FSCA

Financial Sector
Conduct Authority

Statement of need for and intended operation, and statement of expected impact of a regulatory instrument[1]:

Joint Standard on Outsourcing by Insurers

March 2023

Table of Contents

1 This statement is prepared and published in accordance with and in fulfilment of the requirements under section 98(1)(a)(ii) and (ii) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017).

1 Introduction and purpose

1.1 Section 107 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act) empowers the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA) (collectively referred to as the Authorities) to impose requirements in relation to outsourcing arrangements of licensed insurers. The PA and the FSCA have a mandate to ensure that licensed financial institutions are safe and sound and that they treat customers fairly[2]. The draft *Joint Standard on Outsourcing by Insurers* (draft Joint Standard) sets out the Authorities' minimum expectations in relation to outsourcing by licensed insurers, specifically of material functions.

1.2 The minimum requirements expected to be complied with by insurers for the outsourcing of material functions to third-party service providers are necessary to ensure that outsourcing does not impair the prudent management of insurers' business. Proper governance around the outsourcing of business activities is integral to the risk management and internal control of the insurers[3], as outsourcing of material functions can pose various risks to the licensed insurer which, if not properly managed, can have adverse effects on the strategic objectives of the insurer and in turn lead to poor policyholder outcomes.

1.3 The need to regulate outsourcing in the insurance sector is generally well understood and recognised by regulators and global financial sector standard setting bodies, who have embedded high level outsourcing and key requirements

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[2] Treating Customers Fairly (TCF) is an outcomes based regulatory and supervisory approach designed to ensure that regulated financial institutions deliver specific, clearly set out fairness outcomes for policyholders.

[3] Outsourcing of business activities is dealt with under *ICP 8 Risk Management and Internal Controls*. For the purpose of the Joint Standard, third-party service providers should generally be understood to be those entities with whom the licensed insurer has entered into contractual arrangements for the provision of activities and functions that are integral to the nature of the business of the insurer, and which required to be performed by the insurer in terms of financial sector law. The FSR Act defines an "**outsourcing arrangement**" as follows:

> "…*in relation to a financial institution, means an arrangement between a financial institution and another person for the provision to or for the financial institution of any of the following:-*
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> *(a) A control function;*
> *(b) a function that a financial sector law requires to be performed or requires to be performed in a particular way or by a particular person; and*
> *(c) a function that is integral to the nature of a financial product or financial service that the financial institution provides, or is integral to the nature of the market infrastructure,*
>
> *but does not include:-*
>
> *(i) a contract of employment between the financial institution and a person referred to in paragraph (a) or (b) of the definition of "staff member"; or*
> *(ii) an arrangement between a financial institution and a person for the person to act as a representative of the financial institution;*"

in principles aimed collectively at the insurance, banking and securities sectors[4]. In developing the draft Joint Standard, the existing domestic regulatory landscape as well as international regulatory and supervisory standards were considered, specifically existing requirements provided for in *Prudential Standard GOI 5: Outsourcing by Insurers* made in terms of the Insurance Act of 2017[5] (the Insurance Act), and the *Insurance Core Principles* (ICPs) issued by the International Association of Insurance Supervisors (IAIS).

1.4 Section 107 of the Financial Sector Regulation Act (FSR Act) empowers the Authorities to make Joint Standards on matters in respect of which either of them has the power to make. Standards may also be made on additional matters specified in section 108 of the FSR Act, including risk management and internal control requirements, and outsourcing by financial institutions. The Insurance Act[6] requires an insurer to adopt and implement an effective governance framework that adequately protects the interests of its policyholders. The purpose of the Joint Standard therefore is to ensure that regulated financial institutions are able to manage the risks associated with outsourcing material activities and functions, and will assist the Authorities in achieving their regulatory objectives.

1.5 In terms of section 98 of the FSR Act, a financial sector regulator must not make a regulatory instrument[7] unless it has published the following documents:

(i) a draft of the regulatory instrument;
(ii) a statement explaining the need for and the intended operation of the regulatory instrument;
(iii) a statement of the expected impact of the regulatory instrument; and
(iv) a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.

[4] The IAIS, the Basel Committee on Banking Supervision (BCBS), and the International Organization of Securities Commissions (IOSCO). See report released by the Joint Forum, *Outsourcing in Financial Services*, available: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD184.pdf

[5] Act No. 18 of 2017

[6] See section 30, as well as ICP 8 of the Insurance Core Principles issued by the IAIS (Nov 2018) on outsourcing of material activities or functions, it is stated: "*The supervisor requires the insurer to retain at least the same degree of oversight of, and accountability for, any outsourced material activity or function (such as a control function) as applies to non-outsourced activities or functions*."

[7] For the purpose of this statement, this refers to a Joint Standard.

1.6 In fulfilment of the above-mentioned requirements, the Authorities have prepared a statement of the need for, intended operation and expected impact of the draft Joint Standard on outsourcing requirements for insurers (the Statement). This statement is intended to communicate to all relevant stakeholders the policy context and intended application of the draft Joint Standard, and to assist regulated institutions in complying with the draft Joint Standard.

2 Approach taken by the Authorities on the Joint Standard

Outsourcing risk

2.1 Outsourcing of functions or activities in the provision of financial products and financial services is integral to the growth of any modern business. The benefits of outsourcing by a financial institution could entail reduced costs and the ability to maximise efficiencies. However, the complexity of outsourcing arrangements also has the potential to exacerbate risk, and impact on the ability of a regulated financial institution to manage and monitor its own compliance with regulatory requirements. Outsourcing should not impair the ability of the Authorities to monitor an insurer's compliance with its regulatory obligations, nor compromise quality of products and services provided to financial customers and the ability of any insurer in fulfilling its legal and regulatory obligations.

2.2 Outsourcing poses a number of important challenges to both the regulated sector and the Authorities, particularly where activities or functions are outsourced to service providers who may not be regulated. One of the key lessons from the global financial crisis of 2008 (GFC) was the weaknesses in the governance frameworks of financial institutions. The GFC exposed the limitations of the internal controls and monitoring capabilities of some major financial institutions.

2.3 In addition to the GFC, various South African compliance failures have also highlighted the significant risks inherent in business models in which outsourcing of a significant part of an insurer's material functions is a key strategy. Too often the root cause of these failures was a consequence of poor governance practices and lack of oversight over the outsourced activities or functions being performed. Poor market discipline and culture of insurers has often been a driver of these undesirable outsourcing practices and invariably compromises the safety and soundness of insurers. When risks materialise, policyholders are ultimately the people that suffer the consequences.

2.4 Management of outsourcing risk is therefore critical from a conduct of business perspective, in order to ensure fair treatment of and better outcomes for policyholders. In light of this, outsourcing arrangements should not increase risk to an insurer, nor adversely affect the rights and fair treatment of policyholders. When outsourced relationships are entered into, there should be an alignment between an insurer and the service providers to whom functions may be outsourced both from a culture and conduct risk perspective. It is also important that the outsourcing arrangement creates better efficiencies for the insurer and policyholders from a customer services and cost perspective. When an outsourcing relationship is terminated, risks to policyholders should be mitigated and it must be ensured that policyholders are not negatively impacted. Policyholder data is vital in order to enable the servicing of policyholders and/or to ensure that the transfer of the services to a new service provider can be finalised efficiently and expeditiously. Appropriate mechanisms between an insurer and an outsourced service provider must therefore exist to ensure appropriate and timeous sharing of policyholder data.

2.5 An insurer retains responsibility for all regulatory obligations, regardless of whether or not an activity or function is outsourced. Therefore, outsourcing does not relieve an insurer of its responsibility in ensuring that outsourced functions and activities are conducted in compliance with applicable laws and regulations. An insurer’s board of directors (the board) is responsible for the prudent management and oversight of the activities and functions that it has outsourced, and any such decisions it may reliably take on the advice of a person to whom it has outsourced functions. Therefore, insurers need to understand the risks associated with outsourcing arrangements, and the impact third-party relationships have on the integrity and effectiveness of the insurance business, and the delivery of fair outcomes to policyholders. The outsourcing arrangements should not hamper the ability of an insurer in managing its risks and complying with its statutory obligations. The board must put in place an appropriate governance framework that enables the monitoring of risks and the effective management of third-party relationships in order to mitigate risks.

3 Statement of need of the Joint Standard

3.1 Historically, *Directive 159.A.i* issued by the former Financial Services Board (FSB) set out the regulatory framework governing outsourcing by insurers.[8] *Directive 159.A.i* applied in respect of all aspects of the insurance business that could be outsourced to another person and set out the overarching requirements that an insurer ought to comply with when outsourcing any of its insurance business. *Directive 159.A.i* also set out the key principles that ought to inform outsourcing. The Directive fell within the jurisdiction of the then FSB who was tasked with the supervision of insurers, both from a prudential and a conduct perspective.

3.2 On 1 April 2018, the FSR Act took effect, which introduced the "Twin Peaks" model of regulating financial institutions in South Africa by bringing about the establishment of the PA, tasked with amongst other things the prudential supervision of insurers, and the FSCA, tasked with amongst other things the conduct supervision of insurers. The FSCA essentially replaced the erstwhile FSB.

3.3 Subsequent to the FSR Act taking effect, in July 2018 the Insurance Act came into effect. The Insurance Act created a licensing and prudential framework for insurers. The PA was tasked with supervising and enforcing the Insurance Act, whilst the FSCA was still responsible for supervising and enforcing the requirements of the LTIA and STIA which provides the conduct of business legislative framework applicable to insurers.

3.4 With the advent of the Insurance Act, *Directive 159.A.i* was repealed and essentially replaced[9] by *Prudential Standard GOI 5: Outsourcing by Insurers* (GOI 5), which sets out the minimum requirements for the outsourcing of material functions by insurers, was issued by the PA under the Insurance Act. As the PA is the responsible authority for the Insurance Act, this change resulted in the outsourcing by insurers falling within the regulatory scope of the PA, and created a gap from a conduct of business perspective[10]. As a result, there is a need to

[8] *Directive 159.A.i* (LT & ST) issued under the Long-term Insurance Act and the Short-term Insurance Act respectively.
[9] As GOI 5 was to a large extent based on *Directive 159.A.i* and incorporated most of its requirements.
[10] Save for the outsourcing of binder functions as provided for in the LTIA and STIA, and Regulations thereunder.

expand the current outsourcing regulatory framework beyond GOI 5, in order to provide an appropriate and comprehensive regulatory framework governing outsourcing by insurers from both a prudential and conduct perspective. This is permissible in terms of the FSR Act where, in order to avoid unnecessary duplication, the Authorities may issue Joint Standards with respect to areas of overlapping jurisdiction.

3.5 The Joint Standard is therefore intended to harmonise the outsourcing requirements for the insurance sector, and enhance oversight by the Authorities. To achieve their respective objectives, the Authorities are empowered to monitor and keep under review the strengths and weaknesses in the insurance sector, and in doing so, must take into account the need for a primarily pre-emptive, outcomes focused and risk-based approach to regulation and supervision of regulated entities. Rather than applying duplicative requirements, part of the proposal is to repeal *GOI 5,* and replace it with the proposed Joint Standard. Justifiably eliminating the need to issue multiple Standards on the same, or substantially similar, matter ensures that outsourcing requirements are applied uniformly into a single instrument, with each Authority responsible for assessing on-going compliance with the Joint Standard in pursuit of their respective objectives. Such a decisive and holistic approach is at the heart of "Twin Peaks" regulation to enable early regulatory interventions that ensure a safer and more sustainable financial sector for the protection of policyholders.

4 Objective of the proposed Joint Standard

4.1 In order to fill the regulatory gap explained above, the Authorities are proposing the introduction of a draft Joint Standard on Outsourcing by Insurers. In developing the draft Joint Standard, international regulatory and supervisory standards and the existing domestic regulatory landscape were considered. Further considerations were the existing requirements provided for in GOI 5 and the *Insurance Core Principles* issued by the IAIS.

4.2 The draft Joint Standard is intended to address the following:

- Set out minimum requirements for the outsourcing of material functions;
- Set out the concept of "*materiality*" in the business of the insurer;

- Set out the conditions that determine when an outsourcing arrangement requires prior regulatory notification;
- Set out matters that an insurer must consider prior to an outsourcing decision and legal provisions that must be included in any outsourcing contract;
- Set out requirements for the management and review of outsourcing arrangements;
- Require insurers to have a board-approved policy and related procedures for assessing the risks involved with outsourcing; and
- Repeal and replace *GOI 5*.

4.3 The draft Joint Standard sets out the concept of materiality. The responsibility for assessing whether a business activity is material rests with the insurer, and certain matters must be considered prior to an outsourcing decision. These include the financial, operational and reputational impact of a service provider failing to meet its obligations under the outsourcing arrangement (especially the impact of multiple outsourcing arrangements that create interdependencies); the effect on the ability of the insurer to meet its obligations and to comply with the regulatory requirements; and the impact on policyholders (including losses) and other affected parties if the service provider fails to perform as expected. The contract between an insurer and a service provider must provide for business continuity processes should the service provider be placed under business rescue or insolvency, or is for any other reason unable to perform any of the functions or activities that are the subject of an outsourcing arrangement.

4.4 In addition, the Joint Standard provides that an insurer may not enter into outsourcing arrangements related to material functions without prior notification to the Authorities. Notifications must include information about the proposed outsourcing and the key risks associated with the outsourcing and the risk mitigation strategies that will be put in place to address those risks. An insurer must ensure that outsourced activities meet an equivalent level of standard and quality as if they were insourced and that the service providers meet the prescribed fit and proper requirements,[11] and have the operational capability and financial standing to deliver the outsourced function or activity.

4.5 In terms of the draft Joint Standard, an insurer's governance arrangements should ensure that the outsourcing of any functions or activities avoid or mitigate any conflicts of interest that may arise, and do not compromise the interests of policyholders nor the safety and soundness of the insurer itself.

4.6 The Joint Standard clarifies that any arrangement for the provision of a service or activity to an insurer by the insurer's controlling company, a subsidiary of the insurer, or a related or inter-related party of the insurer, is an outsourcing arrangement. An insurer must pay attention to its ownership structure and organisational form, and the risks associated with outsourcing arrangements as a result of interdependencies. It is incumbent on the insurer to monitor and develop appropriate risk-management tools to address these risks. The governance arrangements should ensure that decisions of the affiliated entities do not impair the ability of the insurer to manage its risk and meet its legal and regulatory obligations, and are not detrimental to the fair treatment of policyholders.

4.7 The draft Joint Standard imposes an obligation on the insurer to periodically manage and review its outsourcing arrangements to ensure the ongoing compliance of the arrangements with the Joint Standard and all applicable law. It is incumbent on an insurer to demonstrate competence and ability to understand the technical requirements of the business for which it is licensed to perform and to have appropriate contracts in place to manage the inherent risks associated with any outsourcing arrangement. The contractual terms must specify the level and standard of service that will be rendered by the service provider to the insurer, to ensure the effective functioning of the insurer's business. The contract must require the service providers to comply with applicable laws, including handling of confidentiality, data privacy and security of policyholder information.

4.8 Notwithstanding that retention of responsibility, an insurer may not enter into outsourcing arrangements related to material functions without prior notification

[11] As set out in *Prudential Standard GOI 4 (Fitness and Propriety of Key Persons of Insurers)*

to the Authorities. Notifications must include information about the proposed outsourcing, the key risks associated with the outsourcing and the risk mitigation strategies that will be put in place to address those risks.

5 Intended operation of the Joint Standard

5.1 The Joint Standard will apply to all insurers (including microinsurers) other than Lloyd's and branches of foreign reinsurers. The draft Joint Standard will be overseen by both the PA and the FSCA in pursuit of their respective objectives. This will ensure that the assessment of regulatory compliance is consistent across financial institutions engaged in similar economic activities and performing similar functions.

5.2 Any outsourcing arrangement entered into prior to the commencement date of the Joint Standard must comply with the requirements set out in the Joint Standard within one year.

5.3 Following the implementation of the Joint Standard, the Authorities will assess and evaluate its effectiveness on a continuous basis as part of the Authorities' supervisory responsibilities to ensure that any unintended consequences on the sector and general public are adequately addressed.

6 Statement of expected impact of the Joint Standard

6.1 The Authorities released the *'Draft Joint Standard on Outsourcing by Insurers'* for public comment, together with the document *'Questionnaire on assessment of the expected impact: Joint Standard on Outsourcing by Insurers'* to solicit for industry input on the expected impact of the draft Joint Standard. The purpose of the impact study was to assess the expected impact of implementing the Joint standard.

6.2 Of the insurers that responded to the consultation process, a total of 17 insurers, representing both life and non-life insurers, participated in the survey. Most insurers reported outsourcing binder functions as well as activities related to IT systems and heads of control functions. One insurer reported outsourcing a 100% of its business as a result of operating an outsourced mono-line model. All of the insurers report that a portion of the business was outsourced to 3rd party service providers, who were either regulated as FSPs or not regulated at all.

6.3 All insurers reported to have various policies, procedures and controls in place to monitor and manage risks associated outsourcing. These include outsourcing risk policies, fit & proper policies, and operational risk policies. In addition, comprehensive risk assessments, quality assurance audits and the usual due diligence processes were conducted regularly in order to mitigate any additional risks. Most of these policies are reported to be updated annually. Based on the responses, the outcome of the consultation noted the additional costs would relate to administrative and compliance costs. Concerns were raised that the additional costs of obtaining independent assessments and reviews. The main drivers of expected costs are reported to be additional staff, reporting and independent reviews, however the insures were not able to quantify cost.

6.4 In the context, the Authorities did note that the majority of the draft Joint Standard contained requirements that are already provided for in GOI 5, it therefore expected that the overall impact would not significantly hinder the ability of insures to comply with the requirements of standard. In addition, the Authorities are of the view that any potential additional costs are justified in the context, considering that prudent and responsible management of outsourcing of business activities is integral in the furtherance of the interests of an insurer, the protection of its policyholders and the overall interests of the financial sector.

6.5 In terms of the expected benefits, the proposed draft Joint Standard will streamline regulatory requirements, and avoid duplication without compromising on the quality, as each Authority is acting within their mandate and in pursuit of their respective objectives. This approach has the added benefit of ensuring that the Authorities will have a holistic view of the activities of the insurance entities subject to the draft Joint Standard, as information about the insurer and related matters will be collected, monitored, and enabling a better assessment of the risks connected with outsourcing arrangements and the impact on the insurance landscape.

6.6 Streamlining of regulatory requirements also provides the Authorities with a single source of reference as opposed to the bifurcation of regulatory instruments for similar economic activities that can lead to market distortions as a result of overlapping or duplicative requirements, and increased compliance costs for the industry. The draft Joint Standard is expected to yield enhanced efficiency, oversight and governance of insurers by removing the disparities that may lead to market failures as a consequence of entities that are engaging in similar economic activities being subject to different standards.

6.7 The Authorities expect that the Joint Standard will enhance safety and soundness, support the fair treatment of policyholders and will assist in reducing systemic risk and enhance public trust and confidence in the insurance sector. insurers need be able to demonstrate capacity to ensure safety and soundness, including balancing of risks and benefits associated with outsourcing. Protecting the interests of policyholders and relevant stakeholders should be at the forefront of risk management.

6.8 In practice, the FSCA and PA will adopt a risk-based approach to supervision of the Joint Standard, which means that focus and regulatory interventions will be commensurate to the risks and impact that entities pose to the financial sector. The FSCA and PA may also support compliance with the Joint Standard, helping insurers to understand their regulatory obligations, by providing additional regulatory guidance through for example a Guidance Notice.

7 Conclusion

7.1 The draft Joint Standard and this Statement are prepared and published in terms of section 98 of the FSR Act. Following the public consultation process, the Authorities have updated the draft Joint Standard and this statement accordingly.