Treating customers fairly: questions for the actuarial profession

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ABSTRACT
This discussion paper asks how the Treating Customers Fairly (TCF) regime will work in practice and whether it is complete in its formulation. It reflects on how TCF might address the most important issues in five industry sectors in which actuaries work: long- and short-term insurance, retirement funds, investment markets and health-care financing, the last of these not well covered by TCF at present. Most importantly, however, the paper reflects on how the actuarial profession, with all of its influence and responsibility, could have arrived at this point, where we should need a TCF regime to call on us to prove that we are looking after our customers’ interests effectively.

KEYWORDS
Treating customers fairly; professionalism; insurance; retirement funds; health care financing; investment

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A DIFFERENT DISCOURSE
How have we arrived at this?
We consider in this paper five major financial sectors, long- and short-term insurance, retirement funds, investments and health care financing, in which actuaries play a prominent role. These markets individually and collectively play an enormous role in South Africa's economy. They also play a critical part in the country's quest to encourage the provision of appropriate products and services to the people living within its borders. We support this position of responsibility, for these markets and for the actuaries working in them.

It is not clear, however, that providers operating in these markets play this part with consistent attention to the interests of the customers of these products. We have found some evidence, in contrast, that this is not the case. In this paper, we ask a few questions of our colleagues working in these markets.

Our questions are relatively brief and selective. We have not pursued all of the identified avenues of enquiry because the purpose of the paper is not to classify the full range of concerns but to raise a few examples. We would expect that, for every issue raised, providers would be able to put forward a reasonable explanation for the actions. Some of these arguments have validity. This is not a witch hunt. We are not suggesting that every example included presents a clear case of wrongdoing by providers. But all of them ask whether we have truly put customer interests first. All of them require thoughtful attention.

We take the opportunity to ask as well whether the TCF process is ideal for the problems at hand. It is not clear, for example, that the six fairness outcomes collectively cover all of the customer-affecting problems that may characterise the markets that TCF aims to improve. We are not sure how we, as participants in or regulators over a set of markets, will know whether or when we have succeeded in meeting the goals of TCF even though creating the necessary tools to review and assess actions within the markets will assist with reaching such goals.

Most significantly, however, we ask our professional colleagues where we were, what we were doing and what we plan to do now. A number of the issues raised in this paper have been around for some time and it is not clear that we have addressed them properly. Some of them are relatively new.

In some ways, the answer is straightforward with the advent of TCF: we will do what we are told to do. But we, our clients and our employers, are now required to demonstrate that we hold customer interests dear. It is difficult to argue against the charge that we have chosen not to lead but to follow. King III for companies, PF130 for retirement funds, codes of the CFA Institute for investment professionals and now the TCF regime are showing the way.

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1 These are not the only markets in which actuaries work in significant numbers. Banking and risk management are two others.
The goals of the Actuarial Society are to... grow the reputation of the actuarial profession in South Africa as one of substance and stature, serving and valued by our stakeholders [and]... develop a profession whose professional conduct and discipline meet the highest professional standards. (Actuarial Society of South Africa)²

We note tentative reference to serving the public interest in the Society’s goals. We suggest that “serving stakeholders” be expanded to include reference to the “public interest”. This paper asks what we must do to regain the moral high ground in the context of our duty to society and to lead, intellectually and ethically, as demonstrated not by our words only but also by our actions.

Philosophical Approach
This paper is not an academic treatise, but a set of opinions, as far as possible backed up by evidence. It is not the subject-matter that calls for this approach – there is no reason why market conduct concerns should not be properly supported by the facts – but the breadth of the material included. Our intention is not to ask detailed questions in one particular area of concern so much as to provide evidence for our sense that insufficient attention has been given to customer need in a wide range of areas in which actuaries work. Accordingly, footnotes are used to indicate sources, but we have not sought to provide documentary substantiation for every point made.

It is difficult to avoid the overlaps between areas. From time to time we raise issues under two different market segments and occasionally we consider an issue in one market that could equally have been discussed in another.

1. PUTTING THE CUSTOMER FIRST
This section asks how TCF might work in practice and whether its formulation is complete for the objectives that it sets out to achieve. We start, however, by describing briefly the system and the outcomes that it seeks to achieve. Material in the section that follows is drawn largely from the roadmap of the Financial Services Board (2011).³ Figure 1 is a variation on the corresponding diagram in that document.

1.1 TCF outcomes
The TCF regime is built around the goal of meeting a number of fairness outcomes. Financial Services entities across a broad range of categories⁴ are required

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⁴ Parties covered by TCF include banks, long- and short-term insurers, and entities contractually authorised by insurers to provide underwriting, administration or claims-handling services for them, investment managers, collective investment scheme management companies, hedge fund managers, investment administration providers, retirement fund trustees and retirement fund administrators, funeral benefit administrators and all other financial service providers like intermediaries.
under TCF to demonstrate that these outcomes have been met in respect of their customers and to give an account of their proposed approach to any shortfall in meeting these outcomes. The outcomes should by now be familiar to those working in these markets. They are:

— **Outcome 1** Customers are confident that they are dealing with firms where the fair treatment of customers is central to the firm culture.

— **Outcome 2** Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly.

— **Outcome 3** Customers are given clear information and are kept appropriately informed before, during and after the time of contracting.

— **Outcome 4** Where customers receive advice, the advice is suitable and takes account of their circumstances.

— **Outcome 5** Customers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and what they have been led to expect.

— **Outcome 6** Customers do not face unreasonable post-sale barriers to change products, switch providers, submit a claim or make a complaint.

A great deal of progress has been made in establishing the extent to which these outcomes may be shown to have been achieved by insurers, investment managers, pension funds, banks and others, including financial advisers. Many of the challenges are becoming clearer. What is not yet clear is whether these outcomes are collectively sufficient to address the fundamental objective of an effective customer-centric marketplace.

The FSB addresses this problem by expressing one central goal and three intermediate outcomes. The long-term goal, expressed by the FSB as a vision, is:

... a market conduct framework that will ensure that customers’ financial services needs are appropriately met through a sustainable industry. (FSB, 2011, op. cit., p 9)

The intermediate outcomes are expressed as follows:

— improved customer confidence,

— the supply of appropriate products and services, and

— enhanced transparency and discipline in the industry.

Figure 1 shows how our supervisory authority sees the fairness outcomes mapping to the intermediate outcomes and what it refers to as the ultimate desired outcome.

### 1.2 Implementation

The TCF regime is a game-changer in many ways, starting with the fact that regulated entities are called on not primarily to meet a list of rules but to demonstrate
the achievement of a set of outcomes. This requires a very different mind-set from these entities and from the supervisory authority. The discussion that follows ask how TCF will be implemented in practice.

In some respects legislation is required. The FSB, in consultation with industry bodies, including the Actuarial Society, has developed an understanding of exactly what legislation is required across all market sectors. It has commenced drafting this material. In many ways, however, legislation is not needed. Entities already under the supervisory responsibility of the FSB, for example, are being strongly encouraged to demonstrate their commitment to the principles of TCF. The FSB is using its existing enforcement rights to do this and promises to continue on this basis.

Organisationally, the FSB has a great deal of work ahead of it. The fundamentals of establishing a market conduct regulator have been outlined in the so-called Twin Peaks legislation that will give to the FSB, or its successor, the wherewithal to move forward with this type of supervision, even if parts of the implementation await further legislation to give them their full impetus. Structures will nevertheless need to be established to give effect to the requirements of a market conduct regulator. Probably more challenging, skills must be developed, since effective supervision in the TCF space will require a different way of thinking and an alternative form of scrutiny and enquiry.

In implementation itself, the market conduct regulator will need to apply the full range of available supervisory approaches and some that are not yet available. While supervised entities will need to demonstrate achievement of the six fairness outcomes, the supervisory authority will augment this requirement with stipulated reporting

**Figure 1** Immediate intermediate and final outcomes under TCF

forms, a set of rules, best practice guidelines, visits to the offices of product and service providers, mystery shopping, customer surveys and other forms of scrutiny.

Probably the most challenging aspect of TCF for providers is that the best ideas for meeting customer concerns today could well become the benchmark for tomorrow’s requirements. This is exactly the way it ought to be. The goal is to make best-practice customer servicing and communication a competitive differentiator. The uncertainty of supervisory options and powers, and the corresponding uncertainty of how things might look in future combine to produce a difficult environment for financial service providers.

In the discussion that follows, we ask a number of questions concerning how it might work out in practice.

1.3 Challenges

The first question we have is what have we left out? Perhaps we have allowed holes in the process that permit suppliers somewhere in the complex market for financial services to avoid their responsibility to contribute to the objective that customer financial services needs are appropriately met through a sustainable industry.

The FSB appears to have considered this from a number of perspectives. First, outcomes are intended to apply to all parts of a product life cycle. The FSB (2011, op. cit.) lists these stages:

— product- or service design,
— promotion and marketing,
— advice,
— point of sale,
— information provided after the point of sale,
— complaints, and
— claims handling.

Second, outcome 1, and the actions required to meet it, provide reasonably well for the possibility that gaps in the outcomes exist. It explicitly requires servicing entities to check that their customers believe in the integrity of their offering. Implicitly, it backs this up with a range of requirements from ownership by the board through good governance and remuneration practices that ought to support this overarching requirement.

Third, the system being put into place in South Africa is not unique. It draws most obviously from the corresponding TCF regime in the United Kingdom, but others have made great progress in implementing similarly customer-centric regulatory systems. Australia provides a good example.5

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5 We ask as an aside what lessons have been learned from the TCF implementation in the United Kingdom and how those lessons are being translated into action here.
We remain nevertheless uneasy at the possibility that the six fairness outcomes and three intermediate outcomes are insufficient collectively to achieve the longer-term goal.

We wonder **how value for money is established**. If this is not an explicit outcome of TCF, then is it a goal of the process? If it is, should it not have been framed as an explicit requirement, rather than implicitly part of outcomes 1 (customers are confident), 2 (products and services meet needs) and 5 (products perform as customers have been led to expect) and, to a lesser extent, outcomes 3 (customers are given clear information), 4 (advice is suitable) and 6 (customers do not face unreasonable barriers to making product changes or submitting claims).

Why has value for money not been included as an explicit fairness outcome? Probably the most likely answer to this is that product pricing is intended to be resolved through free market processes. TCF actually covers value for money through every one of the six fairness outcomes and, continues the argument, helps to establish this market in which price and value are transparently evaluated by customers.

We are concerned that this is unlikely. Put another way, if we are sufficiently uneasy about market dynamics to introduce a system as significant as TCF, what makes us so sure that suppliers will not continue to have a significant information advantage over their customers that would allow them to continue to price to their benefit, even if all requirements of TCF are met?

We are also concerned that, while TCF is a sound initiative, it **risks duplicating a number of other initiatives** that focus on ethical behaviour. Examples of these are

— the Financial Advice and Intermediary Services (FAIS) framework,
— Retirement Fund Circular PF130, *Good Governance of Retirement Funds*, intended to grow from its current status as a guidance note to become part of regulatory requirement, and
— the requirements of company law and supporting regulations and the guidance included in the King III Code of Good Practice.

Honest, customer-focused businesses are likely to be complying with all such requirements, but the cost of demonstrating this is higher now than ever before. It hardly needs to be added that at least part of this cost is likely to be passed on to customers.

Most significantly, **how will we know when it is working?** Hundreds of financial services providers and thousands of retirement funds and their administrators providing evidence of the fairness outcomes is surely a step in the right direction. But how will we establish that **customer financial needs are being appropriately met through a sustainable industry**? If we do not have an objective measure of success, we won’t know whether we can relax in the knowledge that the initiative is working or push regulated entities harder to demonstrate their commitment to this objective.
2. LONG-TERM INSURANCE

The long-term insurance industry plays a key role in South Africa's financial services marketplace, providing protection against events such as death, disability and critical illness, but also mobilising savings. Insurance products are naturally complex, so attention to clear communication and customer-focused design is essential.

2.1 Market Challenges

We start our discussion of this industry sector by considering a few challenging issues with which long-term insurers ought to be grappling. We follow that in Section 2.2 by considering one specific issue in a little more detail.

2.1.1 Long-term Saving

Much has been said and written about the long-term saving environment. There is little doubt that providing a long-term saving product is not straightforward, particularly if your distribution channels are expensive and costs need to be recovered in the event of what we might call default by the customer. Historically, insurers by and large have not done a great job of solving the problems inherent in their proposition. They appeared to accept as inevitable the need to sell the product through expensive channels. They regarded as fact the high costs of administration. Most significantly, they considered the one-sided contract into which they entered with their customers an essential feature of the arrangement.

Some changes have been seen in this space. Other non-traditional insurers have entered the market as competitors with a lower cost base. We are aware that these changing and new organisations are not perfect, but it is appropriate that, if they address the most important concerns with existing products, then for the right reasons, they should attract the attention of customers.

2.1.2 Disclosure

Some years after the study into the costs of saving for retirement, we were involved in a study of long-term saving products aimed at the low-income market segment. The problems noted in the earlier study presented themselves again. This time, though, we had written insurer quotes. Costs were opaque and high. More immediately noticeable, however, was the poor standard of disclosure. Notwithstanding compliance with industry codes covering reduction in yield, it was very difficult to understand how charges actually stacked up.

It is hard to believe that these policy documents had been tested for understanding by prospective customers. It follows that it would stretch credibility were the insurers in question to state that the products had been designed and priced with the customers' interests at the centre of their thinking. Demonstrating this is now a requirement.

problem with applying clear disclosure for the first time is that it exposes the products for what they are, difficult to understand and frequently unnecessarily complex.\footnote{By way of illustration we describe in Section 5.1 the range of technical terms used in the quotation of a relatively straightforward investment product offered by a long-term insurer.}

2.1.3 Synthetic Investment Products

We observe with interest the increasing prevalence of investment products offered by long-term insurers that are built on the back of derivative structures. These are typically presented as five-year plans with a short window of opportunity for purchase, a minimum investment amount and one or more particularly attractive features that verge on the \textit{too good to be true}. Typically, also, they omit information on what is missing from the return that the investor might receive. Where the outcome is dependent on the level of a specified stock market index, for example, the astute investor would recognise that dividends emerging from that market are not paid to the customer. Where the index is overseas, the intelligent customer would know that guarantees expressed in rand terms based on an international currency leave the rand depreciation in the pockets of the provider. Many would not know to look for these omissions.

We are not suggesting that products like these have no place in a mature market. Their success rests to some extent on the manner in which they are positioned. We are curious to see how firms providing products like these meet their TCF obligations to give to customers the full picture and how they ensure customer understanding of the products.

2.1.4 Distribution Differences

In our enormously complex environment with sometimes very expensive distribution channels, it is difficult not to wonder whether insurers with different distribution channels selling different products to the same customers treat these customers fairly.

This issue may hinge to an extent on the value of advice. Some insurers offer customers using direct channels a discount on the corresponding price offered to the customer through a commissioned distribution channel. If the difference doesn’t fairly represent the value of the advice, then it is worth asking whether these two customers are being treated equitably. In instances in which insurers refuse to consider reducing product prices for customers, can the insurers possibly claim to be offering good value to all customers?

Finally, disregarding price, the outcome itself is reliant on the channel. The same customer with the same needs could end up with different solutions depending on which part of the insurer reaches them first.
2.1.5 Risk Pricing

Competition for customers of simple products paying out in the event of death has been intense. This has pushed the price of risk cover down, which is generally good for customers. Things are not always as they seem, however. Insurers have become increasingly willing to package products that start out cheap but come with steeply increasing premiums thereafter. This has been accompanied by progressively euphemistic terminology. Fixed premiums were replaced by those growing at a specified rate. As the rate grew, insurers latched on to the fact that mortality rates grow at an annual rate typically higher than the agreed increases. They introduced *age rated* increases which simply stated that prices would go up with the risk. Soon products with automatic cover increases and premium rates that grew at both the age rating and the same rate as the automatic increase in cover became common.

It is not clear that properly informed customers would willingly purchase a product whose premiums rapidly grow into unaffordability. It is also not clear that these premium increases, and their consequences for long-term affordability, have been communicated clearly to policyholders. Again, it will be interesting to see how these insurers respond to their responsibility under TCF to communicate clearly. They will need to demonstrate to the FSB that they have done so and have tested customer understanding of their communication.8

2.2 Credit Life Insurance

Credit life is globally by far the most common form of long-term insurance by number of policies sold. It is not difficult to understand why.

— Credit life has grown on the back of the burgeoning microfinance industry.
— It is sold often in small denominations and at low premiums, though still at high profit margins.
— The credit life cover is often a requirement of the lender, so a third party has an interest in the sale.
— Customers are, as long as the rules in South Africa are being followed, made aware that they have a choice of provider of such cover, but at the time of applying for the credit do not have the time or know-how to attempt to possibly purchase a cheaper product.

South Africa’s policymakers have long recognised that the market for credit life cover, referred to in a recent National Treasury publication as *consumer credit insurance*, is flawed. We consider the issue in the discussion that follows.

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8 The Financial Services Board, with National Treasury and industry participants, is developing a set of Key Information Documents (KID), summary templates that product providers and advisers need to issue to prospective customers. Whether or not the relevant KID makes clear this pricing dynamic, insurers will be required to disclose these increases to applicants and show that policyholders understand the implications of these premium increases.
2.2.1 The Problem

Credit life insurance is frequently sold, not bought. Where customers are aware of it at all, it is a grudge purchase that they make along with the item purchased for which they need to borrow money. More frequently, despite recent improvements in disclosure requirements, they are not aware of the credit life insurance or its cost. These customers typically are not operating from a strong position of power or understanding. They are frequently in the uncomfortable position in which, even if they were, they are pressed into action by a sales person at the point of purchase of the item attracting the loan. They are in no position to shop around for an alternative and even less to understand the value provided by the insurance cover.

A mystery shopping exercise reported in the National Treasury study suggests that many of the requirements of sales outlets that are intended to protect customers are not being observed, in particular that the cost disclosure is poor:

The full cost of credit, inclusive of initiation fees, administrative fees and credit life cost is also not being fully disclosed. (National Treasury, 2014:19)  

On the supply side, conflicts of interest and inordinately strong distribution channels frequently dominate. The credit provider frequently has a business relationship with the insurer, so incentives to the salesperson on the shop floor to sell the insurance are strong. For the same reason, neither the lender nor the insurer has a meaningful interest in positioning the insurance as a good-value purchase, cheaper or better than the alternative offered by a competitor. Sales staff are strongly incentivised to sell additional insurance to that required to cover the loan. The evidence suggests that they frequently do this.

Microfinance providers, even when independent of insurers, are well aware of their power to move the insurance books that they control. They are known to place demands on the insurers regarding product prices – even the risk premium – and the consequent profit-sharing arrangement. Insurers have a role to play, though, for if they insisted on risk pricing at low margin, customers would get a better deal. The way things are at present, such an insurer might not be able to write business through the majority of available distribution channels, but changes are coming.

There is little doubt that the credit life marketplace is not operating in the best interests of its customers. Insurers may argue that they are effectively powerless to make a difference. This holds little water in the TCF environment that requires them to

— act in the best interest of customers,
— demonstrate that they are doing so, and
— show that they have established that their customers believe that they are acting in their best interests.

The National Treasury study includes consideration of a number of possible actions. These include:

- regulating the pricing of credit or credit life insurance, or addressing the low claims ratios characterising the credit life insurance market,
- addressing the value and sustainability of credit life insurance product features by requiring insurers to offer a specified menu of cover alternatives,
- clarifying the distinction between mandatory and optional cover,
- establishing a level of product standardisation,
- specifying minimum disclosure point of sale requirements, improving ongoing disclosure and aligning disclosure standards with other existing regulation,
- addressing conflicts of interest in distribution models,
- improving access to advice,
- addressing practical constraints to claiming and clarifying the rights and responsibilities of customers and insurers in the claims process,
- addressing the web of relationships arising from the complex credit life insurance value chain, and
- creating a unified regulatory framework in relation to credit life insurance, that is aligned with the anticipated micro-insurance framework, avoids regulatory arbitrage and ensures focused supervision of these products.

National Treasury has also indicated that it is considering removing the right to credit providers to refuse credit on the basis of a customer’s unwillingness to purchase credit life insurance.10

2.2.2 Closing Thoughts

All of this begs the question of how we managed to arrive at a position in which so much is required to address a set of activities quite clearly not in the customer’s interest.

Some might suggest that this is a natural part of a set of market forces that aims to provide increasing profits in a predominantly capitalist society. There may be some truth in this, but it suggests as well that there is no competitive advantage in swimming against the prevailing current and pointing out to prospective customers the advantages of choosing the simpler, clearer, cheaper product.

Another implication of this somewhat fatalist negative view of capitalist forces is that a company led by an individual bound by a code of practice – the actuarial profession for example – is at a competitive disadvantage to its counterpart that picks a leader more prepared to follow the conventional profit-seeking approach. Part of the reason for writing this paper is asking whether this might be a possibility in practice were we to urge our members more explicitly to take the public interest into account.

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10 This, in theory, reduces the willingness of firms to provide credit. In practice, many lenders do not insist on credit life in any case.
We believe that there might be other opportunities for the profession to contribute to the public good. We could consider writing product guidelines for public consumption, for example.

As a profession we are contributing to the process of review, but was there not a great deal more that we could have done before this? Perhaps more important, since the process of reviewing the industry is now well underway, are there other problems brewing that require similar urgent and intensive attention?

We are optimistic that, as challenging as it may be for providers, the TCF process will go a long way to addressing troubling concerns around customer-centricity in insurance products, but we can see this requiring a painful process of change in some instances.

3. SHORT-TERM INSURANCE

The short-term insurance industry is well-established, financially significant and soundly managed on the whole. Regulatory concerns up until now in this market have tended to focus on the validity of services offered by members of the value chain, and the corresponding claim to revenue. The development and roll-out of the TCF regime, however, provides a good opportunity to ask questions about the adequacy with which customer needs are being addressed.

3.1 Market Challenges

Short-term insurers sell a large range of products covering contingencies that range from large, unique corporate risks to the everyday hazards that characterise the large and highly competitive personal cover market. We consider two questions generic to this industry here before turning to a specific issue in more detail in the section that follows.

A number of short-term insurers reach the market through intermediary organisations, usually underwriting managers, granted considerable freedom to design products, set premiums, and approve and pay claims. Insurers will need to be clear how to ensure, through these intermediaries, that customer requirements are adequately met.

They are being helped to some extent – not all of them would regard this as assistance – by the regulations covering binder agreements and outsourcing arrangements. These initiatives have, by and large, aimed to clarify the responsibility of parties in the value chain, putting limits on the income that each could conceivably lay claim to, but the focus on customer interests may assist further in clarifying the roles of entities in the string of service providers.

A second issue that insurers need to consider – they have this in common with their long-term insurance counterparts – is whether their increasingly sophisticated underwriting and pricing methods are in the interest of customers. The debate over the right to underwrite has been raging for some time. It is linked to the corresponding discussion over the relative merits over mutuality, which pools risks but not necessarily
at the same price, and solidarity, which cross-subsidises across known rating factors in order to share risks across the group.\textsuperscript{11}

This is a different question. Are pricing methods that are pushing towards a set of rating factors for each customer in the interests of these customers?

— Rating that actively measures the conduct of a customer has a chance of improving that behaviour, which is likely to be good for all parties to the arrangement, and society as a whole.

— Underwriting, however, is not cost free. Customers must pay for the activities of insurers that aim to differentiate ever more finely between the risks being written. As uncomfortable as it may be, unisex rates in Europe are not going to destroy the industry.

We urge rigorous, open-minded thinking in this tricky area.

3.2 Differential Pricing

The short-term personal lines insurance market is intensely competitive. A number of insurers are competing for a large pool of customers, using a range of creative approaches and it is quite clear that customer acquisition is critical. This appears to be leading to pricing behaviour that may not be regarded as in the interest of customers.

A growing pool of evidence suggests that insurers are prepared to buy loyalty by pricing low and then incentivising customers to stay on while increasing premium levels. The argument in defence of this approach, presumably, is that competition is driving prices to below break-even level, so some way has to be found to generate profit from customers over the longer term.

This type of behaviour is by no means unique to this market. Ericson (2010)\textsuperscript{12} describes similar dynamics in a health insurance market, Part D of the US Medicare market:

I provide evidence that individuals display inertia in this market and are affected by program defaults. Firms respond to this situation when setting prices by initially offering plans at low prices to attract first-time enrollees. The data show that firms subsequently raise prices in later periods when their plans have a base of enrollees “stuck in place”, while new plans are introduced at low prices to attract new individuals entering the market. (Ericson, op. cit., p 1)

He points out that this type of behaviour in markets characterised by customer inertia is not unexpected:

\textsuperscript{11} We are not criticising the right to underwrite, but we ask where it might be going.

A large theoretical literature examines the response of firms to switching costs... and predicts a pattern of “bargains-then-ripoffs”: products are offered at low prices and then subsequently at high prices. (Ericson, op. cit., p 3)

The long and short of it is that insurers operating in certain lines are not pricing solely on risk factors. Should this be regarded as unfair? We’ve just posed the question of whether the use of increasingly sophisticated rating factors is necessarily in the interests of customers. A little thought shows how difficult it is, in fact, to defend such an approach. The consequences of such a strategy are not all positive. Customers who shop around, changing their insurer every year, say, benefit from continually lower prices, perhaps never generating profit for insurers. Policyholders who stay with an insurer but continually test market pricing should similarly benefit, again at the expense of their insurers. Those who are not inclined to shop around lose out.

It is not difficult to conclude that these dynamics are not in the interests of customers. Insurers adopting such practices may have difficult questions to ask themselves of their approach to pricing their products and the consistency of their treatment of customer groups. One way, for example, that insurers encourage customers to stay is to offer them cash-back benefits for staying. The very principle of providing what appears to be a long-term promise while the arrangement contractually is short-term and reviewable is contradictory.

So much for the customer perspective. It is also surely not in the interest of insurers themselves to continue along this path. Predatory pricing with a system of loyalty bonuses may succeed in squeezing smaller competitors out of the market, but it is hard to see the story having a happy ending for surviving firms. As customers become more actively engaged with their products, more of them are likely to take advantage of the pricing patterns and the sector itself becomes risky to participating insurers.

How firms respond to inertia depends on institutional constraints. In the Medicare Part D market, firms submit annual bids and must charge all enrollees the same price. As a result, plans are offered at low prices when they are first introduced. As plans age, prices are raised to take advantage of enrollees’ reduced price sensitivity, creating an incentive for new plans to enter at low prices. Firms’ strategic responses to inertia are relevant for market design in domains other than health insurance. (Ericson, op. cit., p 34)

We challenge insurers to ask themselves whether they believe that a situation like this, questionably in the interests of customers, can be resolved through the activity of providers or whether the regulator may need to take some action. Steps could be taken to prohibit insurers from pricing differently customers that otherwise fall into the same rating category. Perhaps with TCF in place, this shouldn’t be required.
3.2.1 Closing Thoughts

Short-term insurance has flown largely below the radar screen, escaping some of the adverse scrutiny from the personal finance sector that many of its market counterparts have been subject to. Insurers operating in this space have generally done well, investing in good systems, providing high standards of customer service and competing actively and innovatively in ways that, in many cases, have benefited customers. One or two aspects of their practices deserve careful thought, however, and may be put to the test by TCF standards and requirements.

4. Retirement Funds

Retirement funds play a substantial role in protecting our workers and preparing them financially for their old age. Millions of South Africans trust those responsible for the management of their occupational retirement funds, retirement annuities, umbrella funds and preservation funds to play their part in the interests of these members. The combined assets of these arrangements are enormous, amounting to something close to the country’s annual gross domestic product.

The discussion in this section asks whether those playing a part in this industry consistently contribute in a way that is in the interests of its customers. We express our concern that the answer is not always yes.

4.1 Market Challenges

We South Africans have much concerning our retirement system about which we should not be particularly proud. In the discussion that follows we consider some of these before turning to possibly the most important of these, the risks left in the hands of members, largely without adequate assistance.

4.1.1 Pension Fund Conversions

The wave of conversions from defined benefit (DB) to defined contribution (DC) schemes over the last 20 or 30 years was, compared to the corresponding change in other countries, almost unprecedented. Schemes converted with extraordinary frequency and rapidity, leaving very few DB arrangements behind. In the vast majority of cases, furthermore, past service accrual was converted along with the corresponding change to future entitlement. This contrasts the South African environment with counterparts in other parts of the world, the United Kingdom for example, in which existing entitlement to benefits in a DB arrangement were left largely intact.

The actuarial profession cannot be said to have been responsible for the wave of conversions. A specific set of circumstances contributed uniquely to the push for members to be granted access to retirement fund assets. But we probably did not do enough to express the disadvantages to members of these changes. And we certainly came away from the debate over employer rights to surplus in converting funds with a number of questions that we found hard to answer without a measure of embarrassment.

Our concern is not to scrape through the coals of past actions. We have chosen
instead to focus on our collective responsibility to assist the inheritors of the new system with the means to take better care of themselves. We cover this in Section 4.2.

### 4.1.2 High Investment Costs

Notwithstanding the shoots of progress in parts of the index-linked investment market, our pension fund equity allocations are overwhelmingly invested in actively managed mandates. We consider some of the reasons for this tilt in Section 5.1 and reiterate our position here that we are not defending passive management as an approach. It is nevertheless hard to argue against the view that, in aggregate, expenditure by pension funds is unnecessarily high because it is built on the assumption that active managers are able consistently to outperform their benchmark.

Part of this is attributable to what we might describe as intellectual capture by advisers. Rather than aiming to equip their clients, the trustees, with the means to make sound investment decisions themselves, advisers have developed what might be referred to as an intellectual dependence on their services. The dependence is risky because it requires the adviser to be correct in assumptions, assertions and recommendations. Why? Because smart oversight of their recommendations too often doesn’t exist and advisers often assess their own contribution to the fund. Too many of these advisers run flawed business models (refer again to Section 5.1), rendering this intellectual dependence even more risky.

High costs, not limited to the investment space, are encouraged also by pervasive complexity of products, too often in the interests of suppliers and intermediaries but not of the customers that they aim, ostensibly, to benefit. These exacerbate the information and understanding gap between trustees and their service providers.

### 4.1.3 Defined Benefit Valuations

Our professional counterparts supporting DB funds in the United Kingdom engaged more than ten years ago in a robust debate concerning the assumptions that should be applied to valuing these funds. Detractors to the established methodology proposed that it was inappropriate for liabilities to be discounted at a rate that reflected in some way the average returns expected of the assets. They pointed out that such a method, in the context of high equity allocations, depressed liability values and raised the corresponding reported value of the surplus in the fund. They suggested instead that a market-consistent basis should be used and that returns emerging from the assets ought to be accounted for as they emerged on the basis that they were no more than reward for risk taken.

We might have expected to learn our lessons from the painful controversy preceding and following the process of clarifying rights to surplus in South African pension funds. We have persisted instead in our approach to valuing retirement funds, except that we have overlaid it with a complex set of stipulations concerning the calculation of a set of solvency reserves intended, it would seem, to protect members of the fund from undue distribution of surplus.
One of our key stakeholders in these pension funds is the Chief Financial Officer of the sponsoring employer. This individual, who reports in his or her company financials on a market-related basis, must now balance at least two, perhaps three – depending on the solvency reserves – different financial realities concerning the fund over which they have a form of responsibility. Another stakeholder is the member. It is very difficult for either of these stakeholders to understand why, in an instant, if assets are invested more conservatively, the actuarial position of the fund should deteriorate. It is similarly difficult for them to grasp the difference between the value of the liabilities and the corresponding charge quoted by an insurer to buy out these liabilities.

To this short list of concerns we could add others.

— Long-standing conflicts of interest characterising the so-called training of trustees tended to entrench the position of the provider or adviser rather than equipping the recipients of service to assess the quality and value of such service.

— The extraordinary design of insurer-provided retirement annuity products, based on the assumption of a lifetime of saving seldom possible in practice but with penalties loaded against customers in the event of contractual change, has been much discussed. This will surely pass in favour of more customer-centric as-and-when fee arrangements.

— Fee levels in the market for preservation funds continue at high levels, notwithstanding the fact that this environment is characterised by high one-off contributions. This belies the argument that customers are well able to choose based on price because competition appears to have no positive impact on this price.

— Delays in tracing former members in unclaimed benefit funds could result in lower benefits eventually paid to these members due to administrative fees being charged against the members’ benefits.

— Pension fund rules have proved, notwithstanding their legality, to treat groups of members inequitably.13

Where have these signs of inadequate attention to customers left them? We ask this question more fully in the discussion that follows.

4.2 Risks Passed, Risks Forgotten?

One of the consequences that we have inherited from the events of the last twenty years and from the inadequate attention to the well-being of the fund and all of

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13 It is not difficult now to describe the pension increases provided for in the Transnet defined benefit fund as inadequate. Are there other such cases staring us in the face? Notwithstanding the obligation that trustees have to demonstrate TCF thinking, it is not clear that they will be required also to apply their minds to equity considerations in the rules of the funds that they oversee. We ask whether valuation actuaries ought to be applying their minds to the fairness of pension fund rules and what they should be doing where they have concerns that trustees are not addressing.
the parties with an interest in the fund, is the adversarial division between stakeholder groups. The move from DB to DC funds has handed much of the financial risk of preparing for retirement to members but it has not adequately prepared them for this transfer. Many would suggest that South African retirement fund savers are not better off than they were twenty years ago.

Without doubt we have made progress. But in truth, we still have some way to go before we can translate any gains we may be making into a more financially stable world for our workers. Despite the advances, South Africa still has one of the lowest savings rates in the world. (Edward Kieswetter, Alexander Forbes Group Chief Executive, forward to Benefits Barometer 2013, p 2)\(^\text{14}\)

In truth, we played a big part in taking the responsibility and risk of managing retirement accumulation and income-conversion from employers. But we didn’t merely pass it on to their employees. We gave the risk technically to members, but we offered the responsibility to the financial services industry, which took it without hesitation, providers doing the best they could to attract the attention of these members. What are some of the consequences of this system?

— Governance failure At the risk of a touch of harshness, the trustees of occupational schemes have proficiency and experience only in pockets. Some of our large funds are run by skilled, motivated, responsible individuals who put the interests of their members before their own and do their utmost to ensure that member interests are protected and returns maximised at appropriate cost. Such funds are few. The majority of funds are managed by boards doing their best to look after their members but frequently out of their depth and ill-equipped for the decisions that they need to make.\(^\text{15}\) Trustees of umbrella funds, retirement annuities and preservation funds established by for-profit entities may be, on paper, independently able to oversee member interests but are in practice deeply constrained in their ability to exercise their responsibility.\(^\text{16}\)

— Market distortions Inadequate skill at the level of the board allows providers to influence decision-making unduly. Profits to these providers are probably greatest in the market for investment management and poorest in administration. Members’ interests are deeply compromised by the consequent willingness of providers to compromise on the quality of their administration services, and charge as much as they are able on investment management.

\(^\text{14}\) Alexander Forbes (2013) Benefits Barometer, published by the firm
\(^\text{15}\) We don’t even touch on those funds that are simply badly managed or poorly advised.
\(^\text{16}\) This discussion would be incomplete without pointing out that a number of boards, merely creating the illusion of independence, appoint former staff members of the sponsoring firm to their membership. The King III Code of Corporate Governance suggests that a former employee who worked for the firm concerned in the last three years is not truly independent. Umbrella funds committed to good governance should be considering this guideline as a minimum but at heart might still find it difficult to show that the trustees concerned are not under undue pressure to support the goals of the firm that established the umbrella fund.
— **Poor investment allocation** Investment plans for members of DC funds treat these members like a caterpillar in a tank, assuming that it is sufficient to meet the needs apparent to the observer looking in. The caterpillar, to continue the analogy, is not being prepared for a life of satisfaction as a worm surrounded by mulberry leaves. It is being made ready for existence as a butterfly. We have inadequately understood the types of pressures that our members are put under when they leave the protection of the tank, which the large majority of retirement fund members do, or we have chosen to ignore them instead of addressing these issues in a coordinated manner. A sophisticated life-stage plan is of no use to a member who leaves at age 45 and spends his savings, or to his colleague who retires from the plan only to invest everything in an equity-rich income drawdown portfolio.

— **Inadequate guide rails** Income drawdown products are appropriate to retirees with the skills to manage investment risk and with the financial resources to provide adequate protection in the event of investment failure. Very few retirees fall into this category. The incentives that have been provided to sales teams reaching out to these retirees have produced the predictable swing towards these products.

The long and short of it is that South African workers are poorly treated by the system in which they are participating. We have inadequately prepared these workers for their retirement. We have irresponsibly granted them access to expensive products too often not in their interests.

On aggregate, the employee benefits model in South Africa is failing to deliver to its full potential. The level of retirement income secured with retirement fund savings typically lies far below the level of pre-retirement earnings. … All indications are that, without intervention, these outcomes will continue to deteriorate. (Benefits Barometer, op. cit., 2013 p 14)

At the heart of the matter is that we have not done sufficient to understand our customers and their environment, contenting ourselves with the argument that conditions in the tank over which we have responsibility are sufficient to protect customers passing through instead of recognising that, too often, we are contributing to the problem.

### 4.2.1 Closing Thoughts

We have a role to play to identify high-level issues that would make a positive difference to pension fund members, and we would be remiss not to raise them. We risk majoring on the issues that would be of the most significant benefit to our employers, mandatory preservation for example, and putting insufficient emphasis on those that might make us feel a little more uncomfortable, the prevalence of living annuities, perhaps. If we do not provide a balanced perspective on the full range of issues affecting members of retirement funds, our opinions may not be regarded as credible.
Finally, experts who make little or no effort to understand the beneficiaries of their expertise, and their judgments, are not really experts. We should be taking every opportunity to understand the views and the needs of our ultimate customers.

5. INVESTMENT MARKETS

Investment markets play a critical part in the broader financial services landscape. Aggregate figures suggest a healthy environment for asset management, with trillions of rand under the care of a large number of managers in institutional or retail arrangements.

We argue that insufficient attention is being given to the interests of customers. We consider a few broad characteristics of the market that are not consistent with customer needs and we turn then to the issue of performance fees.

5.1 Market Challenges

We start by considering some of the characteristics of this market and setting out some of the main areas in which customers interests are perhaps not being upheld.

5.1.1 Focus on the Margins

The market for investments is characterised by a significant gap, in information and in understanding, between the provider and the customer. Active management, more lucrative to investment managers than its passive management counterpart, rests on the proposition that the expert is able to pick stocks in such a way as to beat the average.

We do not plan to state the case for index-linked investment. It is a natural consequence of an opaque, complex market, however, that the marketing money is spent where the profits are highest.\(^{17}\) This applies not only to investment managers, but to market intermediaries, brokers and advisers of institutions. In aggregate, then, it is hard to describe this market as treating customers fairly.

The rationale for asset-based fees is not clear, at least considered from the perspective of the customer. There are one or two puzzling aspects of the ubiquitous use of such a fee basis. Is it appropriate, for example that, where administrative expenses are not covered by explicit fees, management fees based on assets are used to cover these costs? More fundamentally, is it right for the customer that the primary long-term determinant of the fees paid to the service provider is the level of the markets? We are certainly not the only ones asking this question of the asset management industry.\(^{18}\)

A few arguments may be made in defence.

— *The market is accustomed to this charging approach.* That doesn’t make it right, or in the interest of customers.

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\(^{17}\) We acknowledge that this is a tendency of any market.

\(^{18}\) A large retirement fund recently disclosed to me that, having established the rand level of the investment fees payable, they insist that year-to-year increases are linked to the general price inflation, not to the level of the market.
— Standardised fees aid comparison. This has merit, but is undermined by increasing use of performance fee models that make clear evaluation much more difficult.
— Expenditure is based on assets, so fees should be formulated on the same basis. A very small proportion of an asset manager’s costs are actually related to the level of assets under management.
— A fee expressed as a percentage of assets looks small. Perhaps this is closest to the truth. We needn’t add that it is hardly an example of customer-centric thinking.

Should asset managers be required to state all fees in hard currency terms, both in product quotations and in performance reports or might they do so willingly in the interests of clear disclosure to customers?

5.1.2 Conflicted Advice

It is similarly hard to describe this market as characterised by a culture of best advice. Both retail and institutional advisers are motivated to promote the merits of active management. On the institutional side, advisers of retirement funds are commonly organised in a way that distorts the information that they provide through conflicts of interest.

Few investment consulting firms are completely free of such conflicts. Some of them are part of financial services groups that include investment managers. Some provide services to the investment management market and have an interest in promoting those firms to whom they provide such services. Others actively both advise and invest client assets and surely find it difficult to describe their advice as unbiased. Still others create funnels of revenue in structures that look like bespoke solutions. They persuade clients to invest in a portfolio similar or identical to the corresponding portfolios of their other clients. This lightens their monitoring burden and enables them to streamline their reporting function.

Another consequence of conflicted advice models is that those consultants able to generate other revenue from assets under consultation are able to undercut their competitors who offer only pure consulting. This distorts perceptions of value and risks taking clients into structures from which they may subsequently find it difficult to move. These subtle dynamics are not in the customer interest but can be difficult for trustees to perceive and address.

5.1.3 Customer-unfriendly Intricacy

Complexity is increasingly characterising a market that should not be complex. A straightforward example illustrates the point. A preservation plan quotation produced recently by a large South African financial services group bravely sets out to describe accurately the investment allocation for a single premium and all of the fees included. Terms used in the quotation include:
— initial administration fee,
— initial advisor fee,
— gross allocation,
— net allocation,
— all-in asset management fee,
— annual administration fee,
— annual duration bonus,
— size bonus,
— total expense ratio,
— net asset management fee,
— net administration fee,
— net adviser fee,
— adviser fee adjustment,
— adviser fee discount,
— reduction in yield,
— performance-related fees,
— expense adjusted return, and
— weighted average total fee.

As far as we can tell, this is a straightforward equity allocation to three different investment funds. The figures furthermore make no allowance for investment performance fees, simplifying disclosure requirements. We commend the institution’s determination to express clearly the nature and details of the arrangement, but the complexity is problematic and surely not in the interests of the customer.

The issue that we choose to discuss further is the practice of performance fees. We argue in the discussion below that the almost ubiquitous bonus payable to an investment manager for producing performance in excess of a stipulated benchmark is seldom in the interests of customers.

5.2 Performance Fees

Performance fees are becoming increasingly part of the remuneration earned by investment management companies. The fee for performance, which might more appropriately be called a bonus, is a contractual reward for investment returns above a stipulated threshold within a specified period.

Performance fees have long been part of the hedge fund world, in which the 2 plus 20 model became fairly well established. More recently, these fees have become part of the general equity world. The bonus structure in South Africa’s retail investment markets are now so common, particularly in equity-rich portfolios, that finding a contract without performance fees has become exceptional. The same is not true of institutional investment markets, where a number of trustee boards choose not to accept a contract with a performance fee element, where given the choice.

19 Hedge funds under this model charged 2 per cent of assets and 20 per cent of the performance above a specified level, usually in any given year.
5.2.1 The Rationale

The proposition to customers is straightforward, an apparent alignment of interests. “If we produce a strong performance you win”, goes the argument, “and you would be willing to reward us with part of that performance.” We return to the validity of this argument towards the end of our discussion but start by considering some of the practical concerns with performance fees that render such remuneration inconsistent with customer interests.

5.2.2 The Problems

Performance fees make product charges difficult to compare. Investment management fees are expressed typically as a percentage of assets under management, say 0.4 per cent to 0.8 per cent in the institutional investment space, and between 1.0 per cent and 2.0 per cent in the retail environment.\(^{20}\) Notwithstanding the slightly puzzling insistence that an asset-based fee is fair to customers, the practice is well-established and straightforward. It makes it easy for any customer to put a set of investment managers alongside one another to determine how the fees stack up. The system of performance fees, however, considerably muddies the waters, complicating the basis of remuneration to the provider of service.

A typical performance fee arrangement includes a number of technical measurement points, for example:

- **term**, the period over which the performance is actually determined, which may be discrete or may be described as a set of overlapping periods,
- **base fee**, the fee paid whether or not the performance threshold is achieved,\(^{21}\)
- **threshold**, the performance benchmark above which a performance fee is due, occasionally expressed in strict numeric terms, but much more commonly by reference to an index or the rate of price inflation plus a few percentage points,
- **performance incentive**, the formula that describes how performance above the benchmark translates into reward for the manager,
- **high water mark**, a sub-minimum net asset value that applies to funds that have lost value, under which typically the fund must recover its value to the high water mark before performance fees could be considered,
- **fee cap**, the maximum fee due to the investment manager under the performance fee arrangement.

Even sophisticated institutional investors find it difficult to compare two otherwise similar investment management propositions when the potential for performance

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\(^{20}\) Unit trust members typically pay a fee for access to a fund, perhaps 2 per cent for the cost of administration and 3 per cent as commission to an adviser. These are not intrinsically charges for the investment management service.

\(^{21}\) Although performance fees may aim to enhance customer confidence in the ability of the investment house to generate strong investment returns, we are not aware of any instances in which the investment manager has backed this confidence by waiving its rights to fees where the performance is not achieved.
fees is factored in. Individual investors surely have little chance of effecting a fair comparison.

Performance fees appear to have increased aggregate investment costs. In some cases, investment managers have reduced base fees when introducing performance fees, but this has not been the norm. Anecdotal evidence suggests that fee levels have increased over the last few years, despite the attention given to the matter, and that performance fees have contributed largely to this. The fact that risks are not truly shared – managers do not agree to a cut in fees when they fail to generate performance in line with the benchmark – contributes to this phenomenon.

Performance thresholds are frequently not designed to reward skill. When performance fees were introduced to general equity funds many of them were structured to reward the ability of the manager at picking winning stocks. A sensible market benchmark was used, one of the JSE indices for example, and alpha, performance above that index, was rewarded.

This has largely changed. Performance benchmarks are now commonly expressed relative to inflation, 5 per cent real for example. This is not necessarily in the interest of customers. Long-term investors need sensible long-term asset allocation, not a balanced strategy that with some reliability beats an inflation-related benchmark.

Moreover, the performance fee paid to the manager under this model more frequently rewards luck rather than skill because it depends primarily on the overall movement in equity markets than in the alpha produced by the manager. Over an extended time, with performance fees only paid on upside success, the overall effect on customer returns for a standard equity-rich strategy is detrimental.

Performance fee structures are often stacked in favour of the supplier of service. The formula for determining the performance bonus to the investment manager should express fund performance net of the base fee of the investment manager, for example. While instances of such an approach have been seen, it is not the norm. The performance threshold is thus lower than it appears and the manager is set to receive a bonus in instances in which the net return to the customer is lower than the threshold.

Performance fees probably have no material impact on performance. It is hard to see in practice how performance fees align interests with customers in the sense that they truly motivate investment managers to deliver a better service in the form of better performance. On the margin, managers may perhaps put more effort into their research, hiring one or two more analysts to study market data more deeply, but it is well established that skill in investment management is an elusive characteristic and it is unlikely that a little additional information would make a material difference.

Do investment managers with performance incentives try harder? This is difficult to imagine for it suggests that they didn’t really care about their performance before the fees were in place.

On the assumption that performance fees do impact performance they are unlikely to do so in alignment with customer needs. Let’s assume that these performance fees do have an impact on the behaviour of the manager and that
they somehow stimulate greater activity leading to better fees. It is still difficult for
the manager to claim that the behaviour of its employees is always in line with the
interests of customers. Approaching the end of the performance term, for example, if
the performance is ahead of target, the manager has an incentive to tone back on risks
taken. If at that time performance is behind target, the manager is motivated to scale
up on risks in an effort to reach the target. In both instances, the incentives on the
manager are not aligned with the needs of the customer.

We have even encountered situations in which an investment consultant to a
retirement fund, supposedly the impartial adviser, receives performance bonuses on
top of their standard fees.

Performance fees, in short, do not appear to be in the interests of customers.

5.2.3 Closing Thoughts

Asset management is complex. It is too easy, in the context of this complexity,
to forget that customers depend on investment professionals to provide a service not
only with skill, but also with integrity. The second of these calls for a certain amount
of transparency regarding the service that is being offered. It is not clear that, in the
hurly-burly competition of the businesses that they run, these investment professionals
remember that their most precious commodity is the trust of their customers.

6. Health Care Financing

Medical schemes play a significant role that bridges health care and financial
services. They play a part in extending quality health care to a larger part of the
population than might otherwise be the case. They provide to members protection
against significant health-related expenditure and help to manage household
expenditure through their cost-smoothing mechanism. They are nevertheless not
without their challenges in meeting customer needs transparently.

Much of the market for health care financing does not fall under TCF require-
ments. Medical schemes, for example, supervised by the Council for Medical Schemes,
are not required to demonstrate a commitment to TCF principles. Notwithstanding
this, we have included medical schemes in this paper because the industry employs a
number of actuaries and plays a significant role in South Africa’s financial sector. We
touch also on the role of insurers, whose products, and the manner in which they are
presented to the public for sale, do indeed fall under the scope of TCF.

6.1 Market Challenges

The key problem facing the medical aid environment is the triangular arrange-
ment between customer, service provider and funder. The third-party payment
system presents intractable challenges of conflicts of interest in the context of:
— expenditure largely under the control of the medical personnel and facilities providing the service, but considerably influenced by the member of the scheme through over-utilisation,
— misalignment of member and medical scheme administrator interests,
— ethical pressure to provide the best available service or procedure, and
— technology-driven cost increases.

Medical schemes have taken a number of approaches to addressing the problem, among them
— establishing a schedule of payments covering the services and drugs offered by medical personnel,
— limiting the benefits available to members,
— incentivising member involvement in the pricing of the service by requiring them to bear a share of the costs,
— encouraging members to opt out of parts of the health care arena and self-insure using saving accounts,
— auditing service providers in pursuit of fraudulent activity, and
— comparing the prices charged by similar providers to identify outliers.

Many of these have been successful, reducing fraud and over-servicing considerably. But they do not address the central problem, the unsustainability of the system. Medical costs, and the corresponding expenditure on services, continue to escalate at rates well above price inflation. Members of medical schemes suffer premium increases frequently outpacing their earnings together with cuts to their benefits that continue to increase their out-of-pocket expenditure. Assertions that the medical aid system serves an exclusive shrinking club of members are hard to rebut.

Both the public and the private healthcare sectors’ have become unduly hospital-centred. Expensive curative care in the tertiary sector uses the bulk of the resources. In the private sector the prescribed minimum benefit dispensation forced by regulation on medical schemes may exacerbate this. Establishing true preventative and primary healthcare is the single biggest contribution that can and should be made to bring about sustainability. Government has plans in that regard for the public sector but its track record of delivering on good plans does not instil confidence that it will be implemented successfully and in good time.

22 This is a supplier-induced demand leading to over-servicing.
23 This is turn may be due largely to ignorance.
24 Administrator income is related to claims paid. We cover this point more fully in the discussion that follows.
25 In the meantime, current and intended regulation on the private sector such as on demarcation between insurance and medical schemes may not give due recognition to the need to promote preventative and primary healthcare. Significant vested interests in maintaining the status quo are evident. It is unclear whether the Competition Commission enquiry into the private healthcare sector will recognise the dire need for the priority of universal preventative and primary healthcare.
As challenging a problem as the third-party payment system presents, we wonder whether enough has been done to ask the hard questions about the sustainability of the system and the roles that medical schemes and their administrators should be playing. Have we focused sufficiently on the needs of the customers that we service and on the corresponding needs of the many who cannot participate in the system? In our engagement with policymakers have we demonstrated sufficient understanding and empathy for the goals and people that we seek to reach, or could we validly be accused of putting our effort into defending our turf?

The introduction of medical scheme regulation, such as community rating and open enrolment in the absence of a risk equalisation mechanism and mandatory membership, caused serious disruption and unintended consequences that also undermine sustainability. Against this, the third-party system produces, predictably, a growing incidence of payment shortfalls on serious medical procedures. The prevalence of so-called gap products that position themselves in this space and aim, through underwriting, to pick off the low-hanging fruit from the tree of opportunity, does not endear health financing policymakers to the insurance industry. Improper and inefficient regulation often leads to opportunity for private enterprise, and they could not be blamed for trying to capitalise on it. We nevertheless ought to ask whether we have done enough to consider the consequences for all South Africans of these trends.

Benefit options in open or corporate medical schemes have been available for over twenty years. In the context of the degree of control that members have over their health expenditure, however, the pricing differences between sets of options are frequently exceeded by the corresponding differences in the expenditure of the members in these options. This possibility was clear at the time of introducing these options. Did sufficient thought go into the appropriateness of replacing a system of cross-subsidy by health status – albeit with high levels of control by members – with an alternative in which generally wealthier groups of members were cross-subsidised by their less well-off counterparts due to the inherent unsustainability of the system?

Healthcare utilisation, delivery and financing together form an industry beset with scientific, technical, philosophical, economical and human behaviour and relational complexity. Perfectly valid differences of opinion exist on what it means to treat a customer fairly. Such differences often imply conflicts of interest between the different stakeholders in this industry. We acknowledge that these conflicts may in certain cases or circumstances be impossible to reconcile.

Finding ways to meet broadly-expressed social objectives in a system beset by financial challenges and deep conflicts of interest is difficult. Differences in the philosophical position of protagonists to the discussion do not help. We are not convinced, however, that customers’ needs and perspectives have been considered with sufficient attention.

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26 These were intended from the beginning but were not implemented.
6.2 Conflicts of Interest

Another intractable conflict of interest challenge is highlighted in the discussion that follows.

Medical schemes and their boards of trustees must appoint an administrator to run their operations. Corporate schemes, with restricted membership, might change their administrators if the service provided by these entities were poor, though we are not suggesting that this would be easy. Open schemes are different. It is very difficult for the trustees of a scheme with the badge of a large financial services corporate in its name to imagine exiting the arrangement under which the same corporate provides administration services to the scheme. An umbilical cord frequently exists in practice between an open medical scheme and its administrator, making a mockery of the regulation that establishes a medical scheme as a non-profit entity.\(^{27}\)

Medical scheme administrators have conflicts of interest around the negotiation of the fee. This is exacerbated in a number of ways. First, the administrator is interested primarily in the number of members, of the aggregate contributions – hence administrative fees – that they pay. The schemes’ interest is the risk profile of each additional member. Second, the administrator is frequently resource-rich. The office of the principal officer, in other words the scheme’s executive team, in contrast, often consists of two or three individuals with the back-up of a number of part-time trustees. This results in a poor balance of power, of information and of capacity, sometimes even ability between scheme and administrator.

If realistically the scheme cannot opt out of the administration arrangement, it is difficult to see that the trustees of the scheme have credible freedom to negotiate fees with the administrator for the service rendered. The threat to leave is not realistic and the negotiating position is considerably weakened. The proximity of the relationship between the scheme and its administrator leads frequently to instances in which members of the board of trustees have a relationship with the administrator. This conflict of interest makes it difficult for them to exercise their duty with impartiality.

This is not the only environment in which this conflict exists.\(^{28}\) We are concerned nevertheless that insufficient attention has been given to protecting the interests of members of these medical schemes in which the quality of services provided by the administrator are inadequate or the fees paid for these services inappropriately high.

\(^{27}\) Some may suggest that profits are simply extracted through the contracting with the administrator, and similar other service providers to the scheme.

\(^{28}\) We have raised our concerns about the integrity with which the trustees of umbrella funds established by for-profit entities are able to exercise their fiduciary responsibility to the fund and its members under the set of constraints imposed by the firm that provides administration or investment management services to the fund.
6.2.1 Closing Thoughts

Health care financing around the world presents a number of deep challenges. We acknowledge this. We would like to see more careful attention given to the needs of all South Africans in ongoing debates regarding the alternatives.

7. CONCLUDING THOUGHTS

7.1 Where to from here?

We expect many of our colleagues to take issue with at least some of the points raised in this paper. Some would do so because we have not adequately positioned both sides of an argument and some because they believe that we have unfairly described the actions of the service provider. We would very much like to be put right where we have erred and welcome alternative views on these issues. We submit, however, that it is not the merits of each case that require consideration, but the fact that there are so many of them.

Two specific positions, however, are not really defences at all.

— “We provide advice to the industry. We are not responsible for the ultimate products.” This may be true of some of the individuals working in the profession, but it cannot be described as true of the profession as a whole, which certainly must take some responsibility for products, and for the way in which they are positioned to customers. Many of our members hold positions of high responsibility. Their duty is clear. Furthermore, every member of the profession has an ethical responsibility to stand for the good of all of our stakeholders, more specifically, for those customers who depend on our skill and advice.

— “We serve our employers.” This is a variation of the first point. If our members are putting their duty to their employers before the corresponding duty to their profession, then we are in trouble indeed.

Some might argue that this paper overstates the problem on the basis that few, perhaps none, of the issues raised as examples are new and that many of them are being addressed by policymakers and other members of South African society, along with members of the profession. We respond respectfully that this is precisely the difficulty. Issues that should never have arisen, because we were always there to take care of these customers, have become problems that others are raising and that we need to work to address.

We propose that the why and the how questions around customer fairness are more important than the what. Intractable problems await our attention, value for money of complex products, for example. We need to be clear about our responsibility to those we serve, however, in order to speak with credibility and authority on these issues. A few questions are posed for consideration.

— Does this paper mis-state or overstate the problem of our responsibility to our ultimate customers?
— Should we modify our goals to make specific reference to the public interest or the good of our customers?
— Should we establish explicit whistle-blowing responsibility and how should this obligation be framed?
— Does our professional obligation to act ethically and with the customers’ interests in mind outweigh any duty that we may have to our employers?
— How might we test any concerns we may have that we are not paying sufficient attention to the needs of customers in our work?

South Africa’s actuarial profession looks forward to your thoughts.

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