit is lacking in respect of market conduct issues, the audit itself holds little or no value in respect of ensuring that policyholders are not adversely impacted as a result of the binder relationship.

3.3 Reporting systems and access to information³

The following specific concerns were identified:

- The thematic review revealed that many insurers follow the “letter” of the Binder Regulations but not its underlying intention (“spirit”) when it comes to data exchange and access to information. The Binder Regulations prescribe the intervals⁴ in which data should be submitted to insurers. Certain insurers followed a “tick-box” approach to demonstrate to this Office that they *receive* data as per the regulated

³ For purposes of this thematic review, data was viewed as referring to all information (electronic or hard copy) housed on internal systems or housed on external binder holder systems.

⁴ In terms of the Binder Regulations, the maximum interval is currently 90 days for long-term insurers and 60 days for short-term insurers.

intervals. In many cases, little or no evidence could be demonstrated relating to the integration of data into the insurer's in-house system and/or the subsequent verification and analysis of data;

- Insurers indicated that binder holders are generally not willing to share information on request, and that binder holders, in general, still believe that they are the owners of all policyholder data. This was a concern as this means that, in the event of specific policyholder concerns or risks materialising outside of the regular data reporting intervals, insurers would likely not be able to access relevant data required in order to timeously address such concerns or risks;
- The quality of data received differed vastly across insurers and in many instances data was inaccurate or incomplete, making it difficult for insurers to consistently identify or contact policyholders or to readily ascertain liability or access historical policy data;
- Most insurers require the bare minimum of data from binder holders, which in most cases is limited to financial information. The absence of quality reporting from binder holders on, amongst other things, claims and complaints processes, pointed to the lack of demonstrable and robust oversight of the market conduct of binder holders as described elsewhere in this document;
- The frequency of data collection varies across the industry, but most insurers commented that they prefer to receive data within a maximum period of 30 days. It was commendable that some insurers receive data on a daily basis or have access to binder data on a continuous basis;
- Various methods are used to collect data even within individual insurers, ranging from rudimentary methods like the use of memory sticks and data "dumps", to Excel spread sheets sent via e-mail or through FTP/SFTP protocols; and
- The data being transferred does not generally meet the ACORD standard. According to many of the insurers sampled, the various systems currently being used by them and by their binder holders do not have the capability to meet this standard. Insurers indicated that it is very costly to change and/or enhance systems especially when binder holders do not seem to understand the benefits of having quality, usable data. Many insurers further stated they do not want to be the first

insurer to “push too hard” on system changes, as the binder holder will “simply move their business to another insurer with lesser (data) requirements”.

3.4 Binder fees paid to NMI's

In addition to sampling individual agreements as part of the review, the off-site analysis also looked at the responses received from all insurers in respect of Information Request 7 of 2013 in order to determine the range of fees being paid to NMI's across the industry. Further details regarding the average fee per activity are contained in section 2 above.

During the review, discussions were held with insurers to understand the factors that were taken into account in order to calculate binder fees that are “reasonably commensurate” with the actual costs of performing the activities to which the binder agreements relate, as required in terms of the Binder Regulations.

The following general observations were noted:

- Fees being paid by insurers to binder holders range from 0% to 100% of GWP, due to large inconsistencies in the manner in which these fees are calculated across the industry;
- Some insurers use in-house costs to determine the fee to be paid, and are unwilling to pay more irrespective of whether the actual costs of the binder holder to whom these functions are outsourced are more than the calculated amount;
- Other insurers rely entirely on the binder holders themselves to provide an estimate of costs, which is then used as the basis for fee negotiation;
- In instances where the binder holders are required to provide an estimate of costing, there were inconsistencies in the actual factors being used by the various binder holders to calculate such costs;
- A few insurers revealed that the current fees are based on historical market practice, and were unable to provide evidence of actual activity-based costing to substantiate the fees being paid;

- In some cases, where a binder holder performs more than one binder function, insurers do not negotiate separate fees per function but rather negotiate a single amount across all functions being performed, which then obscures a comparison with the reasonable costs of performing each function;
- Some of the sampled binder agreements included intermediary functions (specifically the collection of premium) and provided for the payment of commission, administration fees and/or outsourcing fees in contravention of the Binder Regulations. It was not always clear what proportion of fees was linked to which function or activity, making it additionally difficult to rule out the possibility of a cross-subsidisation of remuneration for intermediary services in excess of regulated commission in these instances; and
- Generally, where binder fees appeared higher than the industry norm, insurers indicated that this was due to the specialist or niche nature of their products resulting in more labour intensive, complicated and lengthy underwriting and/or claims activities being undertaken by specific binder holders. However, we found little to no evidence to substantiate this and it was apparent that, in most cases, the battle for distribution remains the primary motivation for the provision of binder mandates to NMI's⁵.

4. Supervisory guidance and next steps

The principles contained in this section will inform future conduct of business supervisory focus areas and possible changes to the regulatory framework in respect of insurer activities that are performed through binder and outsourcing arrangements.

4.1 Compliance of binder agreements with regulatory requirements

Given the ample time insurers have been provided to ensure compliance of binder agreements with the requirements of the Binder Regulations, the Registrar will proceed with immediate regulatory action in respect of any binder agreements that are found not to be in compliance with the Binder Regulations.

Such regulatory action could include referral to the FSB's Enforcement Committee for the imposition of an administrative penalty. Where non-compliant binder agreements are associated with a general lack of oversight of binder arrangements by an insurer, this may

⁵ RDR Phase 1 Status Update – Proposal ZZ: Binder fees to multi-tied intermediaries to be capped (page 41 – 44).

also result in regulatory action in the form of a prohibition on the insurer conducting new business through such binder arrangements. The Registrar has already initiated regulatory action against specific insurers due to their non-compliance with the Binder Regulations with respect to binder agreements.

4.2 Governance and oversight

In terms of Directive 159.A.i (LT&ST) (“the Outsourcing Directive”), issued under section 4(4) read with sections 9(3)(b)(i) and 12(1)(c) of the STIA and the LTIA, an insurer must at all times have in place an appropriate governance framework relating to outsourcing, to ensure that it effectively manages risks and meets regulatory obligations in this regard.

In addition, paragraphs 6.2.4 and 6.4.3 of the Outsourcing Directive clearly state that the outsourcing of any function and the remuneration paid in respect of outsourcing may not compromise the fair treatment of, or continuous and satisfactory service to, policyholders.

Paragraphs 7.9 to 7.11 of the Outsourcing Directive provide that an insurer must ensure that it regularly assesses the outsourced party’s governance, risk management, internal controls and operational capability, to ensure that the party is suitably skilled and has the ability to carry out the outsourced activity taking into account the complexity and degree of responsibility involved.

Furthermore, Regulations 6.2.2 to 6.2.4 of the Binder Regulations require continuous monitoring by the insurer of the business relationships that the binder holder has before and after entering into a binder agreement to avoid conflicts of interest.

In light of the regulatory obligations described above, it is implicit that insurers who wish to conduct business through binder arrangements should be able to demonstrate the following:

- That they have made clear to the binder holder any limitations or conditions attached to the mandate being conferred by the insurer, including details of any consequences that would arise should the outsourced party act outside of such limits or fail to comply with such conditions. Examples of such conditions include, but are not limited to, mandatory data and reporting requirements and compliance with applicable regulatory obligations, including the application of Treating Customers Fairly (“TCF”);

- That they have controls in place to ensure the robust identification, assessment, measurement and management of the conduct risks associated with the outsourcing of insurer activities (including, but not limited to, underwriting or claims handling) on an ongoing basis. In other words, insurers must be able to demonstrate that they are aware of, and are actively managing, the potential risk of poor customer outcomes being delivered by third parties who are acting on their behalf; and
- That they are receiving, and have access to, comprehensive and reliable management information (“MI”) that enables them to exercise effective oversight on an ongoing basis, including information that will assist with future conduct of business regulatory reporting to be required from all insurers by the Registrar.

The FSB will produce further guidance on the practical application of these regulatory obligations during the course of 2016, as part of the enhanced standards on outsourcing.

4.3 Reporting systems and access to information

The thematic review has given rise to considerable concern about the inconsistencies evident across insurers in respect of the manner in which they approach compliance with Regulation 6.3(1)(d), (k), (l) and (p) of the Binder Regulations, i.e. those requirements that relate to appropriate information technology, continued access to policyholder information, the confidentiality, privacy and security of policyholder data and the maximum intervals at which data must be provided by binder holders.

There is a substantially increased risk that poor outcomes for customers may not be adequately identified or managed in business models where a significant portion of an insurer’s activities is outsourced to a third party without having proper governance and oversight in place.

Effective oversight requires adequate MI, which in turn require insurers to have robust systems and processes in place that allow for the exchange and management of relevant, comprehensive and reliable data.

In this respect, insurers should be able to demonstrate the following:

- The type of continued access that the insurer has to binder holder data, including the manner in which this access is being facilitated and maintained. This is not

limited to the formal reporting of information in line with the prescribed 60 and 90 day intervals, but covers the right of the insurer to have “on demand” access to relevant policyholder information that is held by the binder holder;

- Documented controls in place by the insurer to manage the risks associated with the manner in which continued access is being facilitated and maintained;
- Documented steps to demonstrate that the insurer can and may request data from the binder holder, i.e. data on demand. In this regard insurers should take note of the FSB’s updated view on RDR Proposal FF⁶, which states that conduct standards will be published in due course to ensure that insurers have adequate access to customer data held by binder holders or other outsourced service providers;
- A comprehensive data specification that is clearly communicated to binder holders which sets out mandatory data fields required by the insurer to identify and contact the policyholder, to identify key policy information and to enable the insurer to assess its liability under the policy;
- The manner in which binder holder data is validated to ensure accuracy and completeness insofar as it relates to policyholder and policy details;
- The process in place to monitor that the data is, at all times, updated within the requisite intervals; and
- Any contingency plans in place in the event that the binder holder is unable to provide the requisite data and/or perform any activities under the binder agreement, for any reason.

As part of the ongoing supervisory and regulatory interventions in respect of reporting and access to information relating to binder and outsourced arrangements, this Office will be taking the following steps to address the aforementioned concerns:

- A select number of additional insurers will be requested to undergo independent reviews, at their own cost, relating to the adequacy and effectiveness of their control environment in respect of access to, and maintenance of, binder holder data;

⁶ General product supplier responsibilities in relation to receiving and providing customer related data – RDR Phase 1 Status Update (page 25 -27).

- Further work is currently being undertaken by the FSB, in collaboration with technical experts and industry bodies, to finalise a regulatory data standard that must be complied with by all insurers who wish to continue conducting insurance business through outsourcing or binder agreements to give effect to the requirements of the Outsourcing Directive. It is envisaged that the data standard will be finalised in the first half of 2016 and insurers wishing to conduct insurance business through binder arrangements will have a 6 month period within which to make the necessary system changes;
- The regulatory data standard will include the minimum data fields that must be provided to insurers as well as details about the manner and frequency of reporting of the relevant data. The data standard will give effect to the FSB's view that outsourcing should enhance administrative efficiency and eliminate duplication of efforts and costs. In order to demonstrate efficiency, data should be exchanged in "real time" and be capable of being integrated with an insurer's system;
- To further improve efficiency across the sector, the compulsory data standard will be aligned with the messaging standards developed by the Association for Cooperative Operations Research and Development (ACORD); and
- As an interim measure until the finalisation of the regulatory data standard mentioned above, the mandatory data specification developed and endorsed by the Short-term Insurance Data Exchange ("STRIDE"), the Financial Intermediaries Association ("FIA") and the South African Insurance Association ("SAIA") (attached to this report as Annexure "A") will be used as a basis for the supervision of compliance with the relevant provisions of the Binder Regulations, with immediate effect. The regulatory data standard mentioned above will build on this mandatory data specification.

4.4 Binder fees paid to NMI's

The concerns relating to remuneration of binder holders and other outsourced providers are dealt with in detail in the various proposals contained in the RDR⁷ Phase 1 Status Update released during November 2015.

Proposal AA⁸ of the RDR states that a binder holder who carries out the binder activity of "entering into, varying or renewing" policies may not also earn any outsourcing fee from an

⁷ Supra footnote 2.

insurer in relation to policy administration. The FSB maintains the position that policy administration is an incidental activity to this binder function⁹.

After reviewing all the comments received on RDR Proposal ZZ¹⁰, and in light of the wide variation in binder fees paid in practice as referenced elsewhere in this paper, the FSB remains of the view¹¹ that the current principle based approach to the setting of binder fees (i.e. to be “reasonably commensurate” with actual costs plus a reasonable rate of return) is not adequate to address the risks of conflict of interest posed by the outsourcing of binder functions to NMI’s. Accordingly, the FSB has indicated that it intends to proceed to introduce caps for binder fees that are paid to NMI’s. Further technical work will be undertaken during 2016 to assess the appropriateness of the caps proposed in the RDR paper.

The FSB is also considering a prohibition on allowing NMI’s to enter into commercial lines binder agreements, in the absence of compelling reasons why such outsourcing would be in the best interests of policyholders. The arguments for efficiency and the ease and speed that apply in the personal lines space are generally not applicable when it comes to commercial lines. Further technical work and additional consultation by the FSB on this issue is planned for 2016.

The current regulatory requirements in respect of binder fees will continue to be monitored as part of the FSB’s on-going conduct of business supervisory process. In this regard, insurers should take note of the following:

- A follow-up Information Request will be issued during 2016 requesting more detailed information relating to binder fees according to product classes. Information Request 7 of 2013 differentiated only between fees payable in the personal and commercial lines of business. Although the responses submitted provided valuable insight relating to the range of fees payable, the follow-up request will enable proper comparison of binder fees in respect of similar product types; and
- Until the finalisation of the proposed RDR regulatory interventions as described in the RDR Phase 1 Status Update, insurers will continue to be expected to provide the basis on which remuneration is being calculated in order to demonstrate that such fees are “reasonably commensurate with the actual costs of the binder holder

⁸ Proposal AA: Certain functions permitted to be outsourced to financial advisers.

⁹ RDR Phase 1 Status Update (page 23).

¹⁰ Proposal ZZ: Binder fees to multi-tied intermediaries to be capped.

¹¹ Supra footnote 5.

associated with rendering the services under the binder agreement, with allowance for a reasonable rate of return for the binder holder¹². The FSB will intervene where this cannot be adequately demonstrated.

¹² Regulation 6.4(1) of the Binder Regulations.