



**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)**

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| Addressee: | Long-term and Short-term insurers | | File: | 10.41.1.5.2 & 10.41.2.5.2 | |
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| 1 st | | | 159.A.i (LT&ST) | Draft | - |
| 2 nd | - | - | - | - | - |
| 3 rd | - | - | - | - | - |
| 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 any aspect of their long-term or short-term insurance business (“insurance business”) to a third party.

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 standards¹ require an appropriate legislative framework that mitigates the adverse effect referred to in paragraph 2.1.

3. APPLICATION AND SCOPE OF DIRECTIVE

- 3.1 This Directive applies to all insurers (including reinsurers).
- 3.2 This Directive applies in respect of all aspects of the insurance business of insurers that are or may be outsourced to a third party, irrespective of that third party being

¹ Insurance core principles (2003) and draft insurance core principles (2011) of the International Association of Insurance Supervision (IAIS). South Africa is a member of IAIS.

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 third party being located outside of South Africa.

3.3 This Directive also applies to –

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

3.3.2 any subsidiary of an insurer, irrespective of the business that that subsidiary conducts.

3.4 This Directive does not apply to processes, services or activities performed by an insurer on behalf of a third party.

3.5 This Directive applies to ancillary services provided under a reinsurance contract (such as pricing and actuarial services by a reinsurer to an insurer), but does not apply to the insurance provided under such a contract.

3.6 This Directive supplements the existing regulatory framework in respect of nominee business, intermediary services, binder agreements (to be promulgated shortly) and assistance business group schemes (under the Long-term Insurance Act). These matters are and remain subject to their specific legislative framework requirements.

4. LEGISLATIVE FRAMEWORK

4.1 Sections 9(1)(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.

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 OF TERMINOLOGY USED IN DIRECTIVE

For purposes of this Directive, -

- 5.1 “**control function**” means the risk management function, the compliance function, the actuarial control function and the internal audit function;
- 5.2 “**management function**” includes a function usually performed by executive management;
- 5.3 “**material function**” includes any function that has the potential, if disrupted, to have a significant impact on the insurer’s business operations or its ability to manage risks effectively; and
- 5.4 “**outsourcing**” means an arrangement of any form between an insurer and a third party, whether that party is supervised under any law or not, in terms of which that party performs a process, a service or an activity, whether directly or by sub-outsourcing, which would otherwise be performed by the insurer itself.

6. KEY PRINCIPLES INFORMING OUTSOURCING

General principle

- 6.1 The board of directors and executive management 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 The outsourcing of any aspect of the insurance business of an insurer must not –
 - 6.2.1 materially impair the quality of the governance framework of the insurer;
 - 6.2.2 materially increase risk to the insurer or materially adversely affect 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;
 - 6.2.4 undermine continuous, fair and satisfactory service to policyholders; or
 - 6.2.5 create potential conflicts of interest in respect of the insurance business of an insurer, the interests of policyholders or the business of the third party that performs the outsourcing.
- 6.3 Remuneration paid in respect of outsourcing must –
 - 6.3.1 be reasonable and commensurate with the actual process, service or activity

outsourced;

6.3.2 not result in any process, service or activity in respect of which commission or a binder fee is payable being remunerated again;

6.3.3 not be structured in a manner that may encourage the unreasonable or unfair treatment of policyholders; and

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

6.4 The principles referred to under paragraphs 6.1 to 6.3 also apply to any sub-outsourcing of an outsourcing by a third party, where that third party is authorised to sub-outsource under the outsourcing contract between the insurer and that third party.

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 overall level of outsourced activities at the insurer and on the number of activities that can be outsourced to the same third party;

7.2.3 provide for the internal review and approvals of any outsourcing in a manner set out in paragraph 7.5 below;

7.2.4 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); and

7.2.5 provide for the regular review of all outsourcing, 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.

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 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 aspect of its insurance business -
- 7.5.1 assess the costs and benefits and potential risk inherent in the proposed outsourcing;
 - 7.5.2 assess how the insurer's risk profile will be affected by the outsourcing;
 - 7.5.3 identify potential third parties to undertake the outsourcing through objective procurement and selection procedures;
 - 7.5.4 consider the potential impact of multiple outsourcing arrangements provided by the preferred third party to a number of insurers;
 - 7.5.5 assess whether the third party is fit and proper;
 - 7.5.6 assess the preferred third party's governance, risk management, and internal controls and its ability to comply with applicable laws;
 - 7.5.7 assess the preferred third party' service capability and financial viability;
 - 7.5.8 develop appropriate management and monitoring procedures for the proposed outsourcing;
 - 7.5.9 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
 - 7.5.10 secure the necessary approvals for the outsourcing in accordance with the outsourcing policy.

Written contracts

- 7.6 All outsourcing must be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities, and expectations of all parties.
- 7.7 A written contract must -
- 7.7.1 specify the duration of the contract;

- 7.7.2 specify the type and frequency of the process service or activity to be performed;
- 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 third party have appropriate governance, risk management, and internal controls in place to perform the outsourced process, service or activity;
- 7.7.5 require that the third party comply with applicable laws;
- 7.7.6 specify the Rand value of the remuneration or consideration payable by the insurer to the third party, or, if the Rand value is not fixed or determinable 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 third party on the process, service or activity performed under the contract;
- 7.7.8 provide for the manner in and the means by which an insurer must monitor the third party's performance under and compliance with the contract;
- 7.7.9 provide for periodic performance reviews of the third party and the regular review of the contract;
- 7.7.10 specify that the insurer has continued access to information relating to the outsourced process, service or activity;
- 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;
- 7.7.15 specify that the third party will take the necessary steps to allow the Registrar access to its business and information in respect of the outsourced process, service 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 third party 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 a third party to sub-outsource any part or the full process, service 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 are appropriately assessed, monitored and managed, and regularly reviewed.

7.10 An insurer must ensure that the level and standard of service of any outsourcing are appropriately monitored, managed, and regularly reviewed.

7.11 An insurer must regularly assess the third party'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 service capability and financial viability.

8. REPORTING

Notification of outsourcing of material and management functions

8.1 An insurer must timeously, prior to entering into an outsourcing contract, notify the Registrar of –

8.1.1 the proposed outsourcing of a management, control or material function (subject to any requirements under the Acts);

8.1.2 the details of the third party 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 termination, material non-performance and the like) with respect to the outsourcing during the duration of the outsourcing contract.
- 8.3 An insurer, in respect of every outsourcing, must determine if the outsourcing constitutes the outsourcing of a material function for purposes of paragraph 7.11. In making this determination, an insurer should, amongst others, consider -
- 8.3.1 the potential impact of the outsourcing on the finances, reputation and operations of the insurer, or a significant part of the insurance business of the insurer, particularly where the third party may fail to perform over a given period of time;
 - 8.3.2 the ability of the insurer to maintain appropriate internal controls and meet regulatory requirements; and
 - 8.3.3 the degree of difficulty and time associated with replacing the third party or performing the process, service or activity "in-house".

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 not later than 30 June 2012.
- 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

GUIDANCE ON RISKS

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

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| Contractual Risk: | The insurer should be able to enforce the contract with the third party. |
| Strategic Risk: | The totality of the third party'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 third party. |
| Reputation Risk: | The third party'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 third party 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 third party 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 third party. The insurer should ensure that the third party does not provide the same or similar function to a significant number of other insurers. |