

**THE IMPACT OF THE FINANCIAL ADVISORY AND INTERMEDIARY  
SERVICES ACT OF 2002 ON CONSUMER AWARENESS AND FINANCIAL  
SERVICE PROVIDERS IN SOUTH AFRICA**

*By*

**MANDUTH RAMCHANDER  
(Student number: 201001591)**

**submitted in fulfilment of the requirements for the degree of**

**DOCTOR OF COMMERCE**

**in the**

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**FACULTY OF COMMERCE, ADMINISTRATION AND LAW**

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.....

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- Management of Cresta, Kennilworth and Pavillion Malls for allowing me permission to administer questionnaires on their premises.

## DECLARATION

I hereby declare that this research is entirely my own work, that all sources used or quoted have been acknowledged and that this dissertation has not been previously submitted for a degree at another educational institution.

.....

Date: .....

**Manduth Ramchander**

## **DEDICATION**

I dedicate this work to my wife, Priscilla, and my children, Drishthi and Darshil. I cannot replace the time and moments that I could not share with you, while busy with this study. I hope that my children have gained an insight into the sacrifices that are sometimes necessary to fulfill objectives.

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## LIST OF ABBREVIATIONS

<b>ANOVA</b>	<b>Analysis of Variance</b>
<b>CCC</b>	<b>Central Coordinating Committee</b>
<b>CEO</b>	<b>Chief Executive Officer</b>
<b>CFO</b>	<b>Chief Financial Officer</b>
<b>CPD</b>	<b>Continuous Professional Development</b>
<b>CRM</b>	<b>Client Relationship Management</b>
<b>EMS</b>	<b>Economic and Management Sciences</b>
<b>FAIS</b>	<b>Financial Advisory and Intermediary Services</b>
<b>FICA</b>	<b>Financial Intelligence Centre Act</b>
<b>FSA</b>	<b>Financial Services Authority</b>
<b>FSB</b>	<b>Financial Services Board</b>
<b>FSCM</b>	<b>Financial Services Commission Mauritius</b>
<b>FSP</b>	<b>Financial Service Provider</b>
<b>GACPF</b>	<b>Generally Accepted Compliance Practice Framework</b>
<b>IAIS</b>	<b>International Association of Insurance Supervisors</b>
<b>IMF</b>	<b>International Monetary Fund</b>
<b>IOSCO</b>	<b>International Organization of Securities Commission</b>
<b>LSM</b>	<b>Living Standards Measure</b>
<b>NAIC</b>	<b>National Association of Insurance Commissioners</b>
<b>OCED</b>	<b>Organization and Economic Co-operation and Development</b>
<b>OFC</b>	<b>Optimal Federal Charter</b>
<b>SAARF</b>	<b>South African Advertising Research Foundation</b>
<b>SAQA</b>	<b>South African Qualifications Authority</b>
<b>SPSS</b>	<b>Statistical Package for Social Science</b>
<b>UK</b>	<b>United Kingdom</b>
<b>USA</b>	<b>United States of America</b>

## **ABSTRACT**

The financial services industry is characterized by product suppliers having more information than consumers regarding product features and services. The purpose of this study is to explore this information asymmetry with particular reference to the Insurance Industry. Financial advisors, acting as intermediaries, are charged with the task of resolving this asymmetry through mandatory disclosures demanded by regulation. In South Africa, the Financial Services Board (FSB) monitors, regulates and supervises the financial services industry through the Financial Advisory and Intermediary Services (FAIS) Act of 2002 (RSA, 2002) and The Code of Conduct (RSA, 2003) for Financial Advisors.

This study distinguishes financial products from other products and highlights the need for disclosures regarding product features, fees charged and contractual limitations of financial advisors. The dissertation starts with a review of literature on asymmetric information, regulatory interventions and consumer literacy. The subsequent sections deal with the methodology used, followed by results obtained and analysis.

Using multistage sampling a national survey was conducted to establish whether consumers: are knowledgeable of the features of basic insurance products; are aware of disclosures they are entitled to; and are aware of the consumer education initiatives of the Financial Services Board. The empirical survey also captures consumers' perceptions of their financial advisor's knowledge of financial products on the market. The extent of and the reasons for premature termination of policies are also established.

A survey was conducted amongst a sample of compliance officers to capture their perceptions regarding the disclosure of fees that are charged by financial advisors; clients' knowledge regarding the features of Life Insurance products; premature termination of policies and some general practices amongst financial advisors. The surveys were supplemented by an interview held with managers at the Financial Services Board.

The findings were that:

- financial advisors do not make sufficient disclosures regarding the financial advisor's fee that is charged.
- consumers of insurance products have a low to very low level of understanding of the features of basic insurance products and this is not a function of Gender, Race, Age Group, Place or Level of Education.
- consumers of insurance products perceive their financial advisors to be knowledgeable of the numerous products available on the market and that the financial advisor recommends the best product for them.
- financial advisors do not disclose, to their clients, their contractual obligations to specific product suppliers.
- consumers have a low to very low level of understanding of the features of basic insurance products.
- consumers have a low level of awareness regarding, legislation pertaining to the provision of financial advice, the activities and the consumer education initiatives of the Financial Services Board.
- compliance officers are predominately middle-aged, White, males with just under half of them holding legal qualifications and no financial/insurance related qualifications.
- there is a high incidence of funeral insurance being provided by entities that are not registered to do so.

It is recommended that:

- (i) the manner in which disclosures regarding financial advisors' fee is made, be revisited to include:
  - the verbal disclosure of the financial advisor's fee charged, over and above any written disclosure, as an important step in the advisory and intermediary process;
  - in the written disclosure of the financial advisor's fee charged, bold print or colour or some kind of differentiation should be used to highlight relevant information so that it stands out from the rest of the printed material; and
  - the client's initials should appear close to the highlighted information to signify that the relevant information has been brought to the client's attention.
  
- (ii) the manner in which disclosures are made regarding contractual obligations be revisited to include:
  - the verbal disclosure, over and above any written disclosure, as an important step in the advisory and intermediary process;
  - in the written disclosure of contractual obligations, bold print or colour or some kind of differentiation should be used to highlight relevant information so that it stands out from the rest of the printed material; and
  - the client's initials should appear close to the highlighted information to signify that the relevant information has been brought to the client's attention.

- (iii) the manner in which disclosure is made regarding a financial advisor or representative who works under supervision be revisited, to include disclosure in a similar manner to that recommended for the disclosures regarding financial advisor's fees charged, and disclosures regarding contractual obligations.
- (iv) the Financial Services Board:
- refocus the consumer education programmes to target consumers of Life Insurance products;
  - in consultation with product suppliers, design educational material for products that would be appropriate for 'life changing moments' of individuals and families;
  - run a column in the mainstream newspapers, where experts with no vested interests, are invited to write on issues relevant to consumers of life Insurance products; and
  - in consultation with product suppliers, prepare a generic product description differentiation matrix that is made available for clients' attention, through the financial advisor.
- (v) that disclosure requirements related to the premature termination of products be revised to the effect that:
- when the product is replaced by another product from the same product supplier, the processing of such a replacement should automatically initiate diagnostic measures at the compliance level to ensure that the premature termination is justified and not tantamount to churning;

- when the product is replaced by another product from a product supplier that is different from the original product supplier, then the disclosure document should comprise two sections. One section should be completed by the original product supplier, facilitated by the financial advisor that sold the product and the other section should be completed through the financial advisor selling the replacement product. Penalties or unrecovered expenses deductible or payable, tax treatment and the vested rights, minimum guaranteed benefits or other guarantees or benefits that may be lost as a result of the premature termination should be contained in the section that is to be completed by the original product supplier. These sections could appear on separate documents. These documents should ideally be standardized and prepared by the relevant authorities at the Financial Services Board.

(vi) the Financial Services Board:

- advertise its website using radio and television to publicise its functions.
- explore the possibilities of arranging for the major product suppliers to flight important FSB messages on their websites.

(vii) representatives working under supervision maintain a logbook that is updated on an on-going basis with regards to supervisory activities to:

- provide evidence that supervisory activity has been taking place on an ongoing basis as planned.
- ensure portability of the record of supervision when the representative joins a new FSP.

(viii) regulatory intervention is required in respect of funeral insurance to include:

- insurers underwriting funeral policies may do so only if it can be ensured that a proper premium collection platform exists or can be provided;
- benefits under funeral policies should offer the option of a cash payout or the provision of a funeral service where the consumer can elect his or her choice;
- where funeral insurance is sold through third parties, the insurer must certify that the premium charged has been determined on an actuarial basis; and
- third parties that collect premiums on behalf of the insurer must maintain a separate bank account and monies must be transferred to the insurer at regular predetermined intervals.

(ix) the Financial Services Board:

- extend the requirements for a compliance officer to include at least a year of industry experience.
- to make it mandatory for practicing compliance officers, without industry experience, to attend continuous professional development activities that is aligned to the insurance industry.

## CHAPTER 1

### AN OVERVIEW OF THE STUDY

#### 1.1 INTRODUCTION

Financial services are provided by institutions such as banks, insurance companies, credit card companies and stock brokerages. The insurance market is an economic institution where the insured is promised benefits in exchange of premiums made to the product supplier, which in this case is the insurer. Insurance companies pool the premiums of the insured to pay for losses of a few of the insured, thereby preventing a financial catastrophe for the sufferers. Pension funds pool the contributions of workers to invest for greater returns, so that a pension income can be provided to the workers after they retire. On the death of the insured, funeral insurance, allows for the payment of a modest cash amount or the provision of a funeral service.

The complex nature of financial products and the deferring cognitive levels of individuals, justify the existence of financial intermediaries that provide advisory services to consumers on behalf of the product suppliers, either in the form of agents or financial service providers. In doing so, the advisory services provided are supposed to resolve any informational misbalance that exists between the consumer and the product supplier. However, in practice, financial services are often characterized by information asymmetry, resulting in clients not fully understanding contracts (Davies, 1998). Financial intermediaries generally have better information than their clients with regards to financial products and any non-disclosure, misrepresentation or misselling on their part may lead to clients entering into contracts to their own downfall.

In addition to there being significant differences between financial products and other products, there are also significant differences amongst financial products, each with its own distinguishing features, benefits and costs. These distinctions may not be easy for the customer to grasp.

Consumer protection and financial literacy lies at the heart of fair play, and, ideally consumers of financial products should have the right to receive information that is clear, complete, accurate and comprehensible. Furthermore, there should be recourse mechanisms that are efficient and cost-effective. Consumers should also be able to access sufficient and appropriate financial education to understand the terms and conditions and other information provided to them by financial service providers.

The need for consumer protection arises from an imbalance of power, information and resources between consumers and their financial service providers, thus placing consumers at a disadvantage. Financial institutions know their products well, but consumers may find it difficult or costly to obtain information regarding their financial purchases. Information that may be too technical or complex would make it difficult for the average consumer to assess. Therefore, any consumer protection framework aimed at reducing the imbalances of power and information between consumers and financial service providers, needs to be very well-designed.

In South Africa, the provision of financial services is regulated by the Financial Services Board, which can enforce its authority through the Financial Advisory and Intermediary Services Act of 2002, which is commonly referred to as the FAIS Act (RSA, 2002). Through the provision of the FAIS Act, the Code of Conduct for Authorized Financial Service Providers and Representatives was established, making it mandatory for a range of disclosures to be made to clients, when an advisory service is provided (RSA, 2002).

The Office of the Ombudsman for Financial Services Providers was established through Section 20(1) of the FAIS Act, and lists the duty of the FAIS Ombud as being to consider and dispose of complaints by clients against financial services providers in terms of the FAIS Act. The FAIS Ombud Committee (2008) reported that material terms and conditions are frequently not brought to the attention of the client, and there have been several judgments made due to cases of non-disclosure.

This thesis starts with a review of literature on information asymmetry, regulatory interventions and consumer literacy. The subsequent section deals with methodology used followed by an analysis of the results. Finally, the study discusses findings, identifies the implications and offers the conclusions and recommendations.

## **1.2 Motivation for the Study**

Van Zyl (2006) raised the question whether it would be reasonable to expect clients to inform themselves before entering investment markets, as they often make an effort to educate themselves before purchasing movable and immovable property (furniture, vehicles and residential property). This study attempts to answer this question by contextualizing the nature of financial products and highlighting the need for regulation.

Manuel (2005:11) stated that “poor and inadequate disclosure of fees and charges has been haunting the industry for decades and having the legal architecture in place is no panacea”. Using this as a point of departure, given the regulatory interventions via the FAIS Act (2002) and the Code of Conduct previously mentioned, the literature review did not evidence any empirical research undertaken to establish what the actual levels of disclosures regarding fees were.

The profile of users of life insurance products is classified into categories of higher levels of living standards as measured by a Living Standard Measure Index (FinMark-Trust, 2004). Higher living standards generally translate into higher levels of academic education. However, it is questionable whether higher levels of academic education do necessarily translate to better decision-making regarding financial products. Despite the consumer education initiatives of the Financial Services Board (FSB), an increasing number of cases are being heard by the Ombudsman. The FSB has the responsibility to oversee the consumer education function. The literature review has not evidenced any research that has been conducted regarding the appropriateness or effectiveness of the consumer education initiatives.

The critique against insurance companies is captured in the following statement made by the Ombudsman of long-term insurance (Nienaber, 2005:5): “One thing you can say about insurers and their marketing material is that they convey an impression of help and assistance, of the milk of human kindness flowing freely towards all mankind, especially potential policy holders, but, judging from the stories we get, beneath that benevolent façade, beats a heart of stone”

Furthermore, the National Treasury (2008) notes that a large proportion of the South African population remains excluded from formal financial services. It also recognizes the challenges presented by changes in intermediation patterns through funeral policies being underwritten and sold through funeral parlours.

### **1.3 Research Questions**

The questions that this study attempts to answer include:

- What are the challenges, recognized by the Financial Services Board, that Financial Service Providers face in complying with regulatory provisions?
- Do financial advisors make the necessary disclosures, as demanded by regulation, to consumers of financial products?
- Do consumers of financial products understand the features of basic insurance products most commonly sold?
- Do consumers of financial products perceive their financial advisors to be knowledgeable on all the products available on the market?
- What are the consumer education initiatives, relating to financial services and products, of the various role players in South Africa?

- How do South African consumer education initiatives, relating to financial services and products, compare with international initiatives?
- Do financial advisors make the necessary disclosures, as demanded by regulation, from a compliance perspective?
- What are the challenges facing the funeral insurance in South Africa?

#### **1.4 Research Objectives**

The main objectives of the study are as follows:

- To interview senior managers at the Financial Services Board to ascertain the challenges faced by Financial Service providers in meeting regulatory requirements.
- To establish the extent to which financial advisors disclose to consumers the fees charged and any contractual obligations to specific product suppliers.
- To establish the extent to which consumers can differentiate between the features and limitations of basic insurance products commonly sold.
- To capture consumers' perception of their financial advisor's knowledge of financial products on the market.
- To undertake an analysis of consumer education initiatives of the Financial Services Board.
- To compare the South African consumer education initiatives with a few international initiatives in USA and the UK.

- To capture the perceptions of compliance officers regarding disclosures, consumers' knowledge of life insurance products and premature cancellations of policies.
- To undertake an analysis of the funeral insurance industry in South Africa.

## **1.5 Research Design and Methodology**

The theoretical basis for the research process consists of scientific works of recognized scientists. The methodological basis was created after thorough and extensive analysis of scientific literature. In this thesis, general epistemological considerations are approached from a position of positivism, and ontological considerations are approached from a position of objectivism.

A descriptive study was undertaken and a formal approach was adopted, beginning with questions, incorporating exact procedures and data collection specifications. The goal was to gain answers to the research questions. Cross-sectional studies were undertaken that aimed at capturing the profile of the population characteristics by making inferences from sample characteristics. The method of data collection included a survey with two questionnaires being administered to collect data as well as an interview. Secondary data was gathered via desktop research and electronic means. To address the research questions relating to consumer education, multi-stage sampling was employed. Random sampling was employed to gather information from compliance officers.

## **1.6 Limitations of the research scope**

A thesis of this nature cannot contain comprehensive reform plans as there would be other factors acting on the provision of financial services beyond information asymmetry. Furthermore, this research is devoted to one sector of the insurance market. The focus is on personal insurance, life insurance in particular, and excludes commercial insurance and other forms of insurance such as short-term insurance and credit life insurance.

## **1.7 Practical and Ethical Considerations.**

Respondents remain anonymous and informed consent was obtained before administering questionnaires. Confidentiality has been maintained throughout the study due to the sensitive nature of the research.

## **1.8 Outline of Chapters**

This thesis embraces seven chapters and a list of references structured in a way to include a discussion of the material extrapolated from a theoretical basis and an empirical survey:

Chapter 1: *An Overview of the Study* contains the introduction and introduces the research problem, aims and objectives of the study, research methods, theoretical perspectives and research methodology.

Chapter 2: *An Overview of the Literature* introduces the concept of asymmetric information, intermediation and remedies for asymmetric information in the provision of financial services. Financial regulation is discussed as one of the means to cope with the consequences of asymmetric information. The nature of financial products is discussed and the necessity for financial regulation and the different forms of financial regulation is explored. The various definitions, theories and models relating to information asymmetry, financial regulation and consumer education will be explored. Existing data and empirical findings, relating to the topic, that have been produced by previous studies were pursued.

Chapter 3: *The Regulation of Financial Services in South Africa* describes the role of the Financial Services Board. Legislative requirements arising from the Financial Advisory and Intermediary Services Act of 2002 and the Code of Conduct are discussed within the context of disclosures and consumer education.

Chapter 4: *Consumer Education and Financial Literacy* looks at the role of financial education. Financial literacy programmes in the United States of America and the United Kingdom are outlined and compared to those in South Africa.

Chapter 5: *Research Methodology* focuses on a discussion of the research methodology applied in this study. Incorporated in this chapter are the description of the sampling techniques adopted and the composition of the sample. The survey instruments are described and the administration thereof are discussed. The analytical tools that would be used for the analysis in the next chapter are discussed.

Chapter 6: *Analysis and Interpretation* in this chapter are devoted to analyzing and interpreting data collected from the surveys.

Chapter 7: *Conclusions and Recommendations* conclude the empirical perspectives and provide conclusions and the recommendations on the research conducted, as well as recommended areas for further research.

## **1.9 Conclusion**

In this chapter, the rationale for the study, the problem statement, objectives and research methodology were discussed. In the next chapter, the literature review, a conceptual framework based on asymmetric information and related theories relating to the study are discussed.

## CHAPTER 2

### AN OVERVIEW OF THE LITERATURE

#### 2.1 Introduction

Financial services are provided by institutions such as banks, insurance companies and credit card companies. Insurance for individuals is underwritten by insurance companies and offered primarily through agents and brokers that can be generally viewed as intermediaries. Modern retail financial services are often characterized by information asymmetry resulting in clients not fully understanding contracts (Davies, 1998).

Asymmetric information exists when one party to the transaction is better informed than the other party and in exercising their roles, intermediaries for example, are supposed to resolve this asymmetry. Intermediaries generally have better information than the clients with regards to financial products, and non-disclosure, poor product description, misrepresentation or misselling on their part may lead to clients entering into contracts to their own detriment.

Asymmetric information is further polarized by clients being unable to determine the quality of the product at the time of purchase. With financial products, experiential learning is limited as purchases are made less frequently, the value of the financial product is difficult to establish at the time of purchase and the nature of the product is abstract. Besides, there being significant differences between financial products and other products, there are also marked differences amongst products, each with its own distinguishing features, benefits and costs. These distinctions may not easily be grasped by clients.

Falkena *et al.*, (2001:24) assert that: “wherever asymmetric information flows are evident, and where the consumer can be exploited, there is an important consumer protection role for the regulatory authorities with integrity, transparency and disclosure in

the supply of financial services being promoted". Remedies for asymmetric information include signaling, advertising or branding, screening, reliance on reputation and regulatory interventions.

Asymmetric information can lead to market failure and this creates a rationale for government intervention. The case for regulation is further strengthened by marked differences between financial and non-financial services. Regulatory interventions also aim to secure systemic stability, institutional soundness through prudential or conduct of business regulation. There are contrasting approaches to regulation with one being the principles-based approach and the other being the rules-based approach.

Schiro (2006) argues that when regulation sets a framework that is complementary to markets, the efficiency and sustainability of markets are enhanced, particularly in the context of markets integrating into one global economy. It is important that regulation be consistent across the markets, otherwise regulation becomes a constraint hampering global firms (Adams *et al.*, 2008).

In this chapter, the concept of information asymmetry will be fully explored and some remedies used to resolve information asymmetry will be discussed. The nature of financial products will be explained to highlight the existence of information asymmetry in the provision of financial services. Finally, financial regulation will be discussed in the context of resolving information asymmetry in the provision of financial services.

## **2.2 Asymmetric information**

Information can be seen as a valuable economic factor, especially in the allocation of scarce economic resources (Nicholson, 1998) and one can determine actions such as, where purchasers buy higher quality goods or services at lower prices (Stigler, 1961). Newton (2008) contends that the most efficient outcomes for economies generally occur when markets operate freely and in perfect competition. Perfect competition is characterized by free entry to and exit out of the market and the availability of perfect

information to buyers and sellers (Newton, 2008). Stiglitz (1993) describes a market where there is perfect information as being one where economic agents have full information about each other and about the goods or services being bought or sold.

In reality, buyers may not have full knowledge of the products and services they buy, and sellers may have a limited knowledge of buyers, thereby creating a situation of imperfect information. Market failure can result from imperfect information as well as incomplete information, misrepresentation and misselling. Asymmetric information is a specific aspect of imperfect information where one individual related to an economic decision has different information to that of another. Asymmetric information may cause the less informed market participant to conclude contracts to their own detriment (Kals, 2007).

The pioneering contributions of George Akerlof, Michael Spence and Joseph Stiglitz form the basis for the theory of markets with asymmetric information (Karl-Gustaf *et al.*, 2009), where phenomena are explained by augmenting the theory with the assumption that one side of the market has better information than the other. Asymmetric information and adverse selection was pioneered by Akerlof (1970), noticing that in markets characterized by asymmetric information, the average value of the commodity goes down, even for commodities with a perfect quality. Akerlof (1970) explored the used car market as an example where buyers do not know whether the cars are “lemons” (of poor quality) or “oranges” (of good quality), so buyers will offer to pay a price between that of a “lemon” and “orange”. The implications of this would be that sellers of good quality products would be reluctant to enter the market, resulting in the average quality of the product on the market being lowered. The price of the product would then drop even further, resulting in sellers of good quality products to stay out of the market.

Misrepresentation is a form of wrongful conduct normally consisting of a false statement of fact causing the other party to react thereto, by entering into a juristic act (Van der Merwe *et al.*, 2007). Nienaber & Reinecke (2009) differentiate misselling from misrepresentation as not relating to false statements, but the expression of an opinion given in the form of advice by someone holding himself/herself out as an expert for that

purpose and has particular reference when the advice is furnished in the field of investments.

Misrepresentation takes place when service providers give advice or profess to possess, when they in fact lack, the requisite qualifications, knowledge, expertise and experience. This is different from misselling which relates not to misstatements inducing the mandate to furnish advice, but to the actual advice furnished in terms thereof (Nienaber, 2005). For example, when an intermediary, acting on behalf of the insurer, assures the policyholder that the return on an investment policy is guaranteed when it is actually not, would be considered a misrepresentation. On the other hand, when an intermediary advises a client to invest in what the intermediary should have realized was a pyramid scheme, would be considered misselling. Misselling also often consists of a commendation to venture into a new investment product or to change or discontinue an existing one. During 2009, the Life Insurance Ombudsman dealt with 173 cases of misselling, 53% of which were in favour of the complainant (Cameron, 2011).

When one market participant has better information than the other market participant, informational misbalance exists (Christozov, Chukova & Mateev, 2006). Kenneth J. Arrow (as cited in Christozov *et al.*, 2006), first introduced this misbalance as a moral hazard. A moral hazard is described as a hidden action problem, where the actions or inactions of one side of the market are unobservable to the other side, resulting in an increased probability of undesired outcomes for one party and the market (Varian, 1990). Other definitions include “the tendency whereby people expend less effort protecting those goods which are insured against theft or damage” (Frank, 1991:46). “Moral hazard arises when individuals, in possession of private information, take actions which adversely affect the probability of bad outcomes” (McTaggart, Findlay & Parkin, 1992: 98). In the preceding definitions, the key feature of moral hazard seems to be hidden action.

Bruce Cameron, an acclaimed journalist warned readers against ‘crooked financial advisors’ who have made themselves beneficiaries of life assurance policies without the policy holders apparently knowing about it (Cameron. 2011). In the insurance industry, the moral hazard on the insurer’s side may include the refusal to pay large claims and cancellation of the contract when the policyholder is not at fault. In 2010, the life insurance ombudsman finalized 2279 complaints about repudiated claims and in 47% of the cases, life insurance companies were instructed to pay (Cameron, 2011).

Adverse selection occurs, in a situation where something about the characteristics of one party is not known to the other party and is often referred to as a hidden information problem in the market, where for example, sellers may know more about a product than a customer (Estrin & Laidler, 1995). Devlin (2005:1042) contends that “asymmetric information may impede entry into financial markets for some consumers, through self-selection” and Williams (2007: 223) adds: “among consumers who do enter the markets, the adverse consequences range from buyers’ remorse, through economic loss from unsuitable products, to financial ruin”.

### **2.3 Intermediation**

Insurance products for individuals are underwritten by insurance companies and offered primarily through agents and brokers that can be generally viewed as intermediaries. Intermediaries mediate to facilitate a transaction between the insurer (product supplier) and the policy holder. The introduction of new business for the insurer entitles the intermediary to a commission in the form of an initial payment. The intermediary may also be entitled to a servicing fee in the form of an annual fee for activities, such as handling enquiries, processing claims, and providing updates.

Allen & Santomero (1999:4) describe the role of intermediaries to be: “the rendering of services to clients to bridge the gap between client’s lack of knowledge and the expertise required to get the most out of increasingly sophisticated financial markets”. Scholtens &

Wensveen (2000) go to the extent of postulating that as soon as markets are perfect, intermediaries would lose their function and become redundant.

The term “agent” is more commonly used to denote someone who acts as a middleman on behalf of someone else. In an insurance context, such agents are insurance agents or insurance brokers. The agents would be those employed by the insurer by means of a contract of employment. Such a representative would typically be committed to market the products exclusively of that particular insurer or others approved by it. The broker, on the other hand, would negotiate between different insurers with a view to facilitating a contract between an insurer and the insured. The insurance broker, although mandated by the insured, is not remunerated by the insured, but by the insurer via a separate arrangement and are supported by broker consultants who are employees of the insurers. Within the context of the provision of financial services, the concept of commission is generally understood to mean an amount of money paid to the financial advisor by the product supplier, but charged directly or indirectly to the consumer.

Paces (2000:483) raised the concern that: “in a typical asymmetric information setting, the likelihood of opportunistic behaviour gives rise to a serious concern regarding the reliability of the financial intermediary’s advice as investors cannot easily evaluate the quality of the financial information and services provided to them”. Consumers can therefore choose an intermediary that may put their own interest (commission) before that of the consumer (Herrig & Santomero, 1995). A policy holder may be wrongfully persuaded by the intermediary, for the purposes of earning extra commission, to cancel an existing policy and replace it by a new policy. This practice is termed churning. When an existing policy is terminated and replaced by a new policy, other upfront costs including commission become payable. Churning at times can take on alarming proportions and transactions involving policy replacement should be closely regulated (Nienaber & Reinecke, 2009).

Another example of own interest above that of the customer could be the overselling of disability insurance, for the purposes of earning commission, resulting in clients paying

for cover that exceeds the amount allowed by law. Botha *et al.*, (2010:242) note that: “The Code of Good Practice for Disability Insurance includes the principle that avoids accepting cover at levels that would make an individual better off after claiming”. The morale hazard would be that, excessive benefits would create an incentive for claiming.

In practice, the financial advisor is supposed to request the client to disclose all other disability cover to establish whether the client is not over-insured before selling any new disability cover. Notwithstanding this, it is common practice for the financial advisor to obtain a letter of authority signed by the client which authorizes the financial advisor to obtain information about products held by the client with other product suppliers. If the client is over-insured, the benefit payable would be reduced proportionately at the claims stage. For example, if a 50 year old client has a total disability cover for R5 000 000, then at the claims stage, the client should be entitled to monthly payments of around R40 000. However, if his monthly salary was R30 000 per month, then that R40 000 would be reduced to R22 500. The aggregate appropriate disability cover for this client should have been not more than R2 700 000. What complicates the matter even further is that clients take private disability cover as well as disability cover under group schemes through the employer, where participation may be compulsory. Fortunately, the cost of disability is minimal when compared to the cost of life cover. Nonetheless, collectively this is tantamount to huge financial resources becoming wasting assets from the clients’ perspective.

With regards to the provision of financial services, Malherbe & Morojele (2001) reported that asymmetric information can be so extreme that the client knows virtually nothing of the product being offered, the nature of the organization offering it, and the intermediary advising the client to buy it, making it difficult for clients to distinguish between good and bad products, explaining why repeated abuse of clients can occur in intermediation. What makes the situation worse is, at the time consumers enter into insurance contracts, they do not actually have the detailed terms of the policies at their disposal, and even if they did, it is very doubtful that they could fully appreciate the terms, because of their professional and cognitive limitations (Schwartz, 2008).

It was earlier stated that intermediaries may have the effect of reducing knowledge gaps, but their presence may have some undesired outcomes. For example, through the use of intermediaries, the opportunity for product suppliers to build long-term relationships with customers is eroded (Fitzgibbon & White, 2005). A very fair question to be raised, relating to the situation where an intermediary terminates the relationship with the product supplier, would be whether the client maintains the contract with the product supplier or whether he or she is induced to switch to the product supplier that the intermediary subsequently becomes associated with.

A 1998 United Kingdom Consumers Association Report (as cited in Falkena *et al.*, 2001) stated that the informational imbalance between the consumers of insurance and investment products and the financial service providers posed problems because of latent penalties for switching and the impossibility of consumers to work out charges because of the use of obscure language that disguise charges.

## **2.4 Remedies for Asymmetric Information**

Spence (1973) first proposed the idea of signaling, suggesting that people signal their type and in doing so transfer to the other person the information that resolves the asymmetry of information. Signaling is an action initiated by the better-informed party to communicate its characteristics in a credible way to the less informed party and in doing so, the opposite party is convinced of the value and quality of the products. The better informed party communicates attributes through signals. For example, higher deductibles and lower premiums will be attractive to low risk consumer.

Advertising and branding are two ways of improving the quality of the signal to try and persuade the consumer that what is being offered is really an “orange” and not a “lemon”. In a study done in the United Kingdom to establish how financial services firms manage their brand architecture, Devlin (2003:1044) found some evidence to suggest that: “a number of financial services organizations grapple with the question of the appropriate approach to the management of their brand architecture”. Another study exploring the

role played by branding regarding the selection of banks by small business owners, Abou, Ennew & McKechnie (2003:1023) found that: “there was only a very limited empirical evidence for the role played by brands in highly intangible contexts such as financial services”.

Stiglitz (1975) pioneered the theory of screening which induces the uninformed party to reveal private information through a structured menu of choices that elicits the other party’s characteristics. Screening is the initiative of the less-informed party. For this theory to be put to practice, the less informed party would require the necessary skills to develop a menu of structured choices or have access to an existing set that is appropriate to the situation. In the insurance context, the less informed party is usually the client, who would also usually be the party with limited skills.

Investors may seek to rely on reputation to overcome informational problems. This may not always be feasible as there have been many scandals involving firms and individuals that have been perceived to have excellent reputations. The scandal involving Fidentia is an example which involved the misappropriation of clients’ monies through a proliferation of private entities (Dixon, 2008).

The problems created by asymmetric information create a rationale for regulation (Llewellyn, 1995) and the provisioning of financial services regulation can address these market imperfections by firstly ensuring that the client is better informed, and secondly, ensuring that product suppliers and intermediaries are honest, competent and financially sound (Malherbe & Morojele, 2001). To the contrary, Schwartz & Wilde (1979) claim that asymmetric information does not always result in markets failing, arguing that marginal consumers exert market constraint on supplier’s opportunistic behaviour. The rationale for the argument is based on the existence of a large enough group at the periphery, who are knowledgeable about market price and quality, that shop around for price and quality combinations that suit their needs. Consequently, suppliers compete for the same consumers at the margin with the net result being that the uninformed becomes protected.

Paccès (1996) commented on the Schwartz and Wilde argument acknowledging that it may be valid for search goods, but criticized it for saying little about markets for experience goods and even less about markets for credence goods, such as financial services. Paccès (2000) also argues the point that market imperfections are characteristic of a wide range of non-financial products and services, but market or business conduct rules and enforcing authorities are in such cases not available to the same extent as in the case of financial markets. However, McVea (2005:430) has noted that: “there has been a remarkable degree of unanimity about the need for comprehensive regulatory controls governing the operations of financial institutions and financial markets”. Much of the consensus derives from the conception that financial markets are very distinct from other kinds of economic activity.

## **2.5 Nature of Financial Products**

Products and services are frequently divided by the economic literature into the following categories, depending on their characteristics: search goods, experience goods and credence goods (Ogus, 1994). There are costs associated with gathering the necessary knowledge and appropriate expertise to make a purchasing decision. These costs are somewhat lower for search goods and significantly higher for credence goods (Paccès, 2000).

With search goods such as clothing, equipment and furniture, the value and quality can be ascertained in advance, the product can also be tested in advance and there may be guarantees or warranties attached, allowing for the rectification of future faults. Furthermore, the value of most products declines over time, lowering the net replacement cost at some time in the future, while that financial nature generally increases with time.

With financial products, the consumer’s opportunity for experiential learning is very limited, as such products are not purchased on a regular basis or frequently. The consumer’s ability to also learn from the experience of others is limited as matters concerning financial products are considered to be very personal and not discussed openly with others. Ironically, one will openly discuss the purchase of an expensive

motor vehicle or house, exploring the pros and cons with another individual, but yet would not engage another on an investment issue, even though if it involves a smaller sum of money. Consequently with credence goods, such as financial products, the value or quality is difficult to establish before and even after the purchase. The financial services market is different from other markets, such as the real estate market or automobile market, wherein goods may be exchanged even under possible asymmetric information, in that with financial services the feedback is not immediate (Paccos, 2000). For example, any latent defects in a vehicle, not declared by a seller to the buyer, are generally bound to manifest itself within a short period of time. The reality is that an extended period of time needs to elapse before one becomes aware of the true value of a financial product or for that matter any shortcomings.

The consumer's ability to learn from experience may be further constrained by the situation where the customer commits to a long term relation with the intermediary (Paccos, 2000). In a long term relationship, where trust and loyalty become the key features, it would be interesting to establish how poor product performance is explained in such a relationship. It would not be unexpected for the intermediary to blame external circumstances such as market influences for poor performance of products rather than incompetence.

While it is acknowledged that an intermediary may be able to present the client with a range of products to choose from, even from different product suppliers, the client's commitment to a single financial service provider may limit the client's options to negotiate any fees charged especially when the financial service provider does not voluntarily discuss the negotiability of her/his fees. In such a relationship, it would be a rare occurrence for the client to check if the same product could be delivered more cost effectively, than through the existing service provider. Bob Burg is renowned for the golden rule which states "All things being equal, people will do business with, and refer business to, those people they know, like and trust" (Pockell & Avita, 2006:33).

In any event, it is doubtful that it is common practice for a client to engage a number of financial service providers simultaneously to acquire a product to satisfy a particular need. This issue warrants further exploration as the same product or a product with equivalent features that can be delivered at a lower initial and annual cost to the client could make a substantial difference over the term of the financial product.

## **2.6 The Insurance Market**

Black and Skipper (1987:14) define insurance as “a social device that combines the risks of many individuals into a group, mathematically predicts losses and uses funds contributed by members of the group to pay for losses”. The insurance market is a vitally important economic institution where mutually beneficial exchanges between consumers and insurance companies take place. Consumers purchase the promise of the insurer to cover the financial consequences of a possible loss, paying the insurance premium for this service. The insurers take the liability to cover the losses in the case of probable harmful events, and issue a contract called the insurance policy. Information is crucial for this market exchange to take place.

South Africa has one of the highest insurance penetrations in the world when measured in terms of premiums as a percentage of Gross Domestic product (GDP), 14% of GDP which exceeds the market average of 3.9% for emerging markets and the 9% average for industrialised countries (Swiss, 2006). During apartheid, insurance companies rarely served the majority of the population, which is the Black race group, but within a very short period of time insurance have become a crucial part of dealing with risks for the poor and middle classes (Bahre, 2011).

### **2.6.1 The Importance of Life Insurance**

The importance of Life Insurance is sometimes understated and is included here for emphasis. Life Insurance provides protection for families and individuals as death proceeds can be safeguarded for the benefit of beneficiaries by being protected against

claims from creditors. Life Insurance contributes to social stability by enabling individuals to minimize financial stress and worry, and it reduces the burden of the state of having to financially support those made destitute by the death of a breadwinner.

Life events that induce or trigger the need for insurance include: a change in marital status, the birth or adoption of a child, a change in employment status, a divorce or separation, the death of a spouse or the dependent or cohabitation. A major part of settling down with a partner involves making plans for the future such as a home, raising a family, and eventual retirement, all of which requires careful planning and creates special insurance needs. If one spouse is the principal wage earner, then life and disability insurance is important to protect this source of family support. Children create both long term and short term insurance needs. With young children, there will be a need to make provisions to provide for them financially, if one is not able to because of death or disability.

Divorce can be a difficult time for those involved and, in particular those that have been relying on another principal wage earner may, find gaps in insurance coverage. Many households today do not fit the traditional family model. For example, couples that choose to live together without the legal bonds of marriage have many of the same insurance needs as married couples but, due to the lack of legal marital status, some employer provided insurance benefits may not be made available to the partner.

Another important component to insurance is microinsurance. Microinsurance refers to insurance that is accessed by the low income population and includes provision for funeral insurance. While it is common for people to have life insurance to take care of loved ones, in the developing world one of the greatest financial shocks a family can experience, is the funeral expense of a loved one.

## 2.6.2 Cultural Elements in Insurance

The purchase of a life insurance policy is a complex and abstract decision, involving uncertain future benefits linked to the eventuality of death. Park & Lemaire (2010) argue that it is unrealistic to assume that consumers will approach life insurance as rational economic agents and believe that culture impacts on decision-making. Park & Lemaire (2010:3) define culture as a collective mental programming, the part of beliefs and values that are shared with members of the extended family, social group, region, country, but not with others.

Individualism and power distance are two cultural dimensions identified by Hofstede (2001). In individualistic societies, such as the US and the UK, there is a tendency for each person to look after his or her interest and that of their immediate family. In contrast, in a collectivist society such as China, there are close ties between individuals with care being taken for the extended family or group. Park and Lemaire (2010) contend that people with an individualistic perspective on life, tend to rely more on insurance for protection than on informal agreements within their group to provide financial security.

Power distance measures how people react to the inherent inequalities in society. According to Chui & Kwok (2008), in high power distance countries such as India and China, individuals readily accept inequalities and surrender to authority and power, but in turn expect their superiors to improve their welfare and take action to reduce their risk. Park & Lemaire (2010), postulate that in such a case the need for insurance would be lessened, due to the expectation that on the death of a breadwinner, the family will be taken care of.

Some cultures place significant emphasis on a dignified funeral. In South Africa, a dignified funeral is given high priority as part of the cultural belief in the importance of honouring ancestors with funerals, including food and transport as the norm (Hougaard & Chamberlain, 2009). Roth (1999) found that funerals in one South African Township

cost approximately fifteen times the average monthly household income. Nabeth & Barrau, 2010, likewise showed that Haitians believe that a dignified funeral is essential to ensure that the soul of the departed will look after them, but point out that this prioritization is not universal, citing the case of Muslims in Senegal where funerals are not emphasized to such a degree.

The strong link between funeral insurance and the underlying service, the funeral, introduces a degree of tangibility to insurance and is recognized as an important driver of demand (CENFRI, 2011). An estimated R5bn per year is spent on funerals in South Africa (CENFRI, 2010). Funeral insurance will be discussed separately under section 2.7 of Chapter 2.

### **2.6.3 Supply and Demand for Insurance**

While risk transfer through insurance is considered to be an appropriate means to mitigate risk, it is often considered to be a “grudge purchase”. For example, while a vehicle owner is prepared to pay premiums to cover future losses that may be incurred through an accident, he/she may consider the premiums paid as a “loss” if no claims are actually made after a period of time. The insured may incorrectly conclude that the insurer has “gained” from the no claim situation. This analogy of the vehicle may be extended to the life insurance as well. The insurance mechanism is based on the concept of pooling the risks of many into a group, accumulating a fund from premiums and paying from this fund for the losses of a few who die. To set premium rates, the insurer calculates the probability of death among its insureds and predicts future losses based on past observations of similar insured groups (Dorfman, 2006).

Insurance theory, developed by Friedman and Savage (1948), claims that risk-averse individuals will always purchase insurance when offered at an actuarially fair premium and that they will purchase insurance, paying up to a risk premium  $\pi$ , above the expected loss. The mathematical model for a single loss exposure is modeled as follows (Ross, 1981: 625):

- (i) The measure of utility,  $U(W)$ , associated with wealth,  $W$ , is a well behaved twice differential where  $U'(W) > 0$  and  $U''(W) < 0$ . That is the marginal utility of wealth increases with wealth, but at a decreasing rate;
- (ii) The utility of zero wealth is assumed to be infinitely negative [ $U(0) = -\infty$ ];
- (iii) For a single loss,  $L$ , with probability,  $p$ , the expected loss and expected wealth will be  $E(L) = pL$  and  $E(W) = p(W-L) + (1-p)W$  respectively;
- (iv) The actuarially fair rate of premium would be  $E(L) + \lambda$ , where  $\lambda$  compensates the insured for expenses and return on capital;
- (v) The wealth in both loss and no loss state would be the initial wealth less the insurance premium ( $W - pL - \lambda$ ); and
- (vi) Individuals will choose to purchase insurance as long as  $\lambda$  is lower than  $\pi$ .

In short, people choose to mitigate risk by transferring the risk to an insurance pool (knowing or unknowingly) using the mechanism of insurance, but there are limits to the premiums they are willing to pay.

#### **2.6.4 Characteristics of Insurance Contracts**

Schwartz (2008:113) summarizes the special characteristics of insurance contracts as follows: “Firstly the subject matter of insurance contracts is an abstract and intangible one. Secondly, the manner of entering into an insurance contract differs from that of other contracts. Thirdly, the insurance contract is usually a standard or adhesion contract. Fourthly, the contents of insurance contracts are lengthy and strewn with concepts that are difficult for a non-professional to understand, and finally, the contract is a relational contract.”

With contracts of adhesion, the smaller party to the transaction has no real ability to negotiate and is subject to the terms dictated by the larger or stronger party and, therefore, the insured's freedom to negotiate and ability to influence its terms are limited. In contract law, courts generally resolve disputes by examining parties' mutual intent which is in contrast with disputes involving insurance contracts, where courts resolve disputes by ignoring the actual intent of the parties and resolve disputes through interpretation of the contract (Scwartz, 2008).

Interpretation rules of insurance are designed to accord protection to the consumer. One example cited by Birds (1997) is the "Interpretation against the drafter" rule which tips the scale in favour of the insured and against the insurer, who drafted the contract whenever the disputed contract text is receptive to two or more reasonable interpretations. The rationale is that since the insurer drafts the contract, it is the party best able to minimize textual ambiguity and, therefore, the insurer must bear the responsibility for any vague wording.

The commencement of an insurance contract is signaled by the payment of the first premium by the insured and the contract binds the parties to perform certain acts during the life of the contract, hence a relational contract. With financial products, the product supplier also takes on a fiduciary responsibility. A fiduciary duty entails a legal or ethical relationship of confidence or trust requiring one party to act for the benefit and interest of the other.

### **2.6.5 Types of Life Insurance Contracts**

With Term-life Insurance, the contract is so arranged that for the sum assured to be paid on the death of the life assured only in the event of death happening during a specified term, for example 20 years. Should the insured survive the term there would be no cover beyond the term. A Term-life cover does not incorporate a savings element and therefore, upon surrender or expiry, has no monetary value. A Whole-life Insurance contract on the other hand, provides for the payment of the sum insured on the death of the life insured

and may be kept in force for the insured's entire life. Should the insured terminate the cover, there would be a surrender value depending on the savings.

Term-life cover is far cheaper than Whole-life cover. For example, a 30 year old married person with two dependents, for an annual premium of R1000 could purchase about R120 000 Whole-life Insurance, but about a R600 000 ten-year Term-life Insurance. A client holding a Whole-Life Insurance cover can be convinced, to his or her own detriment, to terminate it and replace it with the Term-Life Insurance cover just for the purpose of churning commission for the financial service provider.

A Universal Annuity contract makes provision for periodic and single contributions to the fund, including lump sum contributions, by way of transfers from any approved pension, provident or other retirement annuity fund. For example, after terminating employment a client may have R700 000 in pension benefits that become available to transfer, and instead of transferring to a possible existing Universal Annuity contract, may be convinced to initiate a completely new contract. The choice of the latter would mean incurring additional costs averaging about 2% of the transfer amount.

In the provision of financial services, it may be difficult to verify claims and any misrepresentations made by the service provider and, also, easy for relevant information to be concealed from the consumer. The entire cost of acquiring a product may be unknown at the time of acquisition and may be deliberately concealed. An additional example would be the surrendering of a financial contract may come at a substantial cost in the form of penalties when contracts are prematurely cancelled.

The cost of life cover is dependent on age and as age progresses the cost of cover, incorporated in the premium, increases. A mortality curve (illustration of relationship between age and probability of death) would show that life insurance costs little for young people and is exorbitant for advanced ages. For a Term-life policy the premium payment plan may involve a level premium payment plan. With this plan, instead of paying increasing premiums as age progresses through the term, an average premium is

paid for the entire term. In other words, the premium remains constant over the term of the policy. The result is that the premiums in the early years are higher than the actual cost of cover and in the latter years the actual cost of cover is higher than the premiums charged. The excess in the earlier years is used to supplement the shortfall in the latter years. A premature termination of a Term-life cover, based on a level premium plan, would be to the detriment of the client, as amounts paid in excess of the actual cost of cover would not be returned to the client.

## **2.7 Funeral Insurance**

Microinsurance is defined as insurance that is accessed or accessible to the low income population, provided by a variety of different providers and managed in accordance with generally accepted insurance practices that form part of the broader insurance market (IAIS, 2007). Microinsurance includes credit life insurance, crop cover and funeral insurance. The discussion that ensues concentrates on funeral insurance. In poor communities, it is difficult to mitigate risk by saving as individuals may not be able to accumulate sufficient savings to cover the cost of a funeral. Funerals and related expenses are prominent in the minds of low income households and, accordingly, many households place high priority on finding ways to deal with funeral expenses and are willing to dedicate part of their income to funeral cover (CENFRI, 2011).

The salient features of funeral insurance are described by Hougaard & Chamberlain (2009:7) as follows:

- (i) Premiums for funeral insurance are based on the experience of groups, eliminating underwriting, which results in keeping premiums low:
- (ii) Due to uncertainty, insurers generally do not commit to a long-term but rather offer a yearly term cover with a re-newability option on expiry, affording them the opportunity to adjust premiums depending on the claims experience of the group; and

- (iii) Waiting periods are instituted to counter anti-selection to prevent individuals from acquiring cover where death is imminent.

Hougaard & Chamberlain (2009:11) also note that where benefits are linked to a particular funeral service provider there are vulnerabilities that are created in instances where:

- (i) there is no option of a cash payout, clients can only receive the funeral service benefit in the geographic area served by the funeral service provider, and if the client had to move away from the area, problems are created;
- (ii) the funeral service provider knows that the funeral insurance will ensure that people will use its services and may drive up prices, due to having a captive client base, thereby reducing competition in the market;
- (iii) clients are promised a funeral service rather than a cash benefit, there is no guarantee that the cost of the service translates to a stated monetary value; and
- (iv) different family members insure the same life under different policies, all but one policy's benefit is forfeited, should all the benefits be a funeral service with no cash payout.

A qualitative study conducted in a Cape Town township, Tembani, illustrates some problems created as summarized in the following case (Bahre, 2011:14):

Jolanda, a nurse living in Tembani, has mixed feelings about insurance arising out of an incident relating to a colleague. Jolanda's colleague had insurance on the life of her mother but when her mother died the insurance company refused to pay her because her sister had a similar policy on the life of the mother. Jolanda's

colleague and her sister had ‘hidden’ the policy from each other because they worried that the other sibling may not feel responsible for the mother. Jolanda thinks it is not fair that the insurance company refused to pay. Nonetheless, she argued that they were both right to hide the policy from each other. She explained the need to keep the policy a secret from kin is that others must share in the responsibility and also pointed out that family members become suspicious and rumours emerge when one is going to receive money.

In some countries, insurers decouple the insurance benefit from a particular funeral service provider by using a network of funeral service providers and in doing so the abuse of customers can be limited to a certain extent as they would not be tied to one funeral service provider (Hougaard & Chamberlain, 2009). While the funeral service provider is readily recognized as a valuable partner to the insurer, regulatory interventions are warranted to combat anti-competitive and abusive practices. Where funeral insurance is provided outside the regulated insurance market, there is the danger of the insurance business being not separated from the funeral service business.

According to the Centre for Financial Regulation (CENFRI, 2010), where funeral insurance is provided outside the regulated insurance market:

- (i) contributions collected are often not used to provide reserves for future claims;
- (ii) funeral services are often paid for on a cash flow basis and when mortality expenses are higher than expected difficulty is experienced in honouring commitments: and
- (iii) Premiums are often not calculated on an actuarial basis.

As mentioned earlier, the pressure to provide a dignified funeral may emanate from a cultural dimension, but there are social dimensions that are worth discussing. When a funeral benefit is paid out in cash, there may be an implicit obligation for family

members to cater for a funeral costing the equivalent or more. This in turn may create a pressure on others to have funeral services of similar or better levels, irrespective of whether there is funeral insurance or not. As a result more expensive funerals would fuel higher funeral costs.

While funeral insurance is generally applicable to the poor, it is not specifically restricted to the poor as the not so poor can use it as a risk mitigation instrument. Berg (2011:7) states that when there is a conflict of interest between the insurance holder, for example parent, and the beneficiary, for example child, on how a life insurance payout should be spent, funeral insurance can resolve the issue in favour of the parent by functioning as an inter-generational commitment device by presenting the following mathematical model:

- (i) There are two agents: a parent and a child;
- (ii) There are two periods: In the first period the parent is endowed with wealth,  $W$ , and decides how much insurance to buy and pays the premium. If the parent survives the second period with the probability,  $q$ , the parent receives labour income,  $y$ , and consumes everything. If the parent dies, there is no labour income, but the child inherits the parent's remaining wealth and receives an insurance payout and allocates resources between the parent's funeral and own consumption;
- (iii) There are two types of funerals: basic funeral (pauper's funeral) costing nothing and an elaborate (dignified) funeral costing  $p$ ;
- (iv) There are two types of insurance. Life insurance that has a payout,  $L$ , and funeral insurance that has a payout,  $F$ . For both cases, the actuarially fair premium rate is per unit of cover is  $1-q$ .
- (v) Both parent and child have logarithmic consumption utilities: In the case of survival, the parent derives utility from the consumption of all the resources,  $U = \ln(c)$ . In the case of death, the parent derives utility from

her own funeral and, altruistically, the child's consumption,  $U = BD + \ln(c)$ .  $B$  is the fixed utility gain to the parent associated with an elaborate funeral and  $D$  is an indicator, equal to 1 if an elaborate funeral is held and 0 if not. The child's utility is given by  $u = \mu BD + \ln(c)$ . The constant,  $\mu$ , determines the relative importance of the funeral and consumption terms from the child's point of view and  $\mu < 1$ .

The parent's problem is to determine the insurance portfolio that maximizes her expected utility conditional on the child's decision function. The child's problem is to allocate her available resources,  $w$ , between her own consumption and the funeral to maximize utility. The child can arrange a basic funeral and consume all her resources or arrange an elaborate funeral and consume  $w - p$ .

According to Berg (2011:9), the parent's demand for insurance is summarized in Table 2.1.

TABLE 2.1 SUMMARY OF PARENT'S DEMAND FOR FUNERAL INSURANCE

Funeral insurance	Life insurance	Interpretation
F=0	L=y	$(W+qy)/p < (1-q)/1-e^{-(1-q)B}$ When both prefer a basic funeral, the parent buys full life insurance for potential loss of labour income, but does not take any funeral insurance. (applicable for low expected wealth)
$0 < F < p$	L=y+p-F	$(1-q)/1-e^{-(1-q)B} < (W+qy)/p < 1/1-e^{\mu B} - q$ When the parent prefers an elaborate funeral but the child not, the parent buys a portfolio of funeral and life insurance. (applicable for intermediate expected wealth)
F=0	L=y+p	$(W+qy)/p > 1/1-e^{\mu B} - q$ When there is agreement on an elaborate funeral, the parent buys life insurance to cover the cost of income loss as well as the funeral. (Applicable for high expected wealth)

SOURCE: Adapted from Berg (2011:9).

In short, depending on the understanding between the parent and the child regarding the type of funeral service that the parent expects, the parent may use funeral insurance to mitigate the risk of not being provided with the desired level of funeral service. This example could easily be extended to be applicable to relationships including other beneficiaries, for example spouses.

### **2.7.1 Funeral Insurance in South Africa**

The poverty levels of the South African Society are so high that mutual aid by kin or neighbours often does not suffice at the time of need (Bahre, 2011). Unregistered funeral insurance has been prolific for decades in South Africa and the high prevalence of HIV threatens the existence of burial societies, which can only cope by increasing the contributions or excluding benefits for HIV related deaths (Bahre, 2007).

While the National Treasury (2008) notes that South Africa has a well-developed microinsurance industry (particularly funeral insurance), it acknowledges the challenges of addressing potential abuse in the market. The benefits associated with funeral insurance is relatively small, presently limited to R18 000 and are accompanied by relatively low premiums, making up only 1.3% of the total market in terms of premiums (FSB, 2007). However, given the low premiums associated, this figure tends to understate the actual size of the market. A recent survey (FinMark-Trust, 2010), noted that out of the 8.7 million people who reported to have some form of life cover, 60% (5.2 million) have funeral policies only. The nature of the business is high volume, low value cash transactions primarily with the unbanked sector of the population. The inability to use debit orders for premium collection has forced companies to access the market through funeral administrators and funeral parlours (FSB, 2009).

With the introduction of the FAIS Act (2002), funeral parlours and funeral administrators are compelled to obtain a licence. A category IV funeral administrator is defined as persons that require licences, as an assistance business Financial Service Provider (FSP), to render intermediary services in relation to the administration of policies on behalf of

the insurer to the extent agreed to in terms of a written mandate between the insurer and the assistance business FSP (National Treasury, 2008).

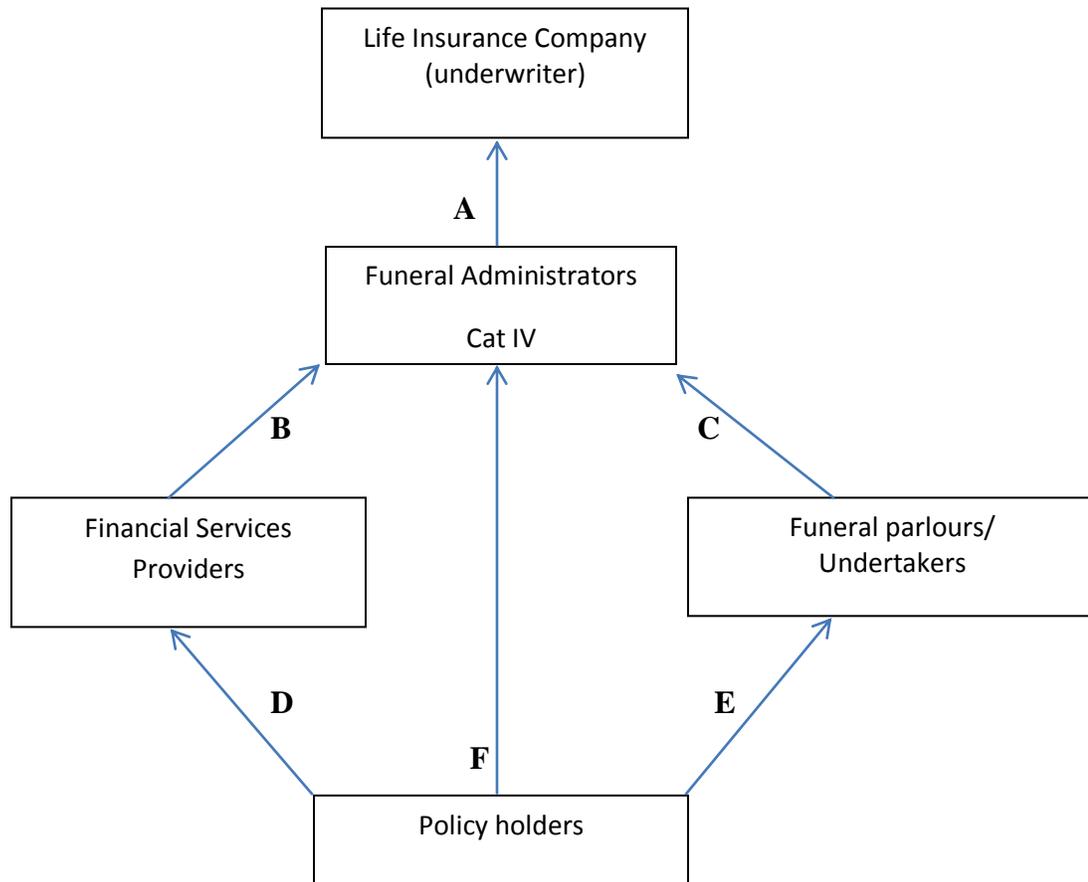
Some funeral insurances cover the funeral arrangements only, while others have additional benefits like the provision of a bus for transport to the gravesite. A number of funeral insurers pay cash benefits that the beneficiary can use at his/her own discretion to buy a funeral service from any funeral service provider or towards any other expense. For budget-constrained individuals the opportunity cost of paying premiums is high and the promise of a sum of money that may not be considered enough to cover expenses at the time of need may be less enticing than the assurance that these expenses will be covered or that certain necessities will be taken care of.

In targeting the improvement of the quality of intermediary services provided, the FAIS Act (2000) has the unintended consequence in dividing the market into advice and non-advice-based intermediation, resulting in an increase of non-advice sales model in an attempt to avoid the regulatory costs associated with advice-based intermediation (National Treasury, 2008). Concerns have been noted about the potential for misselling due to the limited information communicated to the client during intermediation (Bester *et al.*, 2010). An important component to funeral insurance is the swift processing of claims. While in South Africa claims are generally paid within 48 hours of receiving all the necessary documents, in the Phillipines for example, 10 % of the claim is paid within 24 hours, without any need for proof of death and the remaining portion is then paid later (Hougaard & Chamberlain, 2010).

### 2.7.1.1 Business Structure of Category IV FSPs

The business structure of category IV FSPs is illustrated in Figure 2.1 below

**FIGURE 2.1. BUSINESS STRUCTURE OF CATRGORY IV FSP**



SOURCE: Adapted form FSB (2009)

The business structure illustrated in Figure 2.1 above can be summarized as follows (FSB, 2009):

- A: An underwriting agreement is entered into between the Life insurance company and the funeral administrator to provide administrative services and write policies on behalf of the insurer.

- B: An agreement is entered into between the Funeral Administrator and the FSP to sell funeral policies to the public and issue documents underwritten by the insurer.
- C: An agreement is entered into between the Funeral Administrator and the Funeral Parlour (representative of the administrator) that performs numerous services such as preparing the body, graves, and funeral service.
- D: The FSPs sell funeral policies directly to the public.
- E. Policy holders have a choice of either a funeral benefit plan or a payout of a predetermined cash sum.
- F: In some instances funeral administrators sells policies directly to the public through representatives.

The Market Conduct division of the Supervision Department of the FSB conducted on-site visits in 2009 and the serious transgressions noted are summarized below (FSB, 2009):

- (i) Calculation of premium rates:
  - Constantia Funeral Administrators calculated the premium rates instead of the insurer, namely, Constantia Life and Health Insurance Company. The representative, funeral parlours of the administrators, then charged policyholders a premium rate that was 40% higher than that calculated by Constantia Funeral Administrators.
  - B.Botha Investment CC. calculated the premium rates instead of the underwriter, namely Safrican Life Assurance Company;

(ii) Unregistered business:

- Funeral policies sold by Constantia Funeral Brokers reflected Constantia Life and Health as underwriters, but no written agreement existed. R60 000 per month was paid as ‘underwriting fees’ since October 2007, but no claims have ever been settled by the insurance company.
- Funeral policies sold by FSP Bernice B.B Adams disclosed that policies were underwritten by Constantia Life and Health underwriters, but no written agreement existed.
- The mandate between B.Botha Investments CC and the underwriter Safrican Life was not signed.
- RiskFin Funeral Administrators policy documents stated that the policies were underwritten by Channel Life, however, there was no underwriting mandate and no claims were entertained by Channel Life.
- Phuti Funeral Administrator’s stated that the policies were underwritten by Sanlam Sky, but no written mandate existed;

(iii) Disclosures:

- An inspection of policy documents of Constantia Funeral Administrators, for 2008, revealed that underwriter details were not disclosed on the policy documents. Furthermore, the composition of premiums, in terms of commission and administrative charges, was not disclosed on the policy document:

(iv) Change of underwriters:

- In October 2007, Constantia Funeral Administrators changed their underwriters from Safrican Underwriters to Constantia and Health Underwriters that resulted in a large portion of the book being transferred, but the policyholders were not notified of this change; and

(v) Premiums not paid to insurer.

- Since 2005, monthly premiums totalling approximately R697 000 were collected from the International Funeral Society and R135 000 from Olivier and Vermeulen Funeral Parlours but these monies were not paid to the insurer.

In parallel to the move to non-advice models in the low income market innovative new business models have also emerged, where insurers' partner retailers and cell phone airtime vendors to distribute insurance products. Features of the models include the use of cell phone technology, cash premium payment options, through retail stores and passive sales relying on off-the-shelf purchases.

There are two approaches to retail-based insurance distribution. One approach involves partnering with only one insurer. The discussion that follows provides two examples that illustrates such an approach. Hollard Insurance is South Africa's largest privately owned insurance company that partnered with Take it Eezi and Pep. Take it Eezi is a rural and township-based vendor network that uses sim-card based point of sale technology to extend prepaid cellular airtime, electricity and insurance to individuals. The network of vendors comprises 18000 registered agents operating from spaza shops in informal settlements or remote rural areas (Smith *et al.*, 2010). Pep, a major low income clothing retailer in South Africa, has partnered with Hollard insurers that enables the cashier to provide the client with a package containing the policy document, after capturing the

basic details of the client, following which the client receives a call from a call center to activate the policy (Smit & Smith, 2010). Pep is a cash-based, low margin, high volume, clothing retail store with a network of 1159 stores throughout South Africa, extending into remote and rural towns and often being the only branded and network store in some towns (Pep, 2009). The key features of the two partnerships are tabulated in Table 2.2. to illustrate the model used.

TABLE 2.2. RETAIL PARTNERSHIP WITH ONE INSURER

Partnership	Hollard and Take It Eezi	Hollard and Pep
Established	2007	2006
Promotion	Passive sales: promotional material is placed in the Take it Eezi store and clients are required to ask for the insurance product upon seeing the promotional material.	Passive sales: insurance products are placed on shelves in the store near cashiers queues
Policy activation	<ol style="list-style-type: none"> <li>1. Client buys a starter pack for R20 and pays the first premium.</li> <li>2. The vendor uploads the client's information, policy number and identification number</li> <li>3. SMSs are sent to the client, vendor, and to Take it Eezi Hollard's policy administrators, Best Funeral Services contacts the client for additional information.</li> </ol>	<ol style="list-style-type: none"> <li>1. Client buys a starter pack at a price equaling the first months premiums</li> <li>2. Cashier captures the clients name, identification number and telephone number.</li> <li>3. Within 72 hours Hollards' policy administrator, Best funeral practice contacts the client for additional information</li> </ol>
Premium payment	Paid in cash at vendor – Eezi payment device to communicate with its central server and client and vendor receives an SMS to confirm payment.	Paid in cash at till point upon presentation of policy card –also reminder of monthly payment by SMS.
Challenges	Limited incentive for vendors (Just R20 joining fee, but no further incentive for premium collection.	

SOURCE: Adapted from Smith *et al.*, 2010.

The model just discussed is able to take insurance to people, who otherwise would have no access to insurance and avoids regulatory complications under the FAIS Act (2002).

Another approach to retail-based insurance distribution entails the retailer offering more products of more than one insurer. The discussion that follows serves as an illustration of this approach. Shoprite Holdings (Ltd), the holding company for the retail group that includes well-known South African supermarkets Shoprite and Checkers has chosen Shoprite supermarkets as the most appropriate of its stores to distribute low income insurance (Shoprite, 2008). The partnerships that it has with insurers are tabulated in Table 2.3 for comparison purposes.

TABLE 2.3 SHOPRITE’S PARTNESHIPS WITH INSURERS

Partnership with	Old Mutual	Metropolitan
Established	2007	2008
Product	Pay-when-you-can	Cover2Go
Product features	Funeral insurance is dependent on a Pay-when-you-can accidental death insurance a maximum cover amount of R20000 for 60 days. 12 month funeral cover sold on a top up basis with a six month waiting period for natural death.	Cash back funeral policy- a fixed percentage is returned to the client at the end of five years.
Promotion	Products are displayed at cashier isles	
Activation Initiation of product needs to take place at the money market counter	Starter pack is purchased at R9.95 and registers the pack at the money market counter using ID and policy card from the pack. Beneficiary is registered via fax or by visiting Old Mutual client centre.	Starter pack is purchased and registered at the money market counter. Client information is collected telephonically by a call centre.
Premium payment	At money market counter-till system is not advanced enough to capture client information at initiation of product.	
Challenges/Succ esses	Complicated product design Coverage period is unclear –each top up payment acts as a separate policy	Complicated activation process.

SOURCE: Adapted from Smith *et al.*, 2010.

The money market counter is a till point, separate from the normal till points, that is usually in the front of the store. At the money market counter, customers have the option of buying airtime, money transfer products, postage stamps, bus tickets and making flight bookings, theatre and events tickets, paying water, electricity and telephone accounts.

Since the stringent regulatory regime prevents retail employees from giving advice to clients, it is questionable whether prospective clients can conceive the value proposition of insurance through passive sales. While it is accepted that the mere offering of an insurance product in store would not constitute recommendation of the product, it may be argued that the customer may be induced to buy the product just because it is offered by a trusted brand (not the insurer but the retailer brand).

The contracting of retailers and other third parties with large distribution footprints to sell insurance on their behalf is considered by Bester *et al.*, (2010: 15) as being sub-optimal for the following reasons:

- (i) the client has a primary relationship not with the insurer, but with the retailer or other third party.
- (ii) The primary content of the relationship does not relate to insurance, but to the business of the third party.
- (iii) The sales person used to sell the policies do not necessarily contribute to the development of a general insurance culture amongst the client base.

### **2.7.2. Funeral Insurance in Brazil**

Brazil has a population exceeding 190 million, with 85% of the population living in urban areas and is classified as an upper middle-income country (World Bank, 2009). Nonetheless, there is low income market where funeral insurance finds a place. In Brazil, funeral benefits fall outside the regulatory definition of insurance and are, therefore, not

subject to insurance supervision or regulation (Hougaard & Chamberlain, 2009). There is a large informal insurance market comprising up to 25 million clients served by several large and smaller funeral homes (Bester *et al.*, 2010).

The distribution channel for funeral insurance is through funeral homes or private cemeteries, through the use of a commissioned sales force to sell funeral cover through door to door sales techniques. The funeral home can employ agents directly, as it is not subject to expensive bargaining council agreements and is not constrained by restrictions on who may receive commission. The following example provided by Bester *et al.*, (2010 ) serves as an example of funeral insurance distributed through a private cemetery (Grupo Vila). Group Vila is a large family-owned private cemetery and funeral home group. The average monthly premium is around R\$8 that covers a funeral service to the value of R\$2 500. Sales are made through 106 sales women selling door to door. Sales women receive extensive training and are expected to reach their average sales target within six months. To ensure that a consistent message is conveyed, a standard flipchart is used during discussions with prospective clients.

Apart from the cemetery and funeral services, Grupo Vila also runs medical clinics which receive around 5000 visits per month, 80% of whom are on the funeral plan. The clinics were initiated to build customer loyalty. Members of the Vila Grupo funeral plan receive discounted access to the clinics (the clinic is also open to outsiders, but at a higher price). In addition, plan members are informed of the availability of certain check-ups in the clinics during certain times at discounted prices. This is mostly used to attract customers, but can also serve as a proactive management tool to reduce mortality in the risk pool.

Even though direct distribution is not allowed, brokers prevail taking an active role in providing market intelligence and serve as an alternated distribution channel. A number of insurers offer funeral insurance in partnership with funeral service providers, intermediated by a broker. The broker acts as an administrator, collecting premiums and attends to claims. The broker is considered to be an aggregator of clients and has the

power to move the business from one insurer to another. As a countermeasure to the power held by brokers, insurers enter into long term contracts with brokers.

Hougaard & Chamberlain (2009), refer to SINAF, a formal funeral insurer in Brazil, that offers clients a number of options that offers a basic plan covering just funeral expenses to which a cash benefit can be added for accidental death as well as protection income benefit for the loss of a bread winner.

## **2.8 Financial Regulation**

There are several features of financial markets that can lead to inefficient outcomes that may justify government interventions. Many transactions require initial payments from one party to another, offset by payments in the opposite direction in the future that are explicitly contingent or implicitly subject to the risk. The gains for sellers and buyers are maximized under conditions of perfect competition. In markets that are not regulated, resources may not be efficiently and equitably allocated resulting in market failure. The possibility of market failure lays the foundation for regulation (Spulber, 1989; Viscusi, Harrington & Vernon, 2000). McVea (2005: 431) notes that: “firstly, the market may be unable to supply a socially optimal level of information for investors and, secondly, there may be factors which prevent individuals from appreciating this information”. The informational imbalance between expert intermediaries and inexperienced investors may lead to the expert favouring his or her own interest over those of the investor resulting in the misallocation of resources (McVea, 2005).

Governments can intervene and rectify market failure and ensure economic efficiency via regulation (Grace & Klein, 2008). In the absence of regulation market imperfections, create a cost for the consumer because the market outcome would be sub-optimum. Government intervention into markets stemming from market failure entails governments introducing varying levels of regulatory interventions across most economic markets. Regulatory interventions are justified as a socially-optimal good for consumers (Dewing & Russell, 2004). Further, the inability of contract law mechanisms to remedy

asymmetric information provides justification for the introduction of regulatory measures (McVea, 2005).

A desired outcome of regulation would be to set acceptable standards and to expel the previously referred to “lemons” from the market. While the “lemons” problem has the potential to affect every market where asymmetric information is a characteristic, there is no automatic implication that risk averse consumers would leave the market due to being unable to establish the quality of the product (Benston, 1998). Regulatory interventions to correct market failure are generally designed to meet economically sound goals such as ensuring systemic stability, securing institutional soundness and protecting the consumer (Schiro, 2006). Protection for consumers is achieved through firms competing fairly, information disclosure and legal redress (Falkena *et al.*, 2001).

Systemic stability relates to the resistance of financial systems to shocks over time. It is important that the various components of the financial system fulfill their function and are able to withstand sudden shocks to the system as systemic risk can manifest itself in a chain reaction or domino effect. The recent financial sub-prime crisis originating in the USA is an exemplary demonstration of the manifestation of systemic risks. Domino effects resulted in the localized USA sub-prime crisis being turned into a global crisis. The stimulus for the crisis was poor institutional governance and the absence of adequate supervision in mortgage market that allowed loans to be packaged and traded on the derivatives markets.

A derivative is a financial instrument that constitutes an agreement between two parties, the value of which depends on the value of another asset or an underlying asset (Botha *et al.*, 2010). Derivatives are used by investors to speculate and make a profit when the value of the underlying asset moves as expected or in a given direction. Unfortunately, in the recent crisis, the property prices began to drop and move in an unexpected direction in the USA. This compounded the situation which led to panic that resulted from the effect of gearing. Derivatives provides gearing which means that small movements in the

underlying asset can cause a large difference in the value of the derivative (Botha *et al.* 2010).

There are contrasting approaches to regulation with one approach being the principles-based regulation and the other being the rules-based regulation. Boot, Dezelan & Milbourn (1999) refer to this distinction as direct and indirect regulation with the former stipulating behaviour and the latter inducing desired behaviour. With the principles-based approach, a limited number of principles are set to be adhered to by financial service providers. These principles may be supplemented by guidelines that inform the service providers of appropriate behaviour within a degree of discretion and freedom. It would then be up to each service provider to demonstrate how their procedures and practices satisfy the requirements (Grace & Klein, 2008). This approach is advantageous to the service provider as it would enable the provider to minimize its own cost of regulation.

On the other hand, a rules-based regulation is very prescriptive and involves the setting of detailed rules to be complied with by all financial service providers, covering all relevant aspects of how they do their business and how they manage relationships with the consumers and the regulator or regulating body (Grace & Klein, 2008). Direct regulation, therefore, restricts the activities and reduces discretion on the part of financial service providers.

The UK employs a prudential or principles-based approach with emphasis being placed on an adequate solvency margin (Grace & Klein, 2008). In the USA, a more prescriptive or rules-based approach is adopted. However, Grace & Klein (2008) have noted that support for state regulation has eroded and many insurers now support the creation of an Optional Federal Charter (OFC) for insurers, that would pre-empt state regulation for insurers regulated by the federal government.

When markets transcend local borders, regulatory conflict may arise in the different local jurisdictions (Schiro, 2006). In such situations, compliance costs can be excessive and therefore a case may be made for a principles-based approach. Systemic effects are not

restricted to or contained within local jurisdictions, but extend across national and international markets. Consequently any regulatory response to systemic risks demands an international perspective. In many countries a global dimension to regulation has emerged with the tendency to harmonize national financial regulation with the international standards set by bodies such as the International Organization of Securities Commissions (IOSCO) or the International Association of Insurance Supervisors (IAIS) (Falkena, 2001).

Much blurring has taken place about the dividing line that separates the insurance sector from banking as a result of new product innovations, especially on the part of banks as evidenced by single financial market supervisory bodies in the United Kingdom, Germany, Austria, Japan and Canada (Schiro, 2006). IOSCO along with IAIS and the Basel Committee on Banking Supervision make up the joint forum of international financial regulators. The international conduct of business principles adopted by the IOSCO declare that “in conducting its business activity an intermediary should act honestly and fairly and with due skill, care and diligence in the best interest of its customers and the integrity of the market” (as cited in Paccas, 2000). Prudential regulation focuses on the solvency, safety and soundness of financial institutions. Asymmetric information makes prudential regulation necessary as the consumer may be in no position to judge the solvency, safety and soundness and have no control over post-contractual behaviour of a financial service provider.

Under a prudential mandate the financial regulator would aim to disseminate guidance and standards to be followed by financial service providers, control market entry, supervise licenced financial service providers through analysis of periodic returns and selective reviews and inspection. Financial institutions may be faced with a number of risks including market risk, credit risk, liquidity risk and operational risk.

The unexpected reductions in cash inflows or increases in cash outflows can significantly reduce business value. Credit risk refers to the delay or failure of customers and parties to which monies have been lent to make promised payments. With economic activity being

global, output and input prices can vary greatly due to changes in interest rates. Financial institutions demonstrate financial solvency by having adequate capital resources to cover risks. Institutional soundness is also supported by proper financial institutional infrastructure. This may include minimum accounting and audit standards, corporate governance standards and compliance standards. Furthermore, institutional soundness can be enhanced by directors and management meeting certain fit and proper requirements. It is worth pointing out that while prudential parameters are taken into account in a regulatory approach, the regulator cannot take the risks out of financial products as they are inherently risky and that is what generates a potential, though not guaranteed return for investors (FSCM, 2004).

The focus of conduct of business regulation is the way firms conduct business with customers with specific reference to mandatory information disclosure, honesty, integrity and competence of service providers and legal redress (Falkena *et al.*, 2001). With certain products consumers can, at a low cost, shift their business to competitors delivering products and it may be argued that providers may have a strong incentive to maintain a reputation of honesty and fairness. However, this type of reasoning becomes flawed when it is extended to the provision of financial services given the nature of financial services discussed earlier.

Under a consumer mandate the regulator would aim to set business conduct standards and check that they are adhered to, make information available to consumers to choose service providers and services appropriate to their particular circumstances. It is difficult to establish a balance between consumer protection and constraint of service providers (Adams, Antonacopoulou & Neely, 2008). Literature on regulation reflects arguments for and against regulation. A paper by Dewing and Russell (2004) argues against: “command and control type regulation” and favours “sustained and focused exercised by a public agency”.

In a review of regulatory requirements for the financial services industry, Benston (1998) argued against the need for a regulator claiming that “all the regulator’s functions can be

achieved by other means” without the high costs on financial service providers and the restrictive opportunities for competitor entry. McVea (2005:409) also points out that regulation may “weaken competition, create barriers to entry and raise costs in such a way to lead to static inefficiencies with new entrants finding it more difficult to gain a foot-hold within the industry”.

The unique characteristics of insurance contracts have had a direct influence on the formulation of the duties of disclosure and rules of interpretation (Schwartz, 2008). Whenever asymmetric information flows are evident, and where the consumer can potentially be exploited, transparency and disclosure in the supply of financial services have to be promoted (Falkena *et al.*, 2001). Kalss (2007) contends that where the gap between consumers and service providers cannot be bridged by the market process, special duties such as mandatory disclosure must be imposed to supplement the market mechanism.

It is often argued that regulation impedes competition, but, Falkena *et al.*, (2001) point out that when regulation addresses information asymmetries, it is complementary and disclosure, in particular, enhances price competition and widens the dimension in which competition operates. For example, disclosure may enable financial service providers to focus on the terms offered in contracts by various product suppliers. Disclosure is used to help address asymmetric information between the advisor and the consumer. The insurers will be protected by the law if they provide a clear, plain language document detailing, for example, the matters material to the assessment of the risk. However, a disclosure document that is too cumbersome, limits its usefulness by making it too difficult for the consumer to read or understand. On the other hand, the reality is that many people do not read the contracts they enter into in the first place.

The regulatory, monitoring and supervisory services supplied by regulatory agencies are not supplied by the market process and may lead consumers to believe that regulation is a costless or free good (Falkena *et al.*, 2001). The Financial Services Board (FSB) is the body charged with overseeing the regulation of most forms of financial provision in

South Africa. The FSB supervises the compliance with laws regulating financial institutions and the provision of financial services. The FSB is funded from levies and fees that it charges regulated entities. In 2009, the total levies collected were R250.7 million (FSB, 2009).

With reference to the previously mentioned problem arising from the USA sub-prime crisis, insurers in South Africa weathered the financial storm due to a history of sound financial regulation. In 2007, the IMF conducted an evaluation of the regulatory framework in South Africa and concluded that the supervision of the insurance sector was largely in line with core principles developed by IAIS (Dixon, 2008).

## **2.9 Conclusion**

Asymmetric information exists when one party to a transaction has better information than the other party to the transaction. Intermediation is supposed to resolve the asymmetric information that exists between consumers and financial product suppliers. However, financial services providers, in the form of agents, brokers or financial advisors may exploit the information asymmetry in the provision of financial services. This exploitation, in the form of churning new business or commission, would be to the detriment of the client.

The nature of financial products are very unique and the remedies, such as signaling, screening, branding and advertising, that could be used to resolve asymmetrical information in other markets may be inappropriate for the financial services sector. Most importantly financial products can be very complex and the consumer has very little opportunity to learn from experience. Furthermore, the value of the product cannot be easily determined at the time of purchase.

In order to prevent the misallocation of resources, Governments frequently intervene in financial markets via regulation. These interventions are normally harmonized with

international standards set by bodies such as the IOSCO or IAIS with the regulation being either rules-based or principles-based. One of the main objectives of regulation is the promotion of consumer protection in the provision of financial services. An essential ingredient of consumer protection is the disclosure of relevant information that would resolve information asymmetries between the client and the financial service provider.

There is a large, vulnerable South African funeral insurance market. The vulnerability of the market emanates from the importance of having a dignified funeral. There are substantial failures in provision of funeral services that complicate the regulation and functioning of the market. In South Africa, the FSB is the body charged with overseeing the regulation of most forms of financial provision. The regulation of financial services in South Africa will be discussed in the next chapter.

## CHAPTER 3

### THE REGULATION OF FINANCIAL SERVICES IN SOUTH AFRICA

#### 3.1 Introduction

The Financial Services Sector in South Africa is regulated by the Financial Services Board (FSB) specifically in terms of various pieces of legislation. Included amongst these are the Financial Advisory and Intermediary Services Act (FAIS), Policy holder Protection Rules, and the Financial Services Ombud Schemes Act. The General Code of Conduct is a subordinate legislation to the FAIS Act which regulates the provision of advisory and intermediary services by Financial Service Providers, by specifying a step by step process for engaging clients. Another subordinate legislation to the FAIS Act is the Determination of Fit and Proper Requirements demanding financial service providers to behave honourably and fairly with due skill, care and diligence. Furthermore, to protect the consumer against inappropriate financial advice, the FAIS Act requires a FSP to register with the FSB and issues a licence only when predetermined minimum qualifications are met.

To ensure compliance by itself and its representatives with the provisions of the FAIS Act, one or more compliance officers are appointed. If a consumer receives inappropriate advice or a financial service provider has not followed the procedure, the consumer is entitled to make representations with the Ombudsman for Financial Service Providers. A determination by the Ombudsman would be legally binding. Furthermore, to ensure ongoing compliance with financial soundness FSPs are required to maintain financial statements and submit audited financial statements to the FSB annually.

In this chapter the structure of the FSB will be described and pertinent sections of the FAIS Act will be discussed. The General Code of Conduct for financial service providers will highlight the financial advisory and intermediary service process. The purpose of Policy Holder Protection Rules will be discussed. The obligations of Financial Service Providers with regards to demonstrating institutional soundness will be explored.

### **3.2 The Financial Services Board**

The Financial Services Board Amendment Act (RSA, 2000), defines the function of the FSB as, firstly, to supervise the compliance with laws regulating financial institutions and the provision of financial services and, secondly, to promote programmes and initiatives by financial institutions and bodies representing the financial services industry to inform and educate users and potential users of financial products and services.

The regulatory structure of the FSB consists of three departments, namely Registration, Supervision and Enforcement. Registration is responsible for new licence applications, lapsing of licences, queries relating to the status of a FSP's licence and liaison with the FSB's Finance Department regarding the collection of levies. Supervision oversees the analysis of financial statements and compliance reports of FSBs as well as on-site visits to FSPs and compliance officers. Enforcement deals with complaints against the FSPs that cannot be referred to the FAIS Ombudsman. It also has an advisory committee and an Ombud's office for the resolution of consumer complaints that have not been resolved by other internal methods.

The Office of the Ombud for Financial Services Providers (FAIS Ombud) was established through section 20(1) of the FAIS Act (RSA, 2002) and lists the duty of the FAIS Ombud as being to consider and dispose of complaints by clients against financial services providers in terms of the FAIS Act. The FSB liaises with international organizations such as the International Association of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the African Association of Insurance Supervisors and the International Network of Pension Regulators and Supervisors (INPRS).

### 3.3. The FAIS Act

The objective of the FAIS Act (RSA, 2002) is to regulate the rendering of advice and intermediary services to clients. The FAIS Act positions the FSB in the regulatory structure of the FAIS Act, subordinate only to the Minister of Finance (Van Zyl, 2006).

Section 1(1) of the FAIS Act (RSA, 2002) defines advice as “any recommendation, guidance or proposal of a financial nature furnished, by any means or medium, to any client or group of clients in respect of/or:

- (i) the purchase of any financial product;
- (ii) the investment of any financial product;
- (iii) on the conclusion of any transaction, including a loan or cession, and at the incurring of any liability or the acquisition of any right or benefit in respect of any financial product;
- (iv) on the variation of any term or condition applying to a financial product, on the replacement of any such product or on the termination of any purchase of or investment in any such product; and
- (v) irrespective whether or not such advice:
  - (a) is furnished in the course of or incidental to financial planning in connection with the affairs of the client; or
  - (b) results in any such purchase, investment, transaction, variation, replacement or termination, as the case may be, being effected.

The advice covered by the FAIS Act (RSA, 2002) must relate to a financial product, the definition of which is very comprehensive in the Act. It would suffice to point out here that a “financial product” relates to securities and investments, a participatory interest in

collective schemes, long or short-term insurance, pension funds and friendly society benefits, foreign currency-denominated investment instruments, certain bank deposits, and health services provided by medical aid schemes.

Section 1(1) of the FAIS Act (RSA, 2002) defines an intermediary service as any act other than the furnishing of advice, performed by a person for and on behalf of a client or product supplier:

- (i) the result of which is that a client may enter into, offers to enter into or enters into any transaction in respect of a financial product with a product supplier; or
- (ii) with a view to:
  - (a) buying, selling or dealing in, managing, administering, keeping in safe custody, maintaining or servicing a financial product purchased by a client from a product supplier or in which the client has invested;
  - (b) collecting or accounting for premiums or other monies payable by the client to a product supplier in respect of a financial product: or
  - (c) receiving, submitting or processing the claims of a client against a product supplier.

As of 31 March 2009, there were 14256 approved FSPs (FSB, 2009). The FAIS Act (RSA, 2002) defines a financial service provider (FSP) as any person, other than a representative, who as a regular feature of the business of such person furnishes advice, renders an intermediary service or furnishes advice and renders an advisory service. According to the FAIS Act (RSA, 2000) a representative is any person that renders a financial service to a client on behalf of a financial service provider, in terms of conditions of employment or any other mandatory agreement.

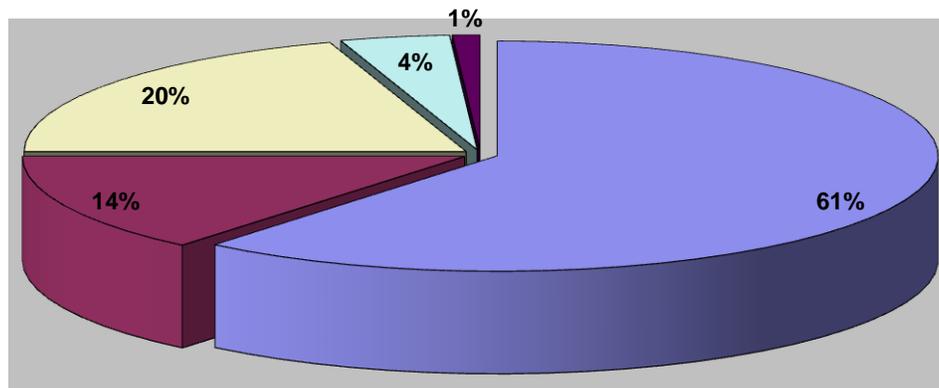
There are two groups of people that carry on business in the field of financial services regulated by the FAIS Act (RSA, 2002). The first group includes those that carry on business in their own names as authorized financial services providers. Such individuals require a licence, for which specific academic or industry-related qualifications and experience are required, and must meet universally accepted 'fit and proper requirement' relating to honesty, competency and solvency. The disadvantage of this is that it may act as a barrier to would-be competitors and also give a false sense of security to the extent that competence may be measured only once and may not be a continuous process.

The second group includes those individuals that carry on business as representatives of licenced providers. Section 13(1)(b) of the FAIS Act (RSA, 2002) dictates that a representative must be able to provide confirmation, certified by the provider, to clients that firstly, a service contract or other mandatory agreement to represent the provider exists and secondly, that the provider accepts responsibility for those activities of the representative performed within the scope of, or in the course of implementing any such contract or agreement. Consequently, the FSP at all times has to be satisfied that their representatives and key individuals are competent. It is mandatory for the FSP to maintain a register of representatives and key individuals, which is available to the registrar for reference and inspection. Clerical, technical, administrative, legal and accounting staff of the FSP is not considered to be representatives.

The specific qualifications relate to a qualification that addresses specific or specialized knowledge, skills and competence that is applicable to the financial services industry. All representatives are required to complete at least the first level regulatory examination and a second level regulatory examination based on the sub-category (long-term insurance, short-term insurance, pension benefits, participatory interest in collective investment schemes, securities and investment) in which they operate.

Figure 3.1 depicts the size of FSPs by the number of representatives linked to the FSP.

**Figure 3.1 Size of Financial Service Providers**



**Source: Financial Services Board Annual Report (FSB, 2009)**

Figure 3.1 indicates that the majority of FSPs in South Africa operate with one representative. The question that needs to be asked is whether the format with only one representative has any significant benefits regarding compliance with the FAIS Act as the key individual and the representative would be one and the same person. This warrants further research that is beyond the scope of this research.

Under section 7(i) of the FAIS Act (RSA, 2002), a person may not act or offer to act as a financial service provider unless such person has been issued with a licence authorized by

the registrar of the FSB. In the granting of the licence, the registrar must be satisfied that the applicant complies with the fit and proper requirements of honesty and integrity, competence and operational ability and financial soundness.

Key individuals are the ones that are involved in a management or supervisory control of staff and the FAIS Act (RSA, 2002) defines the key representative as any natural person responsible for managing or overseeing, either alone or together with other responsible persons, the activities of body, trust or partnership relating to the rendering of any financial service.

Section 15(1) of the FAIS Act (RSA, 2002) makes provision for the registrar of the Financial Services Board to develop a code of conduct to ensure that the clients being rendered financial services, will be able to make informed decisions and that their reasonable financial needs regarding financial products will be appropriately and suitably satisfied.

### **3.4 The General Code of Conduct**

On 8 August 2003, the General Code of Conduct for authorized financial services providers and representatives was published. Section 8(1) of the General Code of Conduct (RSA, 2003) lists one of the duties of the Financial Service Provider or their representatives as being the identification of financial products that will be appropriate to the client's risk profile and financial needs, subject to the limitations imposed on the provider or any contractual arrangements. The limitations refer to the licence categories held by the FSP and contractual arrangements refer to those arrangements with product suppliers. Section 3(1) of the General Code of Conduct describes financial advisory and intermediary service process with several of the steps requiring the presentation of or completion of appropriate documentation (RSA, 2003). In particular, the remuneration to be paid for the financial service has to be established at the initial stage of the professional relationship between the client and the FSP or representative.

According to the General Code of Conduct (RSA, 2003), prior to providing the client with advice, the intermediary must:

- (i) ascertain the client's financial situation, financial product experience and objectives;
- (ii) conduct an analysis based on the information provided;
- (iii) identify the financial product or products that will be appropriate to the client's risk profile and financial needs;
- (iv) where the identified product is to replace an existing product, disclose the actual and potential financial implications, costs and consequences of such a replacement;
- (v) keep a record of the advice given;
- (vi) disclose any contractual relationship with the product supplier or with other product suppliers and disclose any conditions or restrictions imposed by the product suppliers; and
- (vii) disclose all charges, fees, remuneration or monetary obligations.

Section 7(1) of the General Code of Conduct (RSA, 2003) requires the financial service provider to provide a reasonable and appropriate explanation of the nature and material terms of the relevant contract with a client, and generally make a full and frank disclosure of any information that would reasonably expect a client to make an informed decision.

This challenge was highlighted by Swanepoel (2006), pointing out that product suppliers historically simplified their quotations and marketing material by excluding specific terms and conditions resulting in an abbreviated document containing key features of the

product and only send clients relevant and material information, that needs to be disclosed before concluding a transaction, some weeks after the transaction has been concluded. The insured first sees the insurance contract only after entering into it, and consequently, consumers may often be unaware of all the terms and conditions of the transaction.

Opperman (2006), the assistant Ombudsman for financial service providers, through investigating complaints, noted that the office of the Ombud has raised concerns regarding the fine print and the “tickbox” approach to compliance where clients sign documents without being informed about exactly what they are signing. For example, customers find themselves bound by declarations where it is agreed that:

- (i) certain disclosures were handed to the client;
- (ii) the client agreed to the product being sold;
- (iii) a proper explanation of the product was given;
- (vi) all fees, costs, and commissions were disclosed; and
- (v) there was no need for a financial needs analysis.

The extent of the application of the ‘tickbox’ approach to compliance needs to be further explored, but is beyond the scope of this study. Further research is warranted as such a practice clearly undermines the consumer protection role of the FAIS Act.

Clause 8(1) of the FAIS Code of Conduct (RSA, 2003) requires that when a product such as a client's policy is to be replaced by another, to fully disclose to the client the costs and implications of such replacement including:

- (i) fees and charges of the new policy;
- (ii) special terms of the new policy such as waiting periods, loadings, penalties, excesses and restrictions;
- (iii) the impact of age and health on the premium payable;
- (iv) differences between tax implications and investment risks of the existing and new policy;
- (v) penalties or un-recovered expenses deductible or payable due to the termination of the existing policy;
- (vi) the extent to which the new policy is realizable or funds accessible, compared to the existing policy; and
- (vii) the vested rights, minimum guaranteed benefits or other guarantees or benefits that may be lost as a result of the replacement.

A 'checkbox' approach again would also undermine the consumer protection role of the FAIS Act. Opperman (2006) added that some financial advisors focus solely on selling financial products that pay attractive commissions, rather than focusing on rendering a professional service that is in the interest of the client and cites the example where a complainant wanted the proceeds of the sale of her house invested in a money market account only to discover that it was invested in a medium term investment where the broker earned a higher commission. Disclosure requirements relate both to the terms of the contract and the overall financial position of the financial service provider.

The FAIS Act (2002) requires the following records to be kept by providers:

- (i) letter of introduction/disclosure notice;
- (ii) client service instruction;
- (iii) personal client information;
- (iv) letter of authority signed by the client;
- (v) FICA documents;
- (vi) needs analysis questionnaire;
- (vii) risk profile questionnaire;
- (viii) written proposal;
- (ix) advice agreement;
- (x) intermediary service agreement;
- (xi) application form; and
- (xii) minutes of meeting with client.

The letter of introduction or disclosure notice is a document that serves to inform the client of the details of the FSP and the product supplier. The specifics of each of the other documents would not be entered to here and the above list is provided to give an indication of the onerous task involved. It would suffice to acknowledge that individual client files would constitute volumes. It is these files that would be inspected by compliance officers and officials from the FSB during on-site visits.

### **3.5 Institutional Soundness**

The United States of America have tended to apply a prescriptive or rules-based approach to regulating insurers' financial condition that is heavily influenced by an accounting perspective. This is reflected in a voluminous set of laws and regulations that governs the insurers' financial structure and actions. Regulations tend to focus on insurers' compliance with these prescriptions rather than the prudence of their management with the emphasis being on accounting rather than financial risk. The Sarbanes-Oxley Act also known as the Corporate Responsibility Act of 2002 (in the wake of Enron and other accounting and corporate scandals) introduced reforms in corporate responsibility, criminal penalties, accounting regulation and consumer protection. Under corporate responsibility, the Sarbanes-Oxley Act requires the chief financial officer (CFO) and the chief executive officer (CEO) to certify financial reports and audits submitted by the corporation. Additionally CFOs and CEOs are required to forfeit profits and bonuses from earnings related to fraud, face severe penalties such as \$5 million and 20 year prison term for failing to certify financial reports.

The United Kingdom and other European countries have employed or are moving towards a principles-based approach. Presently, in South Africa there is a leaning towards the rules-based approach. The FAIS Act requires FSPs to submit financial statements and compliance reports annually to the FSB. The purpose of the financial statements is to enable the FSB to determine whether the FSP complies with the solvency requirements of the Determination of Fit and Proper Requirements. Section (19) of the FAIS Act (RSA, 2002) imposes the following obligations on FSPs:

- (i) FSPs must maintain full and proper accounting records on a continual basis; these records must be brought up to date monthly;
- (ii) FSPs must prepare annual financial statements reflecting the financial position of the business;

- (iii) FSPs must cause the financial statements to be audited and reported on by an external auditor; and
- (iv) the financial statements so audited and reported on must consist of an audited balance sheet, an audited income statement and audited statement detailing the source and application of funds.

### **3.6 Capital Adequacy Requirements**

The amount provided for in policy holder liabilities is calculated to cover the amount payable due to expected future claims, to cover amount payable for claims that have happened, but that the insurer has not been informed of at the reporting date, as well as claims that the insurer does know about, but that have not yet been paid. The capital adequacy requirement is to provide for the risk that the liabilities may be higher than expected to allow for experiences worse than assumed in the calculation of the policy holder liabilities. This requirement refers to the minimum level of capital upon registration and as the books of the insurer grows, the actual capital may exceed the minimum capital requirement at which point the insurer must hold the higher amount.

### **3.7 Policy Holder Protection Rules**

The policy holder protection rules are separate from those in the Code of Conduct and have a strong consumer protection bias. The purpose of the rules is to ensure that policies are entered into, executed and enforced in accordance with the principles of insurance. The general provisions are:

- (i) the insurer must disclose to the consumer the terms, conditions and exclusions regarding any policy issued to them;
- (ii) the insurer must advise the consumer of any internal complaint resolution procedures;

- (iii) the insurer must provide the full particulars of the insurance ombudsman;
- (iv) no insurer may ask or induce a consumer to waive their rights in terms of the rules; and
- (v) no insurer may allow a consumer to sign a blank or partially completed form necessary for entering a policy.

### **3.8 Competence**

Pacces (2000) notes that the international conduct of business principles adopted by the International Organization of Securities Commissions (IOSCO) declares that a financial intermediary should act honestly, fairly and with due skill, care and diligence in the best interest of its customers and the integrity of the market. Pacces (2000) notes further that the same principles of honesty, fairness and diligence characterize conduct of business regulation in the countries of the European Union.

Nienaber and Reinecke (2009) note that the fit and proper requirements relating to honesty and integrity demand disclosing that five years preceding the date of appointment or approval the individual should:

- (i) have not been found guilty of any criminal proceedings or liable in any civil proceedings by a court of law, acted fraudulently, dishonestly, unprofessionally, dishonourably, or in breach of a fiduciary duty;
- (ii) have not been found guilty by a professional body or industry association to have acted dishonestly, negligently or incompetently; and
- (iii) have not been denied membership to a professional body or industry association due to any of the above.

Key individuals require a licence for which certain academic or industry-related qualification is required. The qualification must be appropriate, credit bearing and registered with the South African Qualification Authority (SAQA). Over and above this, regulatory examinations are to be undertaken and professional development of between 15 to 60 hours has to be undertaken over a three year cycle.

Board Notice 103 (RSA, 2008) lists the purpose of Continuous Professional Development (CPD) is to ensure that FSPs, key individuals and representatives:

- (i) maintain professional competence in order to provide financial services of high quality in the public interest;
- (ii) understand that they have an obligation to develop and maintain their professional competence, relevant to the nature of their work and professional responsibilities; and
- (iii) render financial services with due care, competence and diligence and subject to the continuing duty to maintain knowledge and skill at skill level required to ensure that a client receives competent service based on up to date developments in legislation, industry practice and developments.

A Financial Service Provider, key individual and representative is required to record individual achievements regarding CPD with the registrar of the FSB using the following mechanisms:

- (i) key individuals and representatives are required to provide documentary proof to FSPs on a quarterly basis;
- (ii) CPD activities are to be logged on-line using the CPD register of the FSB; and

- (iii) A FSP or compliance officer will be required to report to the registrar on the CPD activities undertaken by the key individuals or representatives.

Depending on the category or sub-category, between 15 and 60 hours of CPD activities must be completed over a 3 year cycle. The CPD activities and/or programmes must be verifiable. CPD activities offered through industry associations, professional bodies, employers, institutes of higher education and accredited training providers may apply for their offerings to be recognised.

Those who wish to carry on business as representatives of licenced providers will not require a separate licence, but must either be an employee or mandatory of a licenced service provider, who in turn must assume full responsibility for their business activities. McVea (2005) notes that the vetting of the quality of investment advisors through authorization requirements could make investors less vigilant than they might otherwise be.

Suitability and 'fit and proper' standards are implemented for directors, management staff and the compliance office with external auditors and the regulators auditing the quality to ensure adherence to standards (Falkena *et al.*, 2001). Herrig & Santomero (1995) add that it is difficult to determine whether an unfavourable outcome was the result of bad luck, even though good advice was competently and honestly rendered or purely the result of incompetence or dishonesty on the part of the financial service provider.

The non-disclosure of fees, commissions and incentives have always been a topic of heated debate, but statutory disclosure requirements have leveled the playing fields with this being one area where the FAIS Ombud has demonstrated that his office has zero tolerance (Swanepoel, 2005). In this regard, the FAIS Act (RSA, 2002) prescribes the following disclosures to be made:

- (i) the nature and extent of monetary obligations assumed by the client, directly or indirectly, in favour of the provider, including the manner of

payment or discharge thereof, the frequency thereof and the consequences of non-compliance; and

- (ii) the nature, extent and frequency of any incentive, remuneration, consideration, fee or brokerages, which will or may become payable to the provider, directly or indirectly, by any product supplier or any person other than the client, as a result of rendering of financial service, as well as the identity of the product supplier or other person providing or offering the valuable consideration.

### **3.9 Compliance**

Botha *et al.* (2010) describe compliance as conforming to the meeting of requirements of laws and regulations that have been clearly defined and relevant to the financial services industry and lists the objectives of compliance as:

- (i) to provide a framework for regulation;
- (ii) to ensure that members are educated and well-informed;
- (iii) to ensure that businesses follow the principles of best business practice;
- (iv) to create a stable financial services industry; and
- (v) to create a profession in respect of the provision of financial services.

An applicant that utilizes any third party to render administrative or system functions in relation to the rendering of financial services on its behalf must have in place detailed service level agreements. The FSP must ensure that in their internal control structure procedures and controls are in place which includes at least the following:

- (i) segregation of duties and roles and responsibilities where such segregation

is appropriate from an operational risk mitigation perspective;

- (ii) application of logical access security;
- (iii) access rights and data security on electronic data, where applicable;
- (iv) physical security of the providers assets and records, where applicable;
- (v) documentation relating to business processes, policies and controls, and technical requirements; and
- (vi) business continuity plan.

Section 17(1) of the FAIS Act (RSA, 2002) makes it compulsory for the FSP, with more than one key individual or one or more representatives, to appoint (internally or outsource) a compliance officer to establish and maintain procedures to be followed by the representative in order to ensure compliance with the FAIS Act. Section 17(1)(b) of the FAIS Act (RSA, 2002) requires that the compliance officers be approved by the Registrar in accordance with guidelines set down by the Advisory Committee. Further, Chapter 5 of the FAIS Act (RSA, 2002) imposes certain administrative obligations on financial service providers with regards to:

- (i) the appointment of compliance officers;
- (ii) monitoring by compliance officers of the FSP;
- (iii) liaison with the Registrar of the FSB;
- (iv) the maintenance of records; and
- (v) accounting and audit requirements

With regards to the maintenance of records, a FSP must maintain records for a minimum period of five years (RSA, 2002):

- (i) premature cancellations by clients;
- (ii) complaints received and whether resolved;
- (iii) cases of non-compliance and reasons for non-compliance;
- (iv) continued compliance requirements for authorization ; and
- (v) continued compliance requirements for representatives.

With regards to accounting and audit requirements the FSP must:

- (i) maintain full and proper accounting records on a continual basis brought up to date monthly; and
- (ii) prepare, annually, financial statements reflecting the financial position of the business which must be audited by an external auditor approved by the registrar.

Methven (2009: 2), the CEO of The Compliance Institute of South Africa, notes that the Generally Accepted Compliance Practice Framework (GACPF) stresses the following:

- (i) in order for the compliance function to be effective it must be independent of other business activities, so it can discharge its duties objectively, both to the company and the relevant regulator;

- (ii) an adversarial relationship should be avoided and the compliance officer should not be seen as a barrier to conducting normal business;
- (iii) the head of compliance should not have any other responsibilities; and
- (iv) compliance staff should not be remunerated on the basis of business targets.

There are compliance costs imposed on financial institutions as a result of the need to devote resources, that could have been more productively directed elsewhere, to ensure compliance with the regulatory regime (McVea, 2005). Recent decisions of the FAIS Ombud bears testimony that intermediaries are being brought to account more and more for a failure to give appropriate advice and a failure to make proper disclosure required by the FAIS Act (RSA, 2002).

Bracher (2008) postulates that the inequality of bargaining power will continue to be redressed by the Ombudsman in this fashion unless the parties, sensibly, decide to comply strictly with the provisions of the FAIS Act and the Code of Conduct. Without a professional business infrastructure and business system, building a presentable business is difficult. This calls for presentable offices, professional staff, a client relationship management system (CRM) and computer software programmes.

Responses from more than 1000 providers throughout South Africa indicate that not more than 3% of FSPs have read the FAIS Act or the General Code of Conduct and it appears that the majority trust their compliance officers when it comes to compliance issues (Swanepoel, 2007). The accountability and responsibility rests with the FSP as the FAIS Act regulates the FSPs and not the compliance officers.

According to (Swanepoel, 2007) an independent investigation into compliance services has revealed the following:

- (i) many compliance officers do not have experience as financial advisors and tuned to the 'checkbox' approach. (In practice compliance officer looks for a document titled "Needs Analysis" or "Risk Profile" and ticks the box and the provider passed that part of the audit).
- (ii) Providers appear to be using records of advice designed by their compliance officers that are not founded on the law of contract with most containing a list of statements or questions with a space for the FSP to complete.
- (iii) Some of the documents contain waiver of rights clauses which already has been ruled on as an act of non-compliance.

As mentioned earlier, product suppliers are obliged to supply financial service providers with product disclosures, but in reality these terms, conditions and exclusions, are received by the client only after the contract is issued in the policy document. This is tantamount to disclosures being made after the conclusion of the transaction making it difficult for the financial service providers to comply with the Provisions of the General Code of Conduct. Regardless of the fact that product suppliers do not disclose all the information to providers, the latter will remain accountable for such disclosures and will have to request additional information from the product supplier in order to disclose the necessary information to clients (Swanepoel, 2006).

Compliance offices that do point out the problem may be seen as people trying to complicate the provider's advice process instead of helping providers and compliance officers that appear not to be adding value to providers by simplifying the process, may find themselves without a contract (Swanepoel, 2006). Swanepoel (2007) notes that financial service providers include fund fact sheets of investment companies in their written proposals to clients, while being under the false impression that the fund fact sheets comply with the product disclosures of the FAIS Act.

### **3.10 Conclusion**

In this chapter, the role of the FSB was discussed as firstly being a supervisory one, having the duty to ensure that the financial service providers comply with the provisions of the FAIS Act and other legislation. The other legislation includes the General Code of Conduct for Financial Service Providers and Policy Holder Protection Rules.

The provisions of the FAIS Act clearly demonstrate a focus towards a rules-based approach. Discussed in detail were the obligations of the FSP with regards to: the accounting and auditing requirements, the appointment of compliance officers and the maintenance of records. To demonstrate competence, key individuals require a licence that is issued by the FSB, after meeting academic or industry-related qualifications. Key individuals and representatives are expected to engage in CPD over a three year cycle.

The General Code of Conduct describes the financial advisory and intermediary service process as being a step by step process characterized by disclosures regarding fees, contractual relationships and implications of replacing existing products. The entire process is supported by the completion of necessary documents which becomes the evidence to resolve any future grievance.

The other role of the FSB relating to the promotion of programmes to inform and educate users of financial products and services were touched upon in this chapter. This will be discussed in greater detail in the next chapter where the consumer education initiatives in South Africa will be compared to that in the USA and UK.

## CHAPTER 4

### CONSUMER EDUCATION AND FINANCIAL LITERACY

#### 4.1 Introduction

In this chapter the need for consumer education, in the financial services sector, will be discussed. Financial Literacy programmes in the USA and UK will be referred to briefly. Financial Literacy programmes in South Africa will be explored in detail.

The asymmetry of information between retail financial services consumers and financial institutions results in consumers being vulnerable to unfair treatment. Typically, financial institutions have far more expertise and resources available to them in designing, distributing and servicing financial products, than consumers have available to them in making decisions about financial transactions. The problems of asymmetric information are intensified by the consumer's underinvestment in information and the so called "free rider problem".

In many instances, the consequences of unfair treatment or poor decisions are only felt in some cases many years after transacting. In South Africa, these challenges are exacerbated by low levels of both basic and financial literacy, increasing the risk of consumer exploitation. Drawing on the theme of consumer empowerment, consumer education policy in the UK and USA are analysed. Descriptively the analyses identifies how regulators in the aforementioned countries approach the behaviour they seek to promote through their consumer literacy programmes. More critically, these are compared with initiatives in South Africa.

## 4.2 Financial Literacy

Insufficient consumer knowledge is widely regarded to limit the competitive functioning of insurance markets and is a major reason for government regulation of these markets. However, regulations alone cannot assure that consumers make sound purchasing decisions. An educated and informed consuming population is an essential component to market regulation (Tennyson, 2011).

The Financial Services Authority in the UK, notes that people require a basic body of knowledge and understanding, upon which they can draw, when managing their financial affairs, that can be acquired through education, passive receipt of information, the media and information materials produced by the financial institutions (FSA, 2005). Improved financial education reduces the information asymmetries, causes higher demand for financial products and promotes market transparency (Gjebrea, 2006).

Consumer education is the process of gaining knowledge and skills to manage personal resources and participate in decisions that affect individual well-being and the public good. The outcome of the consumer education process is the development of consumer's skills, attitudes, knowledge and understanding of the financial sector and its products and services so that they are able to use consumer information effectively.

Mason & Wilson (2000) define financial literacy as an individual's ability to obtain, understand and evaluate the relevant information necessary to make decisions with an awareness of the likely financial consequences. This definition seems to presume that the relevant information would be readily available and the only constraint would be the individual's ability. Financial literacy has also been defined as the ability to make informed judgments and to take effective decisions regarding the use and management of money (Workington, 2005).

In South Africa, Van Zyl (2006) raised the question whether it would be reasonable to expect clients to inform themselves before entering investment markets as they often make an effort to educate themselves before purchasing movable and immovable property (furniture, vehicles and residential property). It is important to recognize that market forces alone are unlikely to stimulate an optimal supply of financial education as those that would invest in its provision cannot prevent their competitors from reaping the rewards in the future (Eighty20, 2009). Goodhart *et al.*, (1998) contend that consumers, lacking a background in financial studies, have only a limited ability and opportunity to acquire the necessary skills to enter into financial contracts and assess relevant information. Paces (2000) notes that consumers do not spend too much time and resources to acquire such expertise and assumes that they have more profitable matters to deal with, given that the value of people's time has increased over time.

Cheffins (1997) adds that even when there are socially optimal levels of information, market participants may nevertheless lack the aptitude, experience or judgmental ability to make deliberate reasoned decisions and refers to them as "poor judgment transactors". Falkena *et al.*, (2001) caution that consumers are not all equally well-equipped to assess quality because of the technicalities of some financial products.

Falkena *et al.*, (2001) also refer to the 'free rider' problems that result from consumer underinvestment in information, whereby consumers assume that others have investigated the safety and integrity of suppliers of financial services. Sometimes, consumers who are aggrieved by the conduct of financial service providers, could decide not to seek remedial action but cut their losses. While such rationalization could be valid for the individual, it could lead to collective folly by allowing the illegitimate activity to continue (McVea, 2005).

In an international study that examined the relative importance of customer education, Eisingerich & Bell (2006) showed that customer education was the strongest determinant of client loyalty with customer participation showing a significant positive impact and firms' problem management initiatives also showing a significant positive impact on

customer loyalty. One study by Cude (2005) finds that many consumers do not understand insurance disclosures, and admit that they do not read them. A survey by the National Association of Insurance Commissioners (NAIC, 2010) found that only a third of those surveyed believe they have a good understanding of their insurance policies. Survey and focus group evidence show that word-of-mouth and informal sources are the dominant information-gathering strategies for insurance consumers (Schwartz, 2010; Tennyson, 2010). Another study found that consumers who prefer informal sources of information such as family and friends have significantly lower knowledge of insurance than others, and respondents who preferred sources of insurance information from an expert, not directly affiliated with the insurance industry, exhibited the highest knowledge in the study sample (Tennyson, 2010).

Manuel (2005) stated that poor and inadequate disclosure of fees and charges has been haunting the industry for decades, and having the legal architecture in place is no panacea as it must be acknowledged that consumer education and financial literacy is crucial. Section 2(1) of the Financial Services Board Amendment Act (RSA, 2000), lists one of the roles of the FSB to be the promotion of programmes and initiatives by institutions and bodies representing the financial services industry to inform and educate users and potential users of financial products and services.

Proponents often cast financial literacy as a means to reducing barriers to participation in markets and improving the accessibility of relevant information (Cartwright, 2004; Fox, Bartholomae and Lee, 2005; Howells, 2005). Williams (2007) sees financial literacy as working in concert with consumer protection measures to improve decision-making skills enabling individuals to make use of remedies such as disclosure.

The Organization for Economic Co-operation and Development (OECD, 2005) defined financial education as the process by which financial consumers/investors improve their understanding of financial products, services and concepts and through information, instruction and/or objective advice, develop the skills and confidence to become aware of risks and opportunities, to make informed choices, to know where to go for help and to

take other effective actions to improve their financial well-being and protection. This definition has also been adopted by the Financial Services Board in South Africa.

Willis (2008) notes that as products have become more complex, financial literacy education has become a necessary corollary to disclosure, but is not convinced that this type of education turns consumers into active market players, competent to handle their own financial matters. Willis (2008) demonstrated that the belief in the effectiveness of financial-literacy education lacks empirical support, arguing that the gulf between literacy levels of most Americans and that required to access the plethora of insurance, investment products and new products, realistically cannot be bridged.

The cognitive components of financial literacy include being knowledgeable on the issues such as the time value of money in investments and the pooling of risk in insurance (Hogarth, 2002). Turning cognitive literacy into positive action requires a degree of well-calibrated confidence strained by neither over-confidence nor under-confidence (Barber & Odean, 2000).

### **4.3 Consumer Behaviour and the Limits of Learning**

Research on the limits of human rationality, and on literacy and learning expose some of the challenges of trying to inculcate in consumers, the habits, skills and tastes of the responsible financial shopper (Williams, 2007). Behavioural research identifies several reasoning biases that generally prevent consumers from giving effect rationally to their preferences even when they have access to relevant information. Experimental studies have repeatedly shown that individuals select differently from among the same options depending on the context of their choice and how it is framed (Bowles, 1998; Rabin, 1998; Hanson & Kysar, 1999).

Studies document inconsistent preferences in a wide range of different settings from voting to healthcare decisions to financial services and some show persistence of inconsistencies even after individuals have been alerted to them (Benartzi & Thaler,

1999; Kahneman & Tversky, 2000). Robust findings such as these in addition to cognitive limitations influence consumer choices and responses to information asymmetries (Hanson & Kysar, 1999).

Cognitive limitations create incentives for financial firms to pursue increased profits by systematically attempting to manipulate consumer behaviour and firms adopting such a strategy need not attempt to change consumer preferences, since they can achieve goals through product marketing that elicits and exploits inconsistencies in consumers' decisions and communications that deflect information remedies (Williams, 2007).

According to Tversky & Kahneman (1987), education neutralizes behavioural biases when the learner receives "accurate and immediate feedback about the relation between situational conditions and the appropriate response". Neither formal educational nor informal learning experiences, such as reading popular money advice literature or speaking with acquaintances, benefit from such conditions (Williams, 2007). Behavioural scholarship shows that departures from the assumptions of rational decision-making are common, persistent, and difficult for education to correct, with the literature suggesting that even the most intrusive consumer education programmes may have difficulty in changing how consumers decide (Williams, 2007).

Gabriel and Lang (1995) pointed out that vast amounts of money are spent by firms on promotional communications and the collection and scrutiny of data on consumer behaviour. Besides its assumption of consumer rationality, the regulatory project of financial literacy education generally assumes a level of predictability about what consumers learn (Williams, 2007). Educators face a challenge of attempting to teach relatively complex lessons purporting to impart a mix of skills, personal attributes, and information that together will produce responsible, confident and capable consumers (Williams, 2007). Regulators attempts to enhance knowledge and decision making skills may offer consumers valuable resources, but typically do not provide immediate and salient feedback on the relationship between consumers' decision and its consequences (Williams, 2007).

Gabriel & Lang (1995) document the complex nature of the consumer whose behaviour exhibits a wide range of contradictory traits with the same consumer acting in different ways in similar or different settings for reasons that may be “opaque”. These characteristics of consumer behaviour may influence the reception of financial literacy education, with some aspects being embraced by consumers while others are repudiated.

Hodgson (1999) reminds us that education is a complex process requiring the shedding of old beliefs and developing a capacity to unlearn and learn anew, conditioned by the distinctive values, assumptions, and interpretative repertoires by which individuals make sense of their worlds. The same teachings on financial literacy would produce different lessons from one consumer to another.

To conclude that consumers may not be governable in ways that financial regulators envisage, is not to deny that better financial literacy skills improve the experience of financial consumption or that some types of financial education may change some kinds of consumer behaviour. Just like in the USA and the UK, in South Africa policy has been developed pursuant to statutory mandates to improve financial literacy skills. All have represented financial education as empowering consumers to become more effective decision makers. However, none has perceived its role as confined to supplying information that the market fails to generate.

#### **4.4. International Experience in Consumer Financial Education**

Traditionally, financial education has been delivered in private settings, away from the state’s gaze, however, the systemic expansion of financial literacy interventions by national regulators seem to be a distinctive contemporary development (Williams, 2007). The international experience shows that many countries adopt a national strategy for financial education, coordinated by a dedicated government structure, as is the case of New Zealand, United States of America, United Kingdom, Australia and Brazil. In most cases, the national strategy has been launched and coordinated by a dedicated

government structure set up by the authorities as it is the case in the UK being the Financial Services Authorities, in the USA being the Financial Literacy and Education Commission and the Australian Literacy Foundation in Australia.

Concerns about the levels of financial literacy in the United States of America have been voiced by Lamb (2002), Grace & Hauptert (2003), Jackson (2003) and Tossaint-Comeau (2003). There has also been a call to foster financial Literacy in the United kingdom (Burgess, 2003) with the growing gap between peoples' long-term needs and their savings.

#### **4.4.1 Financial Literacy in the United States of America**

A Financial Literacy Scoping Study and Strategy Project by FinMark-Trust (2004: 24) lists the following as some of the most common financial literacy programmes encountered in the United States:

- (i) school programmes based on the notion that early intervention and familiarity with financial management skills build a foundation for progressively and responsibly entering into financial transactions;
- (ii) social service and community-based organisation programmes offered by NGOs or community-based organizations through workshops. While these programmes may be limited in outreach, they have the advantage of a clear understanding of the specific needs of their communities and the ability to design programmes that address their needs;
- (iii) employer-based/workplace programmes that include seminars on pensions and retirements;
- (iv) financial institutions play a significant role in promoting better financial skills for consumers usually targeted at lower income communities focusing on basic literacy, promoting brand recognition and increasing market share;

- (v) Money Smart Adult Financial Literacy Programme is a cooperative venture between the United States Department of Labour and Federal Deposit Insurance cooperation in a training programme to help adults enhance their money skills; and
- (vi) Jump\$tart Coalition for Personal Financial literacy aimed to enrich the curriculum to ensure that basic personal financial management skills are attained during the K-12 educational experience.

Despite a proliferation of financial education programmes in the United States, both financial literacy and financial behaviour fail to show significant improvement in financial literacy (FinMark-Trust, 2004). Only a fifth of American adults have the quantitative literacy, for example, to take a label containing the price and number of ounces of a jar of peanut butter and determine the cost per ounce (Kirsch, 2002).

As an example, Willis (2008) cites the American Jump\$tart nationwide survey of high school seniors consistently showing that financial education does not increase financial knowledge. A longitudinal study conducted in the years 1997, 1999 and 2002 compared a matched sample of former high school students from a single district, who completed a semester long financial management course, five years later were found to be, neither more financially literate nor any more likely to engage in any better financial behaviour than those who had not (as cited in Willis, 2008)

Lusardi & Mitchell (2007:36) note that although higher education is correlated strongly with increased financial literacy, the education through regulation model is not very convincing and make reference to a 2006 survey of Baby Boomers approaching retirement, where nearly 80% could not answer the following question correctly: Let's say if you have \$200 in a savings account earning 10% interest, how much would you have in the account at the end of two years?

Willis (2008) believes that the effectiveness of financial literacy education lacks empirical support arguing, firstly, that the gulf between the literacy levels of most Americans and that required to assess the plethora of products today, and new products as they are invented tomorrow, will realistically not be bridged. Secondly, the information asymmetry inherent in the market with sellers having access to more information and resources to analyze it, and by the time developments, filter through to educators and students, the market place may well have changed, making the material taught obsolete on arrival or by the time the consumer attempts to use it.

Surveys in the US have found that the most effective form of financial education is through the media. In one survey, 71% of consumers chose television, radio, magazines and newspapers as the most effective way to learn about personal finance, while information brochures and presentations in the home were the next most effective method of acquiring financial expertise (Braunstein & Welch, 2002).

Financial education should be provided to adults at “teachable moments” (Braunstein & Welch, 2002). Such moments include the point at which consumers make long-term financial decisions, such as taking on a home mortgage. Other moments occur when consumers plan their retirement and start to save through private pension plans or other long-term saving instruments.

#### **4.4.2 Financial Literacy in the United Kingdom**

The Financial Services Authority (FSA) was constituted as a response to a financial industry restructuring process necessitated after a period of bank failures and widespread misselling of financial products (Williams, 2007). The Financial Services Authority is an independent non-governmental body for the financial services industry in the UK, whose objectives include the promotion of the awareness of financial systems, consumer protection and reduction of financial crime (FinMark-Trust, 2004).

Improved financial education reduces the information asymmetries, causes higher demand for financial products and promotes market transparency (Gjebrea, 2006). The FSA financial literacy programme includes resources to develop financial capability through primary and secondary school teachers. Online information is available to the general public on basic financial products and services as well as information on how to perform basic banking transactions.

In 2001, the National Association of Citizens Advice Bureau conducted a financial literacy study and found that not only did financially illiterate consumers have a difficulty in choosing appropriate products and services, but were also more likely to become victims of abusive practices. One of the subsequent initiatives to improve financial literacy was the introduction of financial education into the National Curriculum accompanied by a bank of information resources with aspects of personal finance being embedded as a statutory part of the national Curriculum for 11-14 year olds and for 14-16 year olds through compulsory teaching of Citizenship. However, due to concerns of some members of the financial industry about the failure of the educational system to prepare children for dealing with financial issues, the Personal Finance Education Group arose, a charity working within schools across the United Kingdom, while maintaining a strong relationship with the Financial Services Authority (FinMark-Trust, 2004).

The Royal Bank of Scotland invests in community projects such as understanding finance, where the bank provides teaching materials and support to teachers (FinMark-Trust, 2004). The Adult Financial Literacy Advisory Group, represented by the Association of British Credit Unions, Association of British Insurers, Association of Unit Trust and Investment funds, Basic Skills agency, British Bankers Association, Department of Employment and Education, Department of Social Security, Financial Services Authority, Department of Treasury, National Association of Citizens Advice Bureau and The University for Industry, were established with the purpose of making recommendations on improving financial literacy of the adult population, with emphasis on disadvantaged individuals (FinMark-Trust, 2004)

Some of the other organizations that have played an active role in financial education include the (FSA, 2006):

- (i) Age Concern, a community-based charity that improves the quality of life for older people with publications such as Taxes and Savings, Pensions Handbook, and Retirement Handbook;
- (ii) Association of British Insurers, providing financial planning material for schools with publications such as Money Management Review, Risk and Reward;
- (iii) Associations of Unit Trusts and Investment Funds, a 24 hour telephone information line with publications such as fact-sheets on unit trusts and investment funds, guide to where to obtain generic information on key aspects of personal finance;
- (iv) Bank of Scotland, provides resources to schools with publications including Money Matters and Managing your Money;
- (v) Barclays Bank, provides resources with publications including Money choices;
- (vi) Credit Action, a debt counselling agency with publications including various guides to Better Money Management; and
- (vii) Lloyds Bank, which distributes material to school by mail order with publications such as The Next Step.

While there are many other organizations that have not been listed, the majority of the organizations provide information on matters relating to money. The results of the FSAs' major financial capability survey showed that in 2005, many UK consumers lacked the confidence and capability to make effective decisions about their money (FSA, 2006). The FSA financial capability survey measured different types of financial behaviour and

attitudes in five key areas: making ends meet, keeping track of money, planning ahead, choosing products and staying informed.

Young adults, students and children feature prominently among those targeted for capacity enhancement under the following projects (FSA, 2006):

- (i) *Learning Money Matters* involves the integration of financial education into the curricular of 1.8 million students in 4000 primary and secondary schools at a cost of \$15 million over five years.
- (ii) *Helping adults make sense of money* is a programme to be delivered to 3.4 million young adults through higher education institution programmes.
- (iii) *Money Box* combines financial information and tools to reinforce the financial capability of 1.5 million new parents.
- (iv) *Make the most of your money* includes 4 million workers participating in workplace seminars on topics such as budgeting, debt, and financial planning, sponsored by the FSA.

Qualitative research, relating to services and costs disclosure, undertaken on behalf of the FSA concluded that (FSA, 2008):

- (i) There was a general lack of recognition that the commission paid could affect the value of the product or that commission might cost the consumer; and
- (ii) Consumers were not aware that they could negotiate on the amount of commission or fee paid to the advisor.

#### 4.5. Financial Literacy in South Africa

Section 3(c) of the FAIS Act (RSA, 2002) outlines the consumer education function of the FSB as follows: “to promote programmes and initiatives by financial services institutions and bodies representing the financial services industry to inform and educate users and potential users of products and services”. This describes the role of the FSB as a promoter and facilitator, rather than as a direct provider or coordinator.

Included in the description above, is the duty to inform users of products which could be interpreted to include product features. However, the literature review did not produce evidence of any efforts to provide education on product features nor any efforts to inform potential clients on the duties of disclosure and awareness of financial advisor’s responsibilities. Any expectation of market forces, by itself, providing an optimal supply of financial education would be considered to be too optimistic. Product suppliers and other providers of financial services may be reluctant to invest in the provision of financial education for the fear of competitors reaping the rewards.

While the FSB has adopted the OECD definition of financial education, efforts so far have emphasized mathematical and financial literacy with much of the focus being on the poor. Arising out of a meeting at the FSB head office, the researcher was furnished with a comprehensive list of the current and past consumer education activities of the FSB (received in July 2010 – see appendix B) prepared by Lyndwill Clark. Discussed below are some of the past initiatives of the FSB.

- (i) “Teacher Development” - the development of financial education resources for teachers in the form of lesson plans and posters based on the National Curriculum Statement. The resource was mediated to 6400 teachers via 99 workshops;
- (ii) “Digitization Project”, a partnership between SAIA, the FSB and the Financial Services Consumer Education Foundation resulted in the production of three

consumer financial education booklets in keeping with the Economic and Management Sciences (EMS) curriculum for the Reception to Grade 9 as well as Mathematical Literacy and Life Orientation for grades 10 to 12. These materials were digitized in a CD-ROM format with four booklets covering the General Education and Further Education and Training band. Sixty workshops in nine provinces were facilitated;

- (iii) “Commuter Education”, where the aim was to reach commuters as they travelled to and from work. Commutanet broadcasted financial literacy messages over their radio station at taxi ranks and at train stations. Kiosks were also set-up at the taxi ranks in order for facilitators to engage with commuters. A CD and tape was also developed to be played in taxis. The target group was commuters in categories 1-5 of the Living Standards Measure (LSM) (see page 92 for explanation of LSM);
- (iv) “KAYA FM” -the FSB had entered into a 6 month contract with KAYA FM to host interviews every Tuesday at 8:30 pm. The topic of the interviews was based on the regulatory and consumer education functions of the FSB. Various ombudsmen and industry role players were also invited to be interviewed. This involved KAYA FM broadcasting from Jabulani (Soweto) and Mamelodi Crossing Malls respectively, using their outside broadcast facilities. FSB staff was on hand to speak to consumers on various consumer issues. The target audience was LSM 1-10;
- (v) “Shopper Education” -the aim was to reach shoppers in the relaxed atmosphere of a mall to engage with them on financial issues. Mall theatre, where short financial shows are performed, also forms part of this project. Target Audience being shoppers in LSM 1-5 areas;
- (vi) “Social grant/ Pension Pay Point Project” - the aim was to reach out to vulnerable consumers at the point of payment. Field workers engage with

pensioners on financial issues such as debt management while they are waiting in line. It is envisaged that volunteers will perform this function in future. The target group was LSM 1-5;

- (vii) “Brochure Development” - the development and translation of brochures for specific areas such as the funeral assistance business, collective investments and trustee training formed a vital part of information dissemination to consumers. It also assisted in providing information on the regulatory functions of the FSB.
- (viii) “Financial Guide for the Youth”. This guide was aimed at youth between 18 and 22 and will address various financial issues such as opening a bank account, debt management, UIF, TAX, PAYE, savings, etc.

A summary of the efforts of the projects and activities initiated and implemented by the Consumer Education Department at the FSB has the following foci: mathematical literacy (simple calculations, interest), financial literacy (debt management, banking, tax), with the target audiences being mostly the poor.

The Head of the Consumer Education Department, Davids (2009), of the FSB acknowledges the need for a new action plan regarding consumer education and presents the vision that “all consumers in South Africa are able to manage their personal and family financial affairs soundly and use available complaints handling mechanisms to report unresolved matters”. Davids (2009) lists one of the strategic objectives as being the establishment of a Consumer Financial Education Central Coordinating Committee (CCC) for consumer financial education in South Africa. The responsibilities of the CCC include: to coordinate the Consumer Financial Education, advise on the development of broad-based criteria and evaluate project proposals.

With about 60% of the households falling in the LSM 1-5 group it is understandable that every effort should be made to support these groups, through education to spend the little money they have as effectively as possible. The initiatives of the FSB is commendable in

this regard, however it does little to reach the actual consumers of Life insurance products. Literacy programmes in schools have proved to have serious shortcomings both in the UK and the USA as discussed previously. What would make the situation worse in South Africa is that educators are challenged with the introduction of Outcomes-Based Education.

The FSB also has a website (available at <http://www.fsb.co.za>) that will be discussed in Chapter 6.

#### **4.6 Empirical Measurement of Insurance Literacy**

A common practice in financial literacy research is to administer knowledge surveys to consumers (Huston, 2010). McCormack *et al.*, (2009) developed a test instrument to examine senior citizens' awareness of health insurance terminology in the USA. The test included ten true/false questions regarding general health insurance terms such as "formulary" and "generic drugs" as well as relating to benefits. The mean overall score on the test was just over 70%, suggesting a moderate level of health insurance literacy among the population which was attributed to senior citizens having more experience with the health care system.

The NAIC (2010) administered a nationwide survey to 1011 respondent comprising ten questions that focused on insurance policy language and insurance contract features in health, property and personal insurance. The overall mean score was 4 out of 10 (40%). Bristow & Tennyson (2001) administered a similar ten question survey to 368 respondents in a single state. The average score was 5.8 out of 10 (58%) which is somewhat better but comparable to the previously mentioned survey.

In insurance, it is difficult to develop reliable assessments of consumer literacy as different insurance products and markets are very distinct, for example-life, health, property, automobile and disability insurance are sold using very different contract forms, terms and concepts

## **4.7 Conclusion**

The desired outcome of consumer education initiatives is supposed to enhance levels of financial literacy amongst consumers so that they would be enabled to make informed decisions regarding financial products. However, such initiatives in the USA and the UK have yielded results, regarding improved literacy levels that can be at best described as being miniscule. Furthermore, most of the initiatives seem to focus on managing money, with very little focus on informing consumers on disclosures. In South Africa, the focus has been very similar, concentrating mainly on the poor.

Several studies have highlighted that there are limits to rational consumer decision making and the lack of valid assessment tools make the evaluation of consumer education initiatives difficult. The next chapter describes the research methodology that would be employed to achieve the objectives of this study.

## CHAPTER 5

### RESEARCH METHODOLOGY

#### 5.1 Introduction

A literature review has been undertaken to explore asymmetric information, the regulation of financial services and consumer education and financial literacy. This chapter outlines the objectives and methodology of the empirical study, incorporating a description of the samples, measuring instruments adopted and the statistical tests used to analyze the data.

##### 5.1.1 Objectives of the Study

The objectives of the study were stated in section 1.4 of chapter one, but are restated here for emphasis. The objectives are:

- To interview senior managers at the Financial Services Board to ascertain the challenges faced by Financial Service providers in meeting regulatory requirements.
- To establish the extent to which financial advisors disclose to consumers the fees charged and any contractual obligations to specific product suppliers.
- To establish the extent to which consumers can differentiate between the features and limitations of basic insurance products commonly sold.
- To capture consumers' perception of their financial advisor's knowledge of financial products on the market.

- To undertake an analysis of consumer education initiatives of the consumer education initiatives of the Financial Services Board.
- To compare the South Africa consumer education initiatives with a few international initiatives in USA and the UK.
- To capture the perceptions of compliance officers regarding disclosures, consumers' knowledge of features of basic life insurance products and premature cancellations.
- To undertake an analysis of the funeral insurance industry in South Africa.

## **5.2 Sampling, Sampling Techniques and Description of the Sample**

Sekaran & Bougie (2010) define the term population as being “the entire group of people, events, or things of interest that the researcher wishes to investigate”. Saunders, Lewis & Thornhill (2009) note that it would be impractical or prohibitive in terms of budgetary and time constraints to survey the entire population. A sample is a subset of a population comprising some members selected from the population. Therefore, the main purpose of sampling is to select a subset of the population in such a manner that it exhibits the same distribution of characteristics as the population.

Probability and non-probability sampling are the two major types of sampling design. In probability sampling the elements in the population have some known, non-zero chance of being selected as sample subjects (Sekaran & Bougie, 2010). For non-probability sampling, the probability of each case being selected from the population is not known making it impossible to make statistical inferences about the characteristics of the population (Saunders, Lewis & Thornhill, 2009).

### **5.2.1 The Sampling Process**

With simple random sampling each member of the population has the same chance of being included in the sample and each sample of a particular size has the same probability of being chosen (Welman, Kruger & Mitchell, 2010). In cluster sampling, the sampling frame is the complete list of clusters rather than the complete list of individual cases in the population (Saunders *et al.*, 2009). Then, a random sample of clusters is drawn and for each selected cluster either all the elements or a sample of elements is selected for data collection (Sekaran & Bougie, 2010). With cluster sampling no units from non-selected clusters are included in the sample. This differs from stratified sampling in which some units are selected from each group. If a subset of units is selected randomly from each selected cluster, it is called a two stage cluster sample. Cluster sampling can also be made in three or more stages and is then referred to as multistage sampling.

Multistage sampling is a development of cluster sampling relying on series of different sampling frames, each involving some form of random sampling. According to Sekaran & Bougie (2010), “multistage sampling involves a probability sampling of the primary sampling units, from each of these primary units, a probability sampling of secondary sampling units is then drawn, a third level of probability sampling is done from each of these secondary units, and so on”. Cluster samples offer more heterogeneity within groups and more homogeneity among groups (Sekaran & Bougie, 2010).

### **5.2.2 Profile of Population**

The Living Standards Measure (LSM) was developed by the South African Advertising Research Foundation (SAARF) whereby households were classified into ten groups according to amenities at the disposal of the household and the area where they live. LSM 1 denotes households with the lowest and LSM 10 the highest living standards. The Bureau of Market Research estimated that for households falling in the LSM 1 group, food, clothing and footwear, and housing contributed to almost 80% of the cash budget of

households with food alone consuming 71% of the budget with this decreasing to 24% for the LSM 6 group and less than 11% for the LSM 10 group. The share of the R52,3 billion rand expenditure on insurance and funds was estimated as being 4% for the LSM 1-4 group, 30.8% for the LSM 5-7 group and 65.2% for the LSM 8-10 group (Martins, 2006).

According to FinMark Trust (2010), 23% (7.8 million) of South African adults have some life assurance products covering a defined risk with 19% (6.3 million) having life coverage comprising 2% of the LSM 1-4 population, 12% of LSM 5-6 population, 35% of the LSM 7-8 population and 56% of the LSM 9-10 population. Further, according to race, 18% of blacks, 54% of Whites, 23% of Coloureds and 47% of Asians have Life cover. Finally, according to monthly income 80% of those that earn R8000+, 65% of those that earn between R4000 – R7999 have life cover and for other categories it is less than 10%

### **5.2.3 The Sample**

#### **5.2.3.1 Sample of Consumers of Life Insurance Products**

The largest province by population is KwaZulu-Natal followed by Gauteng, Eastern Cape, Western Cape, Limpopo, North West, Mpumulanga, Free State and Northern Cape in order of decreasing population sizes. Due to time and monetary constraints, it was decided to conduct the study in three provinces only. More than 75 % of the population is represented in five of the largest provinces. Using these five provinces resulted in 10 permutations of sets of three provinces. From these permutations one set was selected at random. The set of provinces selected was KwaZulu-Natal, Gauteng and Western Cape.

Given the profile of the population (35% and 56% of the LSM 7-8 and LSM 9-10 categories, respectively), it was considered very likely that members of the population would have relatively more disposable income than members of other categories. It was also assumed that much of this disposable income would be spent at retail outlets.

Prinsloo (2010) adjusted the hierarchical model of shopping centres in South Africa, developed by Kahn (1988) for a better understanding of the retail market, by incorporating threshold values of specific LSM groups that are required to warrant retail of any kind. Consumers at super regional centres and major regional centres share the same LSM characteristics, according to Prinsloo's model, as the population.

For each of the selected provinces, a sampling frame was constructed, using the Mall Guide Database, of all the super-regional and major regional centers in each province. From each list a retail centre was selected randomly. In the province of Gauteng, Cresta Mall in the Randburg was selected, in the Western Cape province, Kennilworth mall in Kennilworth was selected and in the province of KwaZulu-Natal the Pavillion Mall in Westville was selected. For each selected mall two consecutive days (Friday and Saturday) were selected randomly from the months of April, June and July 2011 to conduct the survey.

The mall intercept survey is used most frequently for market research. The name is derived from its traditional deployment at shopping malls, where there are many readily available persons to sample and from whom to gather data. Generally, an intercept study entails selecting respondents by stopping them (i.e. intercepting them) in a public place (e.g. a shopping mall). Once a potential respondent is stopped by an interviewer, he or she can be screened using criteria that determine whether an individual would qualify as a subject. To address any limitations regarding representativity, researchers often attempt to conduct the survey in a number of locations and at varying times to try to ensure that the variability within the population of interest is represented.

As population size increases, the sample size increases at a diminishing rate and remains relatively constant at slightly more than 380 cases (Krejcie & Morgan, 1970). This means that a sample size of 380 is equally useful in examining the opinions of a state of 50 000 000 as it would a city of 100 000 individuals. For this study a sample size of around 380 was considered to be appropriate.

### **5.2.3.2 Sample of Compliance Officers**

A sampling frame was constructed using the list of approved compliance practices appearing on the Financial Services Board website. Included in the list were the names, telephone numbers as well as addresses of compliance practices. The number of compliance practices operating as compliance officers for long-term insurance was established to be not more than 1200. Random sampling was used to obtain a sample of 200 compliance officers. The sample size was limited to 200 due to budgetary constraints.

## **5.3 Survey Method**

According to Scheuren (2004) a survey involves the gathering of information from a sample of individuals by means of standardized procedures so that every individual is asked the same questions in more or less the same way. The survey method is a technique of gathering data by asking questions to people who are thought to have desired information. The intent of the survey is not to describe the particular individuals who, by chance are part of the sample but to obtain a composite profile of the population. Surveys provide a speedy and economical means of determining facts about people's knowledge, attitudes, beliefs, expectations and behaviours. This study entailed cross-sectional surveys. Cross-sectional surveys are used to gather information on a population at a particular point in time. The survey methods employed in this study incorporates personally administered questionnaires, mailed questionnaires and an unstructured interview.

### **5.3.1 Personally Administered Questionnaires**

Questionnaires were personally administered to consumers of insurance products by trained research assistants at selected malls.

### **5.3.2 Mail Questionnaires**

Questionnaires were mailed to compliance officers to be self-administered. A return stamped envelope was included. The researcher considered this to be the lowest cost option given the geographic coverage and otherwise inaccessible respondents.

### **5.3.3. Unstructured Interviews**

The advantage of an interview is that the interviewer can probe for answers and use follow-up questions. The interviewer suggests the general theme of discussion and poses further questions as these come up in the spontaneous development of the interaction between the interviewer and the research participant.

The proposal for this study was presented to the Financial Services Board for scrutiny and comment, as the researcher wanted to establish whether a study of this nature was warranted. The Registrar of Financial Services Providers was satisfied (see appendix A) that “this research into the effect of the Financial Advisory and Intermediary Services Act on the consumer is acceptable and will add value to the understanding of the impact of legislation on the consumer”. Furthermore, the Financial Services Board supported the research and endorsed the researcher’s requests for information in pursuit of the research.

In keeping with this, the researcher arranged, through Wendy Hating (Head of FAIS Supervision), an interview (April 2010) with senior managers at the FSB head office in Pretoria. The objective of the interview was to gain first-hand information on the challenges presented by the implementation of legislation. The results of the interview are presented in the next Chapter.

## **5.4 Measuring Instruments**

The research instruments used for data collection were questionnaires. The most common technique for researchers to operationalise variables is to phrase questions in such a manner so that data for analysis and interpretation may be obtained. The questionnaires were planned and designed according to the research questions.

### **5.4.1 Questionnaire for Consumers of Insurance Products**

The questionnaire was undertaken in the English medium. Given that most insurance policies are written in English anyway, it was assumed that those that have entered into such contracts would have a reasonable understanding of English. A questionnaire with two sections was constructed, comprising close-ended questions, constituting structured statements or assertions. The purpose was to elicit perceptions and attitudes held by respondents regarding various variables of interest. Section A comprised biographical information and section B comprised of five questions relating to the variables of interest.

#### **5.4.1.1 Biographical Data**

The biographical data comprised the respondent's gender, age group, educational qualifications, and place of residence. Biographical data was collected to check if they played a role in any variation in the variables of interest and whether they correlated to the variable of interest.

#### **5.4.1.2 Variables**

The variables in this study are the level of disclosures regarding financial advisor's fee charged, level of knowledge of the features of basic insurance products, respondent's perceptions of the level of knowledge of their financial advisors, level of premature terminations of life insurance policies and respondent's level of awareness regarding consumer education initiative. Question 1 comprised of 9 sub-questions relating to

disclosures regarding fees charged. Question 2 comprised 12 sub-questions relating to consumers understanding of the features of basic insurance products. Question 3 comprised of 7 sub-questions that captured the perception of consumers regarding the knowledge level of their financial advisors. Question 4 comprised of 9 sub-questions that relate to the premature termination of Life insurance policies. Question 5 comprised 11 sub-questions relating to awareness of consumer education initiatives.

### **5.4.1.3 Content Validity**

Content validity involves the degree to which the content of a test matches a content domain associated with the construct. Content validity of a measurement instrument for a theoretical construct reflects the degree to which the measurement instrument spans the domain of the construct's theoretical definition Rungtusanatham *et al.*, (1998). The extensive literature survey was very resourceful in reflecting the various magnitudes of the variables in this study. Rungtusanatham *et al.* (1998) contends that literature support is necessary, but an insufficient condition for concluding content validity, arguing that one needs to go beyond invocations of literature support in offering rigorous evidence of content validity.

Foxcroft *et al.*, (2004) note the content validity of a test can be improved by using a panel of experts to review the test specifications and the selection of items. Content validity depends on a theoretical basis for assuming if a test is assessing all domains of a certain criterion. One widely used method of measuring content validity was developed by C.H. Lawshe which entailed a method of gauging agreement among raters regarding how essential a particular item is. Lawshe (1975) proposed that each of the subject matter expert raters respond to the following question for each item: "Is the knowledge measured by this item 'essential', 'useful', but not 'essential' or 'not necessary' to the performance of the construct?" and developed a formula termed the content validity ratio:  $CRV_i = (n_e - N/2)/(N/2)$  where  $n_e$  = number of subject matter panelists indicating "essential",  $N$  = total number of subject matter panelists. The formula yields values from +1 to -1.

In this regard a panel of 10 subject matter experts, comprising lecturers in the field of Risk Management and Insurance, members of the Financial Planning Institute, and managers at the Financial Services Board were asked to indicate whether or not a measurement item in a set of other measurement items is 'essential' to the operationalization of the construct relating to consumers knowledge of the features of basic insurance products. Lawshe (1975) further established minimum CVR values for varying panel sizes based on a one-tailed test at the 0.05 level of significance, for example, a panel size of 10 members items that result in a  $CRV > 0.62$ , is retained in the set and considered to contribute to content validity. The subject matter expert input was then used to compute a content validity ratio for each  $i$ th candidate item in a measurement instrument  $CRV_i$  and those items with a  $CRV < 0.62$  were excluded.

#### **5.4.1.4 Pretesting**

Since the questionnaire comprised a new set of questions pretesting was necessary to correct misunderstandings or biasing effects of different questions. The questionnaire was reviewed by colleagues who are involved in this field and are familiar with the nature of the study. These individuals advocated certain changes leading to the editing of certain questions and the omission of others, thus ensuring proper construction and phrasing of the questionnaires. This strategy ensured face validity, namely, the instrument measures what it intends measuring.

#### **5.4.1.5 Pilot Testing**

One of the methods of improving reliability is to use a pilot version of a measure before applying the final version. A pilot study is conducted to detect weaknesses in design and instrumentation. A pilot study was conducted to determine the validity and suitability of the questionnaire and to make any alterations before administering the questionnaire. The questionnaire was administered to 30 subjects. According to Scheuren (2004), analysis of item non-response rates from the data collected can provide useful information about how well the questionnaire works and missing items are an indicator of

how difficult a question was to answer or how often respondents find certain versions of the question too sensitive to be answered. The pilot study indicated that the subjects understood the instructions and questions were reasonable with no confusing questions, thus leading to no further modification of the questionnaire.

#### **5.4.2 Questionnaire to Compliance Officers**

A questionnaire with two sections was constructed constituting close-ended questions, comprising structured statements or assertions. The purpose was to elicit perceptions and attitudes held by respondents regarding various variables of interest. Section A comprised biographical information and section B comprised of five questions relating to the variables of interest. All questions were closed questions incorporating Likert scales.

### **5.5 Administration of Questionnaire**

Permission was formally requested from the Management of the selected malls to administer the questionnaire within the mall premises. In all cases, an area was designated where a stand, comprising a table, chairs and banners, was set up. For each city, experienced research assistants were arranged for by universities in the region. The research assistants for Randburg, Kennilworth and Westville were drawn from the Universities of Johannesburg, Cape Town and KwaZulu-Natal respectively. For each venue, four research assistants were used and were trained and supervised by the researcher. Research Assistants intercepted passing consumers at random and posed the screening question: "Did you purchase any insurance related financial product in the past 8 years?". Those that responded positively were then asked whether they would want to participate in a survey that involved completing a questionnaire which took about 15 minutes to complete. Questionnaires were administered over two consecutive days at each mall.

Regarding the questionnaire to compliance officers, they were posted in August 2010. The researcher continued to receive returns until June 2011, although at a very slow rate.

## **5.6 Data Editing**

Data editing detects errors and omissions and corrects them where possible and assures that the data is accurate, complete and uniformly entered.

### **5.6.1 Coding**

According to Lockyer (2004) coding is a systematic way in which to condense extensive data sets into smaller analyzable units through the creation of categories and concepts derived from the data. Coding converts non-numeric codes by assigning numbers to answers in a questionnaire. According to Bourque (2004) for surveys or questionnaires, codes are finalized as the questionnaire is developed. Codes need to be collectively exhaustive and mutually exclusive (Shenton, 2004).

### **5.6.2 Data Cleaning**

The data was initially entered into a Microsoft Excel file. Formulae incorporating conditional formatting were used to address wild codes and inconsistencies. Wild codes include codes that lie outside the valid range. For example, if 1 = female and 2 = male then any code not equal to 1 or 2 is a wild code that needs to be cross referenced to the actual response on the questionnaire. Inconsistencies include responses to a question that is inconsistent with a response to another question. For example, if the highest qualification is post graduate, the age is 5 years then an inconsistency exists. The count function was used to check for missing values. Blanks identified had to be checked with the questionnaire to establish whether there were actually blanks on the questionnaire or an error in data capture. If more than 25% of the questionnaire was blank it was discarded. If just a few items were left blank the value given was the majority response. In the case where many questionnaires had the same item as a blank, the item was ignored for analysis.

### **5.6.3 Data Capture**

Data capture entails the process of storing the data into the data editor of a software package. The software package that was used was SPSS (Statistical Package for Social Science) where rows were cases and columns were variables. The Excel files created earlier were imported into SPSS.

## **5.7 Statistical Analysis of the Data**

According to Dodge (2003), statistics is the study of the collection, organization, analysis, and interpretation of data, including the planning of data collection in terms of the design of surveys and experiments. Whenever undertaking statistical analysis, the four levels of measurement, namely, nominal, ordinal, interval and ratio levels of measure must be taken into account because the level of measurement depends on the way in which a construct is conceptualized, that is, whether it has particular characteristics.

### **5.7.1 Levels of Measurement**

According to Pagano (1994) in nominal measurement responses are classified into categories that are mutually exclusive and collectively exhaustive. For example “agree” is coded as “1” and disagree is coded as “2”. The numeric value attached to the answers has no meaning and is a mere identification. In this study, gender and race are at the nominal level of measurement. Also at the nominal level of measurement are the responses to statements regarding disclosures of fees charged by the financial advisor, understanding some of the basic features of insurance products, perceptions of respondent financial advisor, premature termination of life insurance and questions relating to consumer awareness.

Welman *et al.*, (2010) state that an ordinal measurement not only categorizes the variables in such a way as to denote qualitative differences, it also rank orders the

categories in some meaningful way, but the differences of the magnitude between the responses is not known. In this study, educational qualification is at the ordinal level of measurement. Welman *et al.*, (2010) note that the interval measurement not only groups the responses according to certain categories and taps the order, it also measures the magnitude of the differences in the responses. In this study, age group is taken to be at the interval level of measurement.

According to Murthy & Bhojanna (2010), the ratio scale is a special kind of measurement that has a meaningful zero point and is the most powerful type of measurement allowing for mathematical operations such as multiplication and division. In this study, the computed level of knowledge score and level of awareness score is at the ratio level of measurement.

### **5.7.2. Descriptive Statistics**

Pagano (1994) states that descriptive statistics includes both specific numbers (central tendency and measures of variability) and the presentation of data in tabular and graphical form in order to make information explicit. Measures of central tendency that will be used in this study include the mean, mode and median. Measures of variability that will be used in this study include the range, variance and the standard deviation. Data will also be presented using frequency distributions, graphs, pie charts and tables.

### **5.7.3. Inferential Statistics**

Inferential statistics embrace techniques that allow one to use sample data to draw conclusions about the population (Pagano, 1994). Parametric statistics are based on the assumption that data has a normal distribution and there is homogeneity of variances between groups. Parametric testing also assumes the data being analyzed are at the interval or ratio level. Parametric tests include Chi Square, t-Test, ANOVA and Pearson's Product Moment Correlation. In this study, Levene's test was employed to

check for homogeneity of variances and the Kolmogorov-Smirnov test was used to check for the normality of distributions.

Levene's test is used to check whether variances are different in different groups. It tests the hypotheses that the variances in the two groups are equal (the differences between the variances is zero). If Levene's test is significant at  $p \leq .05$  then the variances are significantly different and the assumption of homogeneity of variances has been violated. Levene's test may not necessarily be the best way to judge whether variances are unequal enough to cause problems. If the value obtained when the largest variance is divided by the smallest variance it should be smaller than a critical value of 5. When group sizes are unequal, violations of the assumptions of homogeneity of variance can have serious consequences. If the homogeneity of variance assumption is broken Brown-Forsythe F-ratio is more robust.

According to the Central Limit Theorem, in Mathematics, the distribution of an average will tend to be normal as the sample size increases, regardless of the distribution from which the average is taken (Field, 2010). The sum of a large number of independent observations from the same distribution has an approximate normal distribution. In other words, the mean of a sufficiently large number of independent random samples, each with a finite mean and variance, will be approximately normally distributed. The null hypothesis for the test of normality states that the actual distribution of the variable is equal to the expected distribution, i.e. the variable is normally distributed.

Non-parametric tests make no assumption about the distribution of the data nor do they rely on estimates of population parameters such as the mean. Non-parametric statistics include various tests that are based on rank order of the data rather than on the mean. However, non-parametric tests are more prone to type II errors than parametric methods. This means that non-parametric tests typically require comparably larger sample sizes in order to demonstrate an effect when it is present. In this study, where the distribution is found to be not normal, the non-parametric counterpart will be used, for example, the

Kruskal–Wallis test instead of ANOVA. Where homogeneity of variances have been violated, the Robust test for equality of means would be used (Brown –Forsythe F-ratios).

A normal distribution is a continuous distribution. To use the normal approximation we first acknowledge that the normal distribution is continuous and apply the continuity correction. A continuity correction is applied when discrete distributions supported on integers are approximated by the normal distribution (Devore, 1995). In other words, a continuity correction factor is used when a continuous function is used to approximate a discrete function.

The Pearson’s product-moment correlation coefficient is commonly used to assess the relationship between two variables. If instead the two variables are measured at the nominal level, the relationship is assessed by cross-tabulating in a contingency table (Field, 2010). A contingency table is two-dimensional (rows x columns) table formed by ‘cross classifying’ subjects or events on two categorical variables. One variable’s categories define the rows while the other variable’s categories define the columns. The intersection (cross tabulation) of each row and column forms a cell, which displays the count (frequency) of cases classified as being in the applicable category of both variables.

Even though a statistical test may show statistical significance between two variables, the relationship between these variables may not be substantially important. Other measures of association are available to help evaluate the relative strength of a statistical significant relationship. A contingency table represents the cross-classification of two or more categorical variables arranged in a grid, with the number of each category being noted in the cells of the table and the significance level is interpreted to measure strength (Field, 2010). The Pearson’s Contingency may be used to interpret the measure of the relative strength of an association between two variables (Field, 2010).

## **5.8 Conclusion**

To capture the perceptions of consumers of insurance products, a sample size of around 380 was employed. Multistage sampling was adopted as a sampling strategy to conduct a survey in Johannesburg, Cape Town and Durban. A mall-intercept survey method was employed to administer a questionnaire to respondents. The questionnaire was validated and pretesting and pilot testing was undertaken. Random sampling was used to obtain a sample of 200 compliance practices. The descriptive statistics and inferential tests that would be used in the next chapter were discussed.

## **CHAPTER SIX**

### **ANALYSIS AND INTERPRETATION**

#### **6.1 INTRODUCTION**

A total of 369 questionnaires were administered to consumers of insurance products, thus falling short of the target of 380. Seventy five of the two hundred questionnaires that were mailed to compliance officers were returned. Descriptive and inferential statistics, using SPSS, were used to analyze the results of the study. The primary questions that needed to be answered are based on a number of secondary questions or statements. The answers to the secondary questions or responses to the statements will determine the answers to the primary questions. An interview was also conducted with managers at the FSB to establish some of the challenges faced by Financial Service providers.

The discussion in this chapter starts with the analysis of the questionnaires administered to consumers of insurance products to be followed by an analysis of the questionnaires administered to compliance officers. This chapter concludes with a discussion of the interview held at the FSB head office.

#### **6.2 Analysis of Questionnaires Completed by Consumers of Insurance Products**

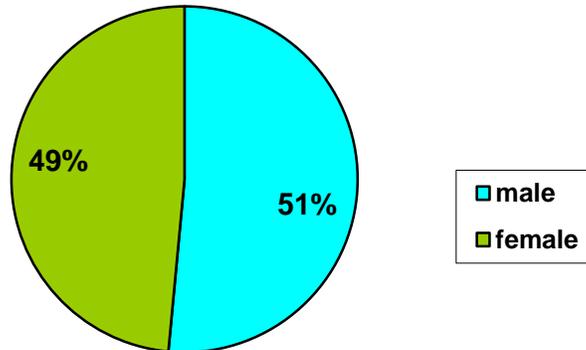
The mall intercept survey did not target respondents according to predetermined numbers relating to gender and race as customers were intercepted at random. It was therefore considered important to establish the gender and race distributions of respondents and establish whether they were representative by comparing the distributions to previously used distributions in a related study such as the FinScope study (FinMark-Trust, 2010).

According to Saunders *et al.*, (2009) it is possible to compare the data collected from the sample with data from another source for the population and if there is no statistically significant difference then the sample is representative.

### 6.2.1 Gender distribution

Questionnaires were administered to 190 (51%) males and 179 (49%) females as illustrated in Figure 6.1.

**FIGURE 6.1 GENDER DISTRIBUTION**



The gender distribution was considered to be satisfactory as it was comparable to the statistics provided by FinMark-Trust (2010), specifically 47% male and 53% female.

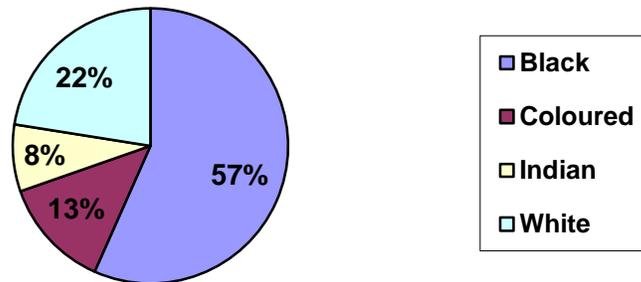
### 6.2.2 Race Distribution

Of the respondents, 209 (57%) were Black, 48 (13%) were Coloured, 29 (8%) were Indian and 83 (22%) were White, as listed in Table 6.1 and illustrated in Figure 6.2.

**TABLE 6.1 RACE DISTRIBUTION**

RACE	NUMBER
Black	209
White	83
Coloured	48
Indian	29
TOTAL	369

**FIGURE 6.2 RACE DISTRIBUTION**



**TABLE 6.2 RACE DISTRIBUTION COMPARISON**

FINSCOPE TRUST STATISTICS						SAMPLE
	% Adults	Number of adults	% with Insurance	Adults with Insurance	%	%
BLACK	75	23 642 653	18	4 255 677	55.21	56.63
WHITE	13	4 098 059	54	2 212 952	28.71	22.6
COLOURED	9	2 837 118	28	794 393	10.31	13.04
INDIAN	3	945 706	47	444 482	5.77	7.88
	100	31 523 536		7 707 504	100	100

SOURCE: Adapted from FinMark-Trust (2010)

Since multistage sampling was used it was deemed necessary to establish whether the distribution according to Race was representative. In order to do this the distribution according to Race had to be compared to Race distributions employed in another study.

The race distribution in the sample compares very well with the FinMark-Trust statistics, and is therefore considered to be representative of the population. The maximum difference between the observed cumulative proportion and the specified cumulative proportion was 0.05 as calculated and tabulated in the Table 6.3.

**TABLE 6.3 RACE GROUP CUMULATIVE PROPORTION DIFFERENCE**

RACE	FINSCOPE %	CUMULATIVE PROPORTION	SAMPLE %	CUMULATIVE PROPORTION	DIFFERENCE
BLACK	55.21	0.55	56.63	0.57	0.02
WHITE	28.71	0.84	22.6	0.79	0.05
COLOURED	10.31	0.94	13.04	0.92	0.02
INDIAN	5.77	0.1	7.88	0.1	0
	100		100		

It may be concluded that the respondents did not differ significantly from the total population in terms of race distribution.

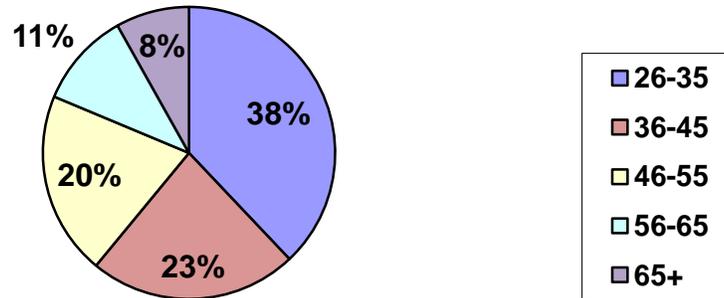
### 6.2.3 Age Group Distribution

The age distribution of the respondents in the sample is tabulated in Table 6.4 and illustrated in Figure 6.3.

**TABLE 6.4 AGE GROUP DISTRIBUTION OF RESPONDENTS**

Age Group	26-35	36-45	46-55	56-65	65+	Total
Number of respondents	140	85	75	39	30	369
Percentage of respondents	38%	23%	20%	11%	8%	100%

**FIGURE 6.3. AGE GROUP DISTRIBUTION OF RESPONDENTS**



The greatest proportion (38%) of respondents was from the 26-35 age group. Despite the research assistants being given training, the researcher was concerned about the possibility that the research assistants would have found it easier to intercept respondents of younger age groups. It was therefore considered important to compare the age group distribution with another source. The mid-year population estimates (Statistics South Africa, 2010) was used as a comparison. The results are presented in Table 6.5

**TABLE 6.5 AGE GROUP CUMMULATIVE PROPORTION DIFFERENCE**

AGE GROUP	MID-YEAR POPULATION ESTIMATES		SAMPLE STATISTICS		DIFFERENCE
	PERCENTAGE	CUMULATIVE PROPORTION	PERCENTAGE	CUMULATIVE PROPORTION	
26-35	35.3	0.35	38	0.38	0.03
36-45	24.7	0.60	23	0.61	0.01
46-55	17.5	0.78	20	0.81	0.03
56-65	12.3	0.90	11	0.92	0.02
65+	10.2	1	8		
	100		100		

The maximum difference between the observed cumulative proportion and the specified cumulative proportion was 0.03 as calculated and tabulated in the Table 6.5.

The age group distribution in the sample compares very well with the mid-year population estimates (Statistics South Africa, 2010), and is considered to be representative of the population and therefore not biased to any age group.

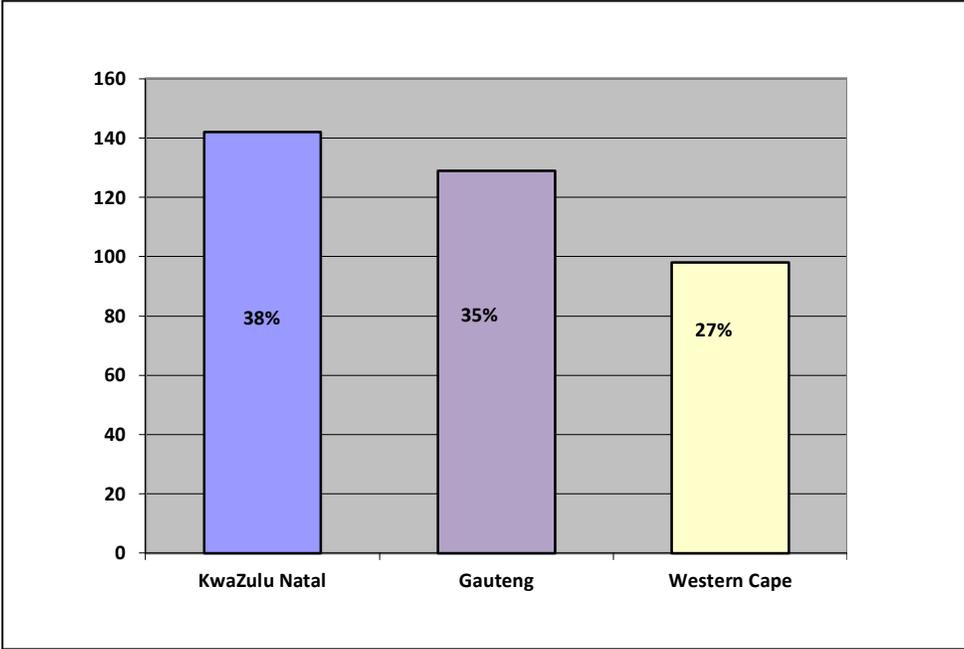
**6.2.4 Place Distribution**

Of the respondents, 129 (35%) were from Gauteng, 98 (27%) were from the Western Cape and 142 (38%) were from KwaZulu Natal as illustrated in Table 6.6 and Figure 6.4.

**TABLE 6.6 PLACE DISTRIBUTION**

	GAUTENG	WESTERN CAPE	KWAZULU-NATAL	TOTAL
NUMBER	129	98	142	369
PERCENTAGE	35%	27%	38%	100%

**FIGURE 6.4 PLACE DISTRIBUTION**

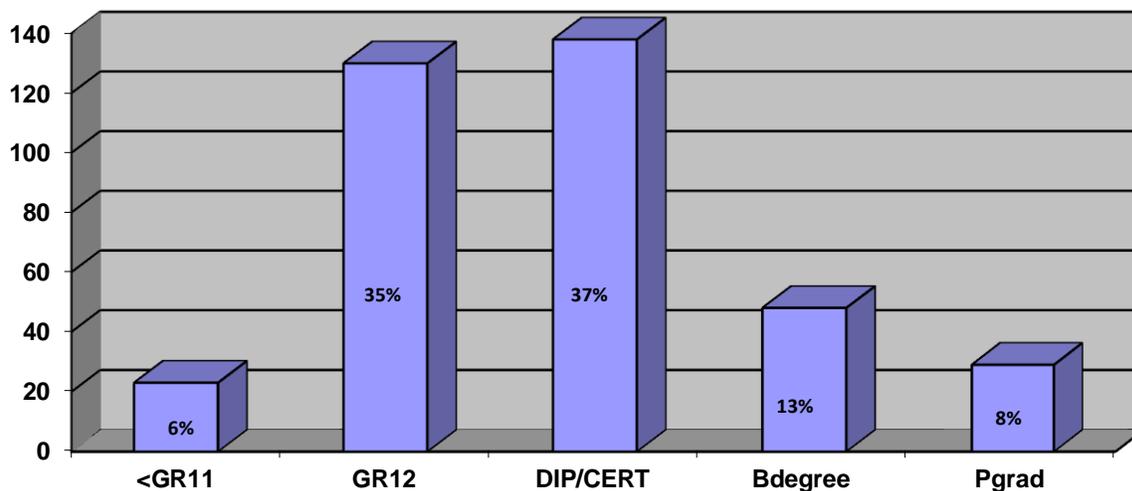


The ratio of the distribution of the sample according to provinces (38%; 35% and 27%) compares favourably to the ratio of the Finscope study (FinMark-Trust, 2010) statistics previously used for comparison (41%; 39% and 20%)

### 6.2.5 Educational Qualification

Of the respondents, 23 have a grade 11 or lower level of education, 130 have a grade 12, 139 have a post matric diploma or certificate, 48 hold Baccalaureate degrees and 29 are post graduates as illustrated in Figure 6.5.

**FIGURE 6.5 EDUCATIONAL QUALIFICATIONS**

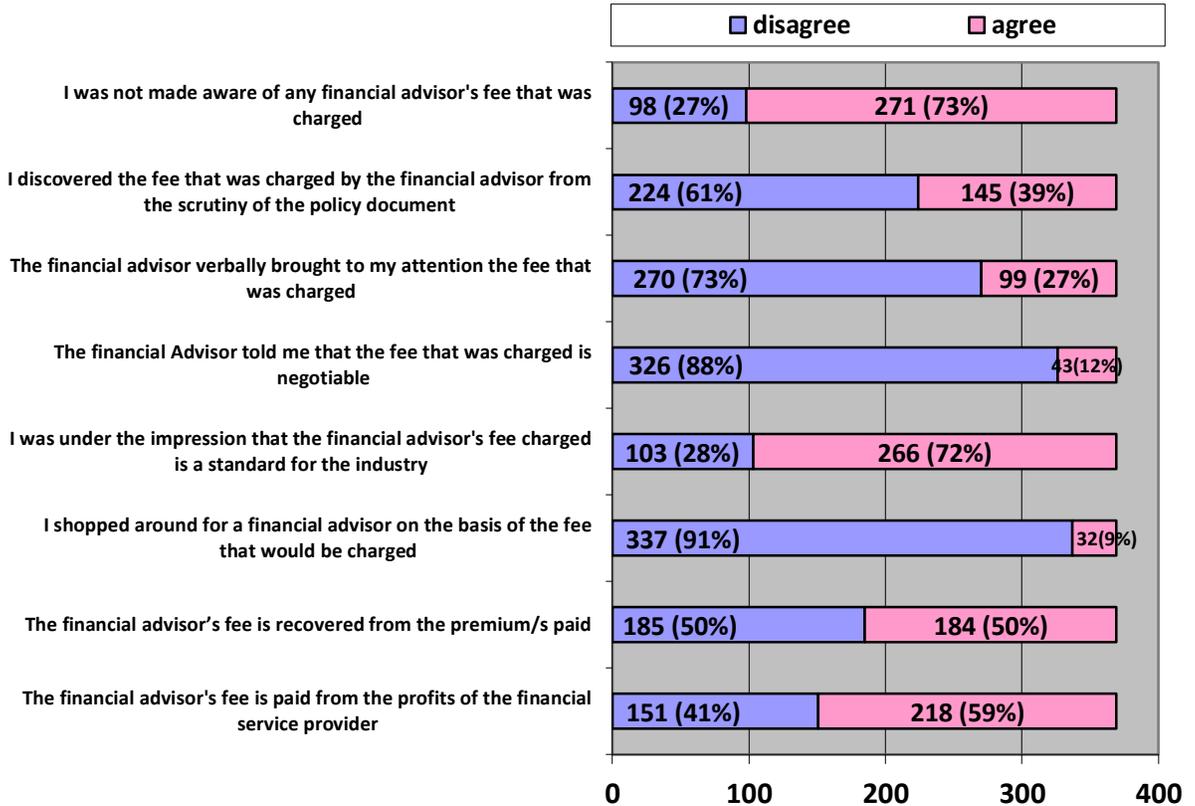


It appears that the users of insurance products in the sample are well-educated with the majority holding post-matric qualifications. This lends support to the view that it was appropriate to administer the questionnaire, to consumers, in the English medium. However, this does not imply that well-educated people are English speakers only. In South Africa, it is common for those students who take other official languages at the first language level in grade 12, to offer English at the second language level. Furthermore, the medium of instruction in most of the higher education institutions is English.

## 6.2.6 Responses to Disclosures Regarding Fees Charged

The responses to statements regarding disclosures of fees charged by financial advisors are illustrated in Figure 6.6 below.

**FIGURE 6.6. RESPONSES TO DISCLOSURES REGARDING FEES CHARGED**

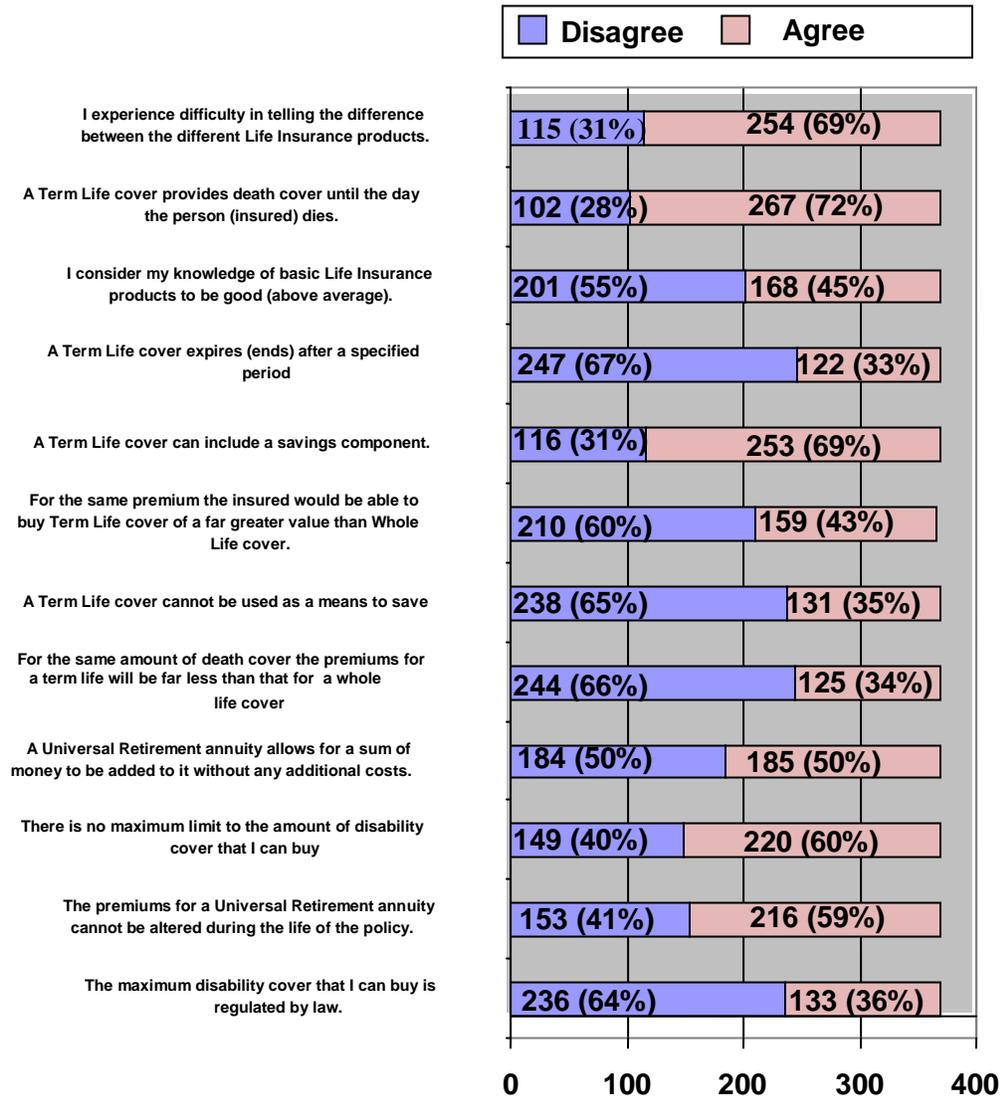


Regarding the financial advisor's fee charged, 73% were not made aware that any advisor's fee was charged and in only 27% of the cases did the financial advisor verbally bring to the attention that a fee was charged. However, even when the fee charged was verbally brought to the attention of the client, only in 12% of the cases did the advisor indicate that the fee was negotiable. It is not surprising that 72% of the respondents thought that the advisor's fee charged is a standard for the industry and only 9% of the respondents shopped around for an advisor on the basis of the fee that would be charged. About 59% of the respondents think that the financial advisor's fee is paid from the profits of the financial service provider. Of the respondents, 39% discovered the fee charged from the scrutiny of the policy document. In conclusion, **Financial Advisors do not make sufficient disclosures regarding the financial advisors fee that is charged.**

## 6.2.7 Responses to Knowledge of Features of Basic Insurance Products

The responses to statements regarding knowledge of the features of basic insurance products are illustrated in Figure 6.7.

**FIGURE 6.7 RESPOSES TO KNOWLEDGE OF FEATURE OF BASIC INSURANCE PRODUCTS**



Just over two thirds (69%) of the respondents agreed that they experience difficulty in telling the difference between the different life insurance products. Furthermore, only

45% of the respondents considered that their knowledge of basic life insurance products was good or above average. These responses serve as an indicator that the level of knowledge regarding basic life insurance products was rather limited. The implication of this is that respondents have entered into life insurance contracts with a somewhat limited understanding of product features. A further implication is that the asymmetric information between product suppliers and consumers has not satisfactorily been resolved by the intermediary, who is the financial advisor in this case.

As indicated in the literature review with Term-life Insurance the contract is so arranged that for the sum assured to be paid on the death of the life assured only in the event of death happening during a specified term. However, 72% of the respondents think that a term life cover provides cover until the day the person dies. This incorrect understanding is further reinforced by close to the same proportion (67%) of the respondents disagreeing that a term life cover expires after a specified date. Further misunderstandings of the features of term life cover are illustrated by respondents (69%) believing that a Term-life cover can include a savings element. This incorrect understanding is further reinforced by only 35% of the respondents agreeing that a Term-life cover cannot be used as a means to save.

These findings are significant in the sense that respondents have false expectations regarding the benefits of Term-life insurance and upon the expiry of a term the respondents may:

- (i) find themselves without cover or having no option but to initiate new cover at much higher premiums due to advancement in age at the point in time; and/or
- (ii) anticipate some cash value when there is really none.

Two further responses indicate that respondents do not understand the impact on the premiums paid depending whether term life cover or Whole-life cover is elected. As indicated in the literature review, for the same individual, Term-life cover is significantly cheaper than Whole-life cover. In the first response 60% of the respondents disagreed with the statement that for the same premium the insured would be able to buy Term-life cover of far greater value than whole life cover. This incorrect understanding was further reinforced by 66% disagreeing that for the same amount of death cover the premiums for a Term-life cover will be far less than that for a Whole-life cover.

These findings are significant as consumers may for the same spend:

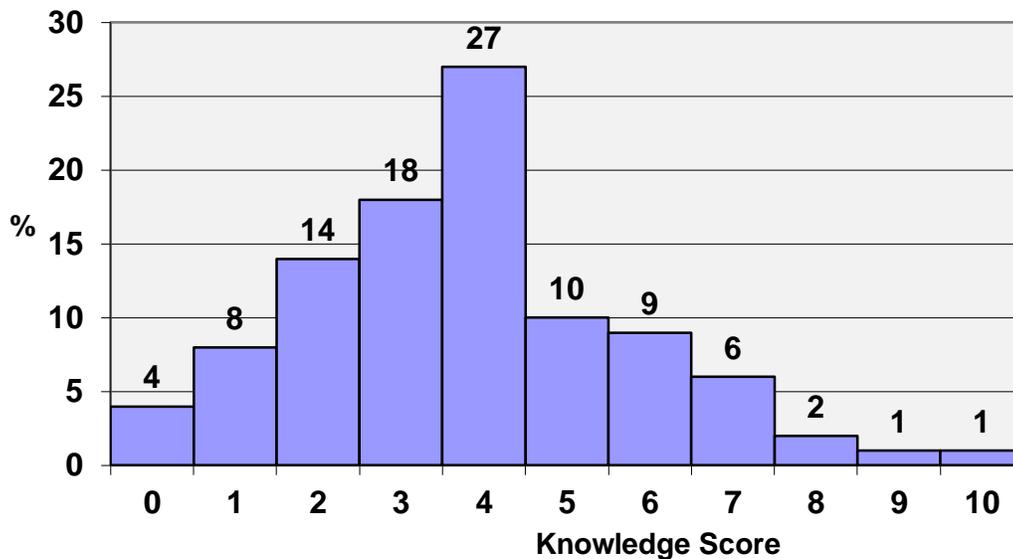
- (i) select Term-life cover when Whole-life cover is really needed;
- (ii) cancel an existing Whole-life cover and substitute a Term-life cover believing that they are getting better value for money and
- (iii) compare the amount of Term-life cover offered by one product supplier to the amount of Whole-life cover offered by another product supplier and decide that there is greater value for money in the one as compared to the other.

The literature review reflects that a Universal Retirement Annuity contract makes provision for periodic and single contributions to the fund including lump sum contributions by way of transfers in any approved pension, provident or other retirement annuity fund. However, respondents seem to be equally divided on whether a Universal Retirement annuity allows for a sum of money to be added to it without any additional costs. Finally, 60% of the respondents agree with the statement that there is no maximum limit to the amount of disability cover that can be bought, which is an incorrect statement. Furthermore, with 64% disagreeing with the correct statement that the maximum disability cover is regulated by law, it may come as a surprise in the unfortunate case of disability, that benefits would be reduced proportionately as mentioned in the literature survey.

### 6.2.8 Knowledge Score

A knowledge score was computed depending on the correctness of the answers provided to the questions relating to the features of basic insurance products (under question in questionnaire). The minimum score possible was zero and the maximum possible score was 10. The mean score was 3.74 with a standard deviation of 1.94. The results are illustrated in Figure 6.8.

FIGURE 6.8 KNOWLEDGE SCORE



The distribution of the knowledge score appears to be positively skewed (skewness value of 0.353). The Kolmogorov-Smirnov test was used to establish whether the distribution was normal. This was considered an important step in the analysis as it would dictate the statistical tests that could be used hereafter. The Kolmogorov-Smirnov test compares the score in a sample to a normally distributed set of scores with the same mean and standard deviation. According to Field (2010), if the test is not significant ( $p > 0.05$ ) then the distribution is not significantly different from a normal distribution, and if the test is significant ( $p < 0.05$ ), then the distribution is significantly different from a normal distribution (not normal). The Kolmogorov-Smirnov test was highly significant [ $D(369) = 0.162, p < 0.001$ ]. It was concluded that the distribution was not normal. To use the normal approximation continuity corrections were applied.

### 6.2.8.1 Reliability of Knowledge Score

The test on Knowledge included 10 questions. However, there were only five key questions, each asked in two different ways. Question 2.1 relates to question 2.3, question 2.2 relates to question 2.4, and so on. The sets of questions were cross-tabulated to establish whether respondents answered the related questions in the same way. The responses are cross-tabulated in Table 6.7. Yate's continuity correction prevents the overestimation of statistical significance, by adjusting Pearson's chi-square in discrete distributions (Devore, 1995). Even though a chi-square test may show a statistical significance between two variables, the relationship between those variables may not be substantially important. Pearson's contingency coefficient is therefore used to measure the relative strength of an association between two variables (Field, 2010).

**TABLE 6.7 CROSS-TABULATION MATRIX FOR RESPONSES TO KNOWLEDG QUESTIONS**

	Continuity correction			Contingency coefficient	
	Value	df	Asymp. Sig	Value	Approx. Sig
N=369					
Term-life provides death cover until the day the person dies/ Term-life cover expires after a specified period	87.31	1	.004*	.550**	.005
A Term Life cover can include a savings component/ A Term-life cover cannot be used as a means to save	122.9	1	.000*	.504**	.000
For the same premium the insured would be able to buy Term cover of a far greater value than Whole-life cover/ For the same amount of death cover the premiums for a Term-life cover will be far less than that for a Whole-life cover	219.1	1	.000*	.613**	.000
A Universal Retirement annuity allows for a sum of money to be added to it without additional costs/ The premiums for a universal annuity cannot be altered during the life of the policy	73.09	1	.005*	.545**	.005
There is no limit to the amount of disability cover that I can buy.	146.6	1	.000*	.537**	.000

\* There were significant relationships ( $p < .05$ ) between cross-tabulated items.

\*\*The strength of the relationships was high ( $> 0.5$ ).

It may be inferred that respondents seem to have understood the questions and answered them consistently.

### 6.2.8.2 Knowledge Score According to Demographics

Table 6.8 presents the Knowledge Score according to gender.

**TABLE 6.8 KNOWLEDGE SCORE ACCORDING TO GENDER**

	Gender	N	Mean	Std. Deviation	Std. Error Mean
Score for Section B	Female	190	3.92	2.062	.150
	Male	179	3.55	1.787	.134

The mean score for males was 3.92 and that for females was 3.55. This difference was explored further through the Independent Samples Test illustrated in Table 6.9.

**TABLE 6.9 INDEPENDENT SAMPLES TEST FOR GENDER**

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	T	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	4.077	.044	1.855	367	.064	.374	.201	-.022	.770
Equal variances not assumed			1.863	364.48	.063	.374	.201	-.021	.768

According to Field (2010), Levene's test tests the null hypothesis that the variances in different groups are equal and concludes that the assumption of equal variance is tenable at  $p > 0.05$ . The assumption of homogeneity of variances would be violated at  $p < 0.05$ . Levene's test [ $F(1,367) = 4.077, p < 0.05$ ] indicated that the variances between the knowledge scores for males and females were significantly different. However, the t-Test [ $t(364.48) = 1.863, p > 0.05$ ] for gender (equal variance not assumed) indicated that there was no evidence to suggest that males and females performed differently with respect to knowledge scores.

According to Girden (1992), Analysis of variation (ANOVA) is a statistical test used to determine if more than two population means are equal, by using the F-distribution function and information about the variances of each population and groupings of populations to establish if variability between and within each population are significantly different. Table 6.10 presents the ANOVA according to Race, Age group, Place and Level of Educational qualification.

**TABE 6.10 ANOVA ACCORDING TO RACE. AGE GROUP, PLACE AND LEVEL OF EDUCATIONAL QUALIFICATION**

	Homogeneity of variance				ANOVA		
	Levene Statistic	df1	df2	Sig	df	F	Sig
RACE	1.383	3	365	0.254	3	0.156	0.926
AGE GROUP	0.238	4	364	0.917	4	2.039	0.088
PLACE	19.345	2	366	0.000	2	1.041	0.354
LEVEL OF EDUCATIONAL QUALIFICATION	2.884	4	364	0.023	4	0.763	0.550

The ANOVA that were performed by Race [ $F(3.365) = 0.155$ ,  $p > 0.5$ ], Age group [ $F(4.464) = 2.039$ ,  $p > 0.05$ ], Place [ $F(2.366) = 1.041$ ,  $p > 0.05$ ], and Level of Educational Qualification [ $F(4.364) = 0.763$ ,  $p > 0.05$ ] does not present any evidence to suggest that respondents performed differently on the knowledge score, due to Race, Age, Place and Level of Education.

The Knowledge scores were then grouped into four categories (very low, low, high, very high) as illustrated in Table 6.10

**TABLE 6.11 KNOWLEDGE SCORE ACCORDING TO CATEGORIES**

<b>Knowledge Score Category</b>	<b>Frequency</b>	<b>Percentage</b>	<b>Cumulative Percent</b>
Very low	96	26.0	26.0
Low	168	45.5	71.5
High	94	25.5	97.0
Very high	11	3.0	100
	369	100.0	

It was found that 71.5% of the respondents scored either at the low or very low level of understanding of the features of basic insurance products.

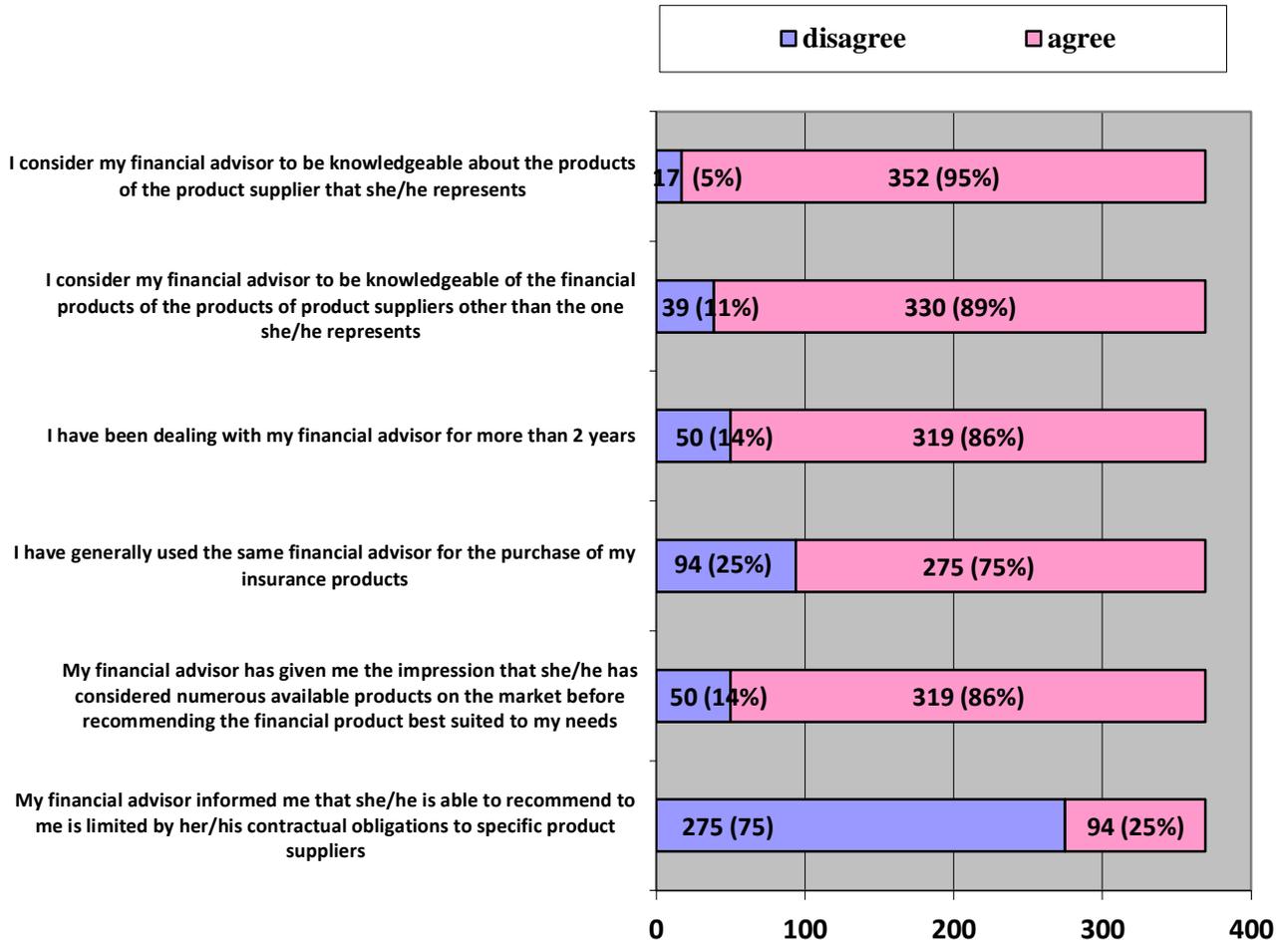
**Consumers of insurance products have a low to very low level of understanding of the features of basic insurance products, and this knowledge is not a function of Gender, Race, Age, Place or Level of Education.** For example, any inference such as an individual holding a postgraduate qualification would be in a better position to make an informed decision would be totally unfounded and contrary to the findings.

This finding is particularly significant as the present consumer education initiatives of the Financial Services Board are focused on the lower LSM categories.

## 6.2.9 Respondents' Perceptions of their Financial Advisor

The responses or respondents' perceptions of their financial advisor is illustrated in Figure 6.9.

FIGURE 6.9 RESPONDENTS' PERCEPTIONS OF THEIR FINANCIAL ADVISOR



Of the respondents, 95% consider their financial advisor to be knowledgeable about the products of the product supplier that the financial advisor represents. It is therefore no surprise that just over 86% of the respondent have been dealing through their financial advisor for over two years and almost 75% have used the same financial advisor for the purchase of most of their insurance products.

What is of concern is that 89% of the respondents consider their financial advisor to be knowledgeable of the products of product suppliers other than the one the financial advisor represents. In the absence of a contract between the product supplier and the financial service provider, product suppliers would not engage with nor entitle the financial advisors to product training. On the other hand, where a contract exists, there are obligations that restrict the financial advisor from selling the products of other product suppliers. What is even more concerning is that 86% of the respondents have the impression that their financial advisor has considered numerous products available on the market before recommending the product best suited their needs. It would be an unrealistic expectation to expect the financial advisor to be knowledgeable of the numerous products on the market.

The FAIS Act (2002) demands that contractual obligations to specific products suppliers be disclosed, but according to the responses of the respondents only in 25% of the cases, has the advisor informed the respondent that the range of products she/he is able to recommend is limited by contractual limitations to specific product suppliers. Respondents seem to be unaware that contractual limitations restrict the range of products that can be recommended.

**Consumers perceive their financial advisors to be knowledgeable of the various products available on the market and that the financial advisor recommends the best product for them.**

#### **6.2.10 Premature Termination of Policies**

Of the respondents, 134 or 36% had previously prematurely terminated a life insurance policy. The results relating to the premature termination of policies are tabulated in Table 6.12

**TABLE 6.12 REASONS FOR PREMATURE TERMINATION OF POLICIES**

The premature termination of my life insurance policy was due to		Yes	No	Total
my receiving advice from my financial advisor.	Count	57	77	134
	%	42.5%	57.5%	100.0%
my being unable to afford the premiums.	Count	74	60	134
	%	55.2%	44.8%	100.0%
my realizing that the product was not what I thought it was.	Count	72	62	134
	%	53.7%	46.3%	100.0%

The reason for the premature termination of a life insurance policy was due to affordability (55%), inappropriate product (53.7%) and on the advice of a financial advisor (42.5%). At the time of inception, a product must have been considered to be appropriate by the financial advisor. At the time of premature termination of the product either, the original product must be considered to be really inappropriate and the premature termination is warranted or, alternatively, the original product is still appropriate but the financial advisor recommends premature termination for the purposes of churning. In both cases the fault with this lies with the financial advisor. The action taken after the termination of a life insurance policy prematurely is presented in Table 6.13.

**TABLE 6.13 ACTION TAKEN AFTER PREMATURE TERMINATION OF A LIFE INSURANCE POLICY**

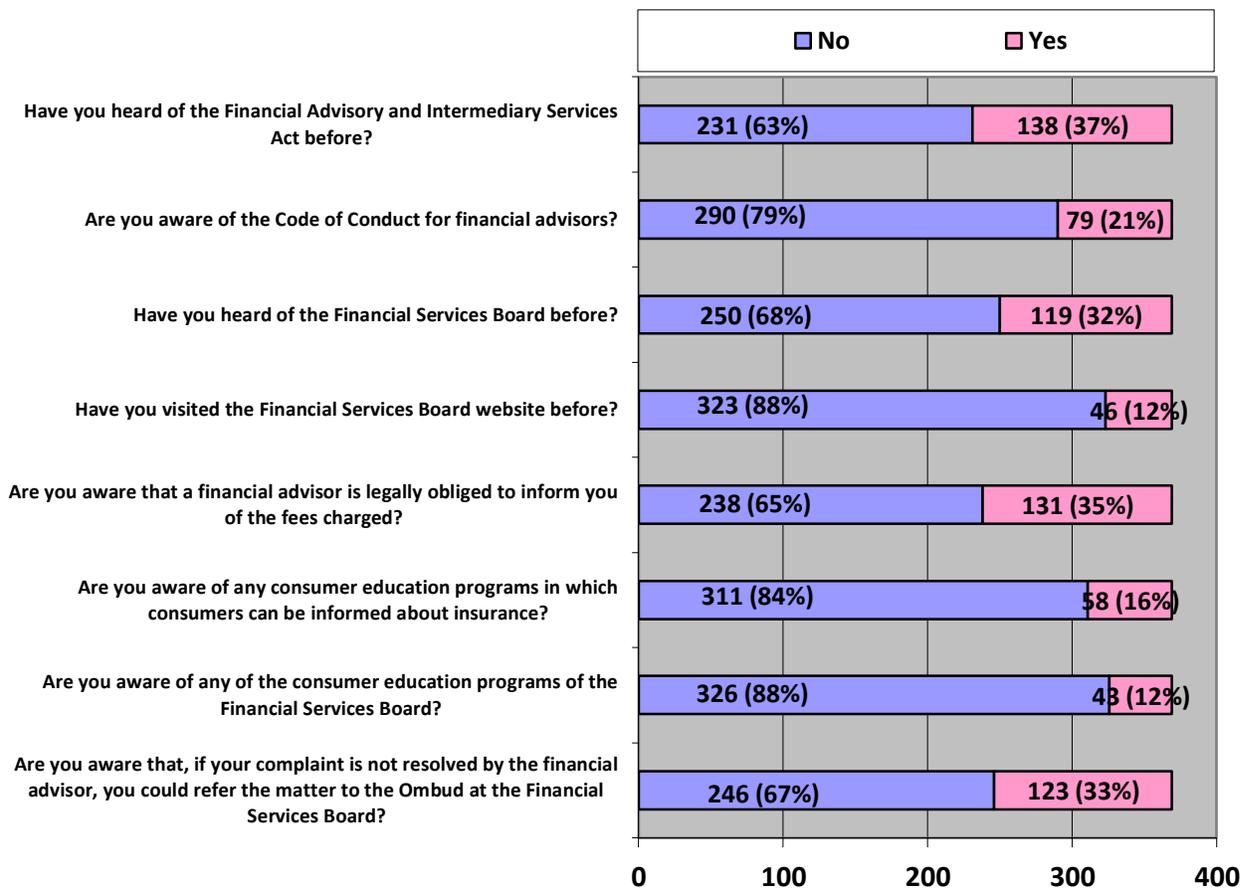
		Yes	No	Total
Replaced another life insurance policy from the same supplier	Count	42	92	134
	%	31.3%	68.7%	100%
Informed of the disadvantages of the premature termination of the insurance policy	Count	64	70	134
	%	47.8%	52.2%	100

31% replaced the terminated policy with another life insurance policy. It is difficult to make sense of this action especially when, as mentioned in the literature survey, the premature termination of a life insurance is at a significant cost to the policy holder. Just over 52% of the clients were not advised of the disadvantages of the premature termination of the insurance policy.

### 6.2.11 Responses Related to Consumer Awareness

Responses to questions relating to consumer awareness are listed in Figure 6.10 below.

**FIGURE 6.10 CONSUMER AWARENESS**



Of the respondents, 63% have not heard of the Financial Advisory and Intermediary Services Act before, and 79% of the respondents are not aware of the Code of Conduct

for financial advisors. Regarding the Financial Services Board, 68% have not heard of it before, and only 12% have visited the website before. While it is agreed that the FAIS Act and the Code of Conduct referred to are of particular relevance to financial advisors, it appears that, they have not been widely published as is the case with some other Acts such as the Consumer Protection Act. Further, the above results do not augur well for a body that is tasked with a consumer education responsibility.

Of the respondents, 84% are not aware of any consumer education programmes in which consumers can be informed about insurance and only 12% are aware of the consumer education programmes of the Financial Services Board. This is not surprising as much of the consumer education initiatives, as mentioned in Chapter 4, have been focused towards consumers in the lower LSM categories, and not towards the users of insurance products that are from the higher categories. 65% are not aware that the financial advisor is legally obliged to inform them of the fees charged. This result is in keeping with previous results regarding disclosures regarding fees charged under section 6.2.6. On a positive note, although a small proportion, 31% of the respondents are aware that if their complaint is not resolved by the financial service provider, the matter could be referred to the Ombudsman at the Financial Services Board.

#### **6.2.12 Awareness score**

A level of awareness score was computed depending on whether a respondent answered Yes to questions relating to consumer awareness. The minimum score possible was zero and the maximum possible score was 8. The scores obtained were compared according to various groupings, namely race, age groupings, place and educational level. With the normality of the distribution not being assumed and the groups being unbalanced the Kruskal-Wallis test was warranted. According to Field (2010), the Kruskal-Wallis test orders scores from lowest to highest, ignoring the group to which it belongs, and then assigns the lowest score a rank of 1, the next highest a rank of 2 and so on. Field (2010) adds that, if the *Asymp.Sig.* in the output is less than 0.05 then the groups are significantly different.

### 6.2.12.1 Comparison by Race

The output for the Kruskal-Wallis test according to race grouping is presented in Table 6.14.

**FIGURE 6.14 KRUSKAL-WALLIS TEST BY RACE**

	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum
					Lower Bound	Upper Bound		
Black	209	1.95	2.216	.153	1.65	2.25	0	8
Coloured	68	1.97	2.051	.249	1.47	2.47	0	8
Indian	39	1.77	1.842	.295	1.17	2.37	0	6
White	53	2.43	2.249	.309	1.81	3.05	0	8
Total	369	2.01	2.154	.112	1.78	2.23	0	8

RANK			
	Race	N	Mean Rank
Total YES answers for Q5	Black	209	179.81
	Coloured	68	184.73
	Indian	39	180.26
	White	53	209.30
	Total	369	

TEST STATISTIC	
	Total Yes Answers for Question 5
Chi-square	3.495
Df	3
Asym. Sig	0.321

For the entire sample, the mean level of awareness was 2.01, which is a low score when compared to the maximum possible score of 8. The corresponding standard deviation is 2.154 indicating a relatively large variation of scores around the mean. The mean for the level of awareness amongst the different races ranged from 1.77 (for Indians) to 2.01 (for Whites). The Kruskal-Wallis test was done to establish whether these variations in level of consumer awareness varied significantly according to race. The Kruskal-Wallis test showed that there was no difference in the level of awareness between the race groups [ $H(3) = 3.495, p > 0.05 (0.321)$ ]. **The level of consumer awareness is low and independent of race.**

### 6.2.12.2 Comparison by Age Group

The output for the Kruskal-Wallis test according to age grouping is presented in Table 6.15

**TABLE 6.15 KRUSKAL-WALLIS TEST BY AGE GROUP**

Age Group	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum	
					Lower Bound	Upper Bound			
26 – 35	140	1.96	2.122	.179	1.60	2.31	0	8	
36 - 45	85	1.95	2.098	.228	1.50	2.41	0	8	
46 – 55	75	2.31	2.218	.256	1.80	2.82	0	8	
56 – 65	39	2.18	2.349	.376	1.42	2.94	0	8	
65 +	30	1.40	2.027	.370	.64	2.16	0	7	
Total	369	2.01	2.154	.112	1.78	2.23	0	8	
<b>Ranks</b>									
<b>Age</b>					<b>N</b>	<b>Mean rank</b>			
Yes answers for Q5			26-35			140	183.06		
			36-45			85	183.48		
			46-55			75	201.70		
			56-65			39	189.74		
			65+			30	150.45		
			Total			369			
<b>TEST STATISTICS</b>									
Chi-square						5.392			
Df						4			
Asym. Sig						0.249			

The mean for the level of awareness amongst the different age groups ranged from 1.40 (65+ age group) to 2.31 (46-55 age group). The Kruskal-Wallis test was done to establish whether levels of consumer awareness varied significantly according to age group. The Kruskal-Wallis test showed that there was no difference in the level of awareness between the race groups,  $H(4) = 5.392$ ,  $p > 0.05$  (0.249). **The level of consumer awareness is independent of age group of respondents.**

### 6.2.12.3 Comparison by Place

The output for the Kruskal-Wallis test according to Place is presented in Table 6.16.

**TABLE 6.16 KRUSKAL-WALLIS TEST BY PLACE**

	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum
					Lower Bound	Upper Bound		
Johannesburg	119	2.41	2.256	.207	2.00	2.82	0	8
Cape Town	108	2.40	2.332	.224	1.95	2.84	0	8
Durban	142	1.37	1.748	.147	1.08	1.66	0	8
Total	369	2.01	2.154	.112	1.78	2.23	0	8
Ranks								
		Place	N	Mean Rank				
Total Yes answers for Q5		Johannesburg	119	203.41				
		Cape Town	108	203.09				
		Durban	142	155.82				
		Total	369					
Test Statistics								
Chi-square					18.174			
Df					2			
Asym.Sig					0.00			

The mean for the level of awareness amongst the different age groups ranged from 1.37 (Durban) to 2.41 (Johannesburg). The Kruskal-Wallis test was done to establish whether levels of consumer awareness varied significantly according to place. The Kruskal-Wallis test shows that there are differences in the level of awareness according to Place [ $H(2) = 18.174$ ,  $p < 0.001$  (0.000)]. The Kruskal-Wallis Test was followed by the Mann-Whitney tests to identify where the differences lie. The results are reflected in Tables 6.17, 6.18 and 6.19. According to Field (2010), the Mann-Whitney test is the non-parametric equivalent of the independent t-test that compares two conditions when different participants take part in each, and if the *Asymp.Sig* in the output is less than 0.05 then the two groups are significantly different.

**TABLE 6.17 MANN-WHITNEY TEST RESULTS – Johannesburg-Cape Town**

	Place	N	Mean Rank	Sum of Ranks
Total Yes answers for Q5	Johannesburg	119	114.19	13588.50
	Cape Town	108	113.79	12289.50
	Total	227		
<b>Test Statistics</b>				
Mann-Whitney U		6403.500		
Asymp. Sig (2-tailed)		0.963		

The differences in level of awareness do not lie between respondents in Johannesburg and Cape Town [ $U = 6403.5$ ,  $z = -0.046$ ,  $p > 0.05$  (0.0963)].

**TABLE 6.18 MANN-WHITNEY TEST RESULTS – Johannesburg-Durban**

	Place	N	Mean Rank	Sum of Ranks
Total Yes answers for Q5	Johannesburg	119	149.22	17757.00
	Durban	142	115.73	16434.00
	Total	261		
<b>Test Statistics</b>				
Mann-Whitney U		6281.000		
Asymp.Sig (2-tailed)		0.000		

There are significant differences in level of awareness between respondents in Johannesburg and Durban,  $U = 6281.0$ ,  $z = -3.678$ ,  $p < 0.001$  (0.000)

**TABLE 6.19 MANN-WHITNEY TEST RESULTS – Durban-Cape Town**

	Place	N	Mean Rank	Sum of Ranks
Total yes correct answers for Q5	Cape Town	108	143.80	15530.00
	Durban	142	111.58	15845.00
	Total	250		
<b>Test Statistics</b>				
Mann-Whitney U		5692.00		
Asymp.Sig (2-tailed)		0.00		

There are significant differences in level of awareness between respondents in Cape Town and Durban [ $U = 5692.0$ ,  $z = -3.601$ ,  $p < 0.001$  (0.000)].

**There is a lower level of consumer awareness in Durban as compared to Johannesburg and Cape Town.**

### 6.2.12.4 Comparison by Educational Qualification

The output for the Kruskal-Wallis test according to Qualifications is presented in table 6.20.

**TABLE 6.20 KRUSKAL-WALLIS TEST BY QUALIFICATIONS**

	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum
					Lower Bound	Upper Bound		
Grade11 or lower	23	1.28	1.934	.170	.95	1.62	0	7
Grade 12	130	1.83	1.946	.406	-.98	2.67	0	8
Post matric diploma or certificate	139	1.97	2.147	.182	1.61	2.33	0	8
Baccalaureate degree	48	2.83	1.917	.277	2.28	3.39	0	8
Post-graduate degree(s)	29	4.17	1.853	.344	3.47	4.88	0	8
Total	369	2.01	2.154	.112	1.78	2.23	0	8

Ranks			
	Ed.Qual	N	Mean Rank
Total Yes answers for Q5	Grade11 or lower	23	180.98
	Grade 12	130	143.55
	Post matric diploma or certificate	139	184.55
	Baccalaureate degree	48	238.16
	Post-graduate degree(s)	29	288.17
	Total	369	

Test Statistics	
Chi-square	61.760
Df	4
Asymp. Sig.	0.00

The mean ranges from 1.28 to 4.17, which is a rather large variation. The Kruskal-Wallis test confirms that there are significant differences in the level of awareness according to qualification [ $H(4) = 61.760, p < 0.001 (0.000)$ ].

The Kruskal-Wallis Test was followed by Mann-Whitney tests to identify where the differences lie. As a result of there being so many Mann-Whitney tests to be conducted, the chances of inflating Type 1 error rate was considered. According to Saunders *et al.*, (2009), Type 1 errors involve concluding that two variables are related when they are not, or incorrectly concluding that a sample statistic exceeds the value that would be

expected by chance alone. To avoid this, Field (2010) suggests that a Bonerroni correction be applied. The effect of this correction was that instead of using 0.05 as the critical value of the significance for each test, the critical value that was used was 0.005, obtained from dividing 0.05 by the number of tests (10). The results are reflected in the Table below 6.21.

**TABLE: 6.21 MANN-WHITNEY TEST ACCORDING TO QUALIFICATIONS**

Rank				Test statistics		
Educational Qualification	N	Mean Rank	Sum of ranks	Mann-Whitney	Z	Asymp.Sig (2 tailed)
Grade 11 or lower	23	91.15	2096.50	1169.500	-1.767	0.077
Grade 12	130	74.50	9684.50			
Total	153					
Grade 11 or lower	23	91.15	1846.50	1570.500	-0.138	0.890
Post matric diploma/certificate	139	74.50	11356.50			
Total	162					
Grade 11 or lower	23	28.04	645.00	369.000	-2.282	0.002*
Baccalaureate degree	48	38.91	1911.00			
Total	71					
Grade 11 or lower	23	17.50	402.50	126.500	-3.865	0.000*
Post graduate degree	29	33.64	975.50			
Total	52					
Grade 12	130	118.87	15452.50	6937.500	-3.428	0.001*
Post matric dip/cert	139	150.09	20862.50			
Total	269					
Grade 12	130	76.94	10002,00	1487.000	-5.555	0.000*
Baccalaurete degree	48	123.52	5929.00			
Total	178					
Grade 12	130	69.75	9067.50	552.500	-6.199	0.000*
Post-graduate degree	29	125.95	3652.50			
Total	159					
Post martic dip/cert	139	86.65	12044.00	2314.000	-3.22	0.001*
Baccalaurete degree	48	115.29	5534.00			
Total	187					
Post martic dip/cert	139	76.11	10579.50	849.500	-4.977	0.000*
Post-graduate deg.	29	124.71	3616.50			
Total	16					
Baccalaurete degree	48	33.03	1585.50	409.500	-3.056	0.002*
Post-graduate degree	29	48.88	1417.50			
Total	77					

\* indicates significant differences

When the level of awareness between grade 11 or lower qualified respondents were compared to grade 12 and post matric diploma/certificate holders, there appeared to be no significant differences. Otherwise, there are significant differences between the level of awareness between respondents holding different levels of qualifications.

There is an increase in level of awareness according to qualification ranging from a mean score of 1.28 (grade 11 or lower qualification) to 4.17 (Post-graduate degree).

**The level of consumer awareness is positively correlated to educational qualification.**

### 6.2.13 Level of Awareness Score

The Awareness scores were then grouped into three categories (low, moderate, high) and are illustrated in Table 6.22.

**TABLE 6.22 LEVEL OF AWARENESS SCORE**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Low	243	65.9	65.9	65.9
	Moderate	95	25.7	25.7	91.6
	High	31	8.4	8.4	100.0
	Total	369	100.0	100.0	

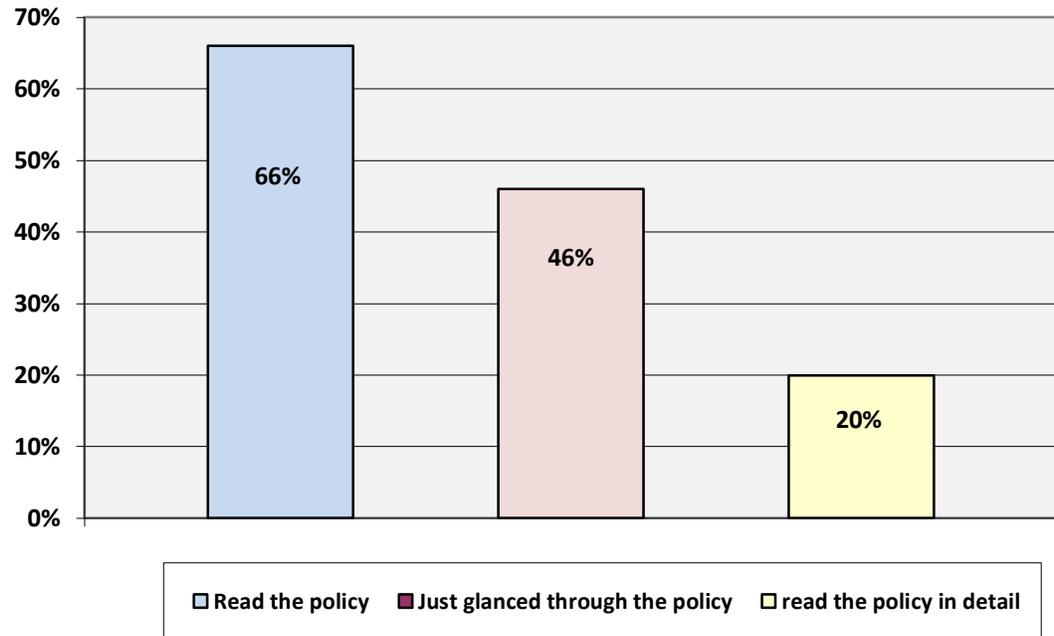
Notwithstanding, that level of awareness is positively correlated with level of education, that 65.9% of the respondents scored at the low level of awareness and 91.6% scored at the low or moderate level of awareness. **The level of consumer awareness is low.**

### 6.2.14 Reading of policy document

Respondents were asked whether they read the policy document at all and if they read the policy document did they just glance through it or did they read it in detail?

The responses are illustrated in Figure 6.11.

**FIGURE 6.11 RESPONSES TO DETAIL TO WHICH POLICY DOCUMENT WAS READ.**



Of the respondents, 66% read their policy documents and 44% did not read their policy documents at all. However, of those respondents that read their policy documents only 20% read the policy document in detail while 46% just glanced through the policy document. This study did not attempt to ascertain respondents' understanding of the contents of policy documents. In hindsight, given that a policy document is a legal contract, it would have been of interest to capture respondents' perceptions regarding any challenges presented in interpreting policy documents.

### 6.3 Analysis of Questionnaires Administered to Compliance Officers

200 questionnaires were mailed to different compliance practices. Only 75 of the questionnaires were returned reflecting a low response rate of 37.5 %. Upon observing that the response rate was low, the researcher telephoned a few of the compliance practices to enquire about the questionnaires. It was discovered that a number of the compliance officers were conducting their business relative to short term insurance only and not life insurance. Furthermore, other responses received in the mail included:

- (i) “would willingly have completed your questionnaire, however we are in short-term insurance, not life or long-term. This would not give you the information you need”;
- (ii) “I am not a compliance officer any longer”
- (iii) “ The company’s current product set includes equity funds and a range of hedge fund solutions”

It became clear that the sampling frame extracted from the FSB website was a composite list of all the compliance practices. Despite the low response rate it was considered that an analysis of the responses would make a valuable contribution to the study. A descriptive approach to the analysis was adopted.

#### 6.3.1 Gender Distribution

The distribution according to gender is summarized in Table 6.23.

**TABLE 6.23 GENDER DISTRIBUTION**

	MALE	FEMALE	TOTAL
NUMBER	55	20	75
PERCENTAGE	73%	27%	100%

**The majority (73%) of the compliance officers are males.**

### 6.3.2. Race Distribution

The distribution according to race is summarized in Table 6.24.

**TABLE 6.24 DISTRIBUTIONS ACCORDING TO RACE**

RACE	BLACK	WHITE	COLOURED	ASIAN	TOTAL
NUMBER	6	65	0	5	75
PERCENTAGE	8%	87%	0%	5%	100%

**The majority (87%) of compliance officers are White.**

### 6.3.3 Age Group Distribution

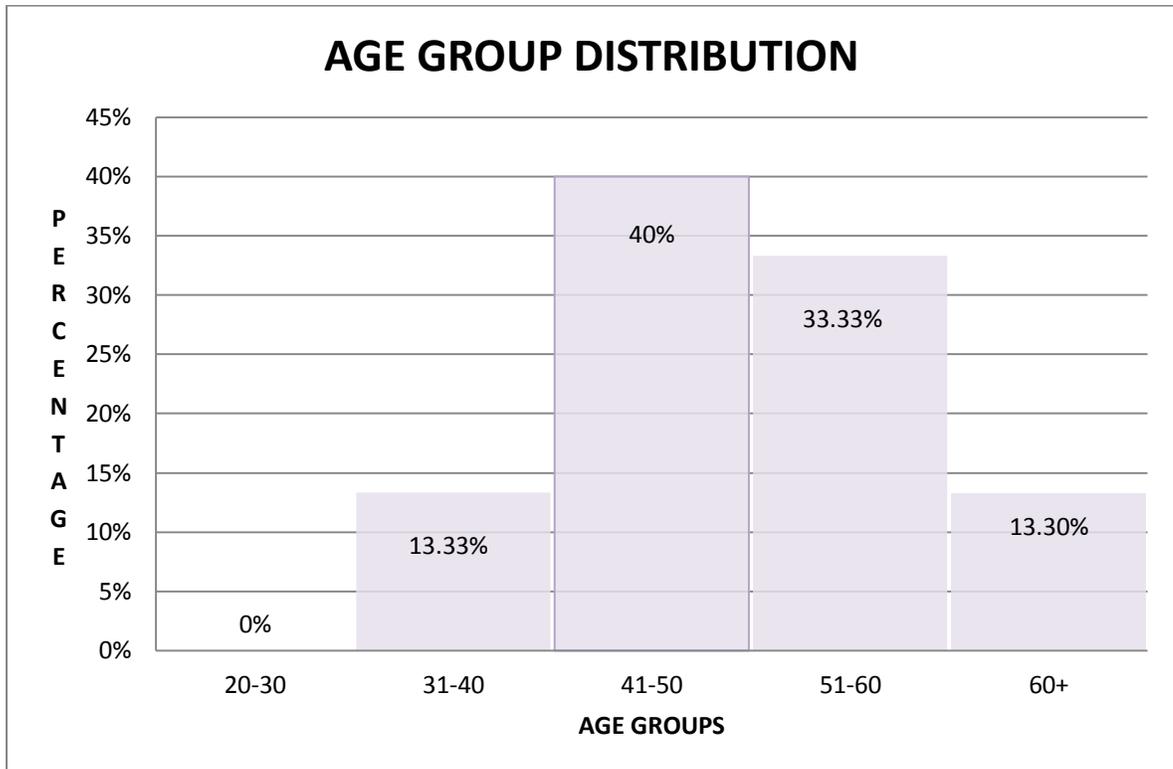
The distribution according to age group is summarized in Table 6.25

**TABLE 6.25 DISTRIBUTIONS ACCORDING TO AGE GROUP**

AGE GROUP	20-30	31-40	41-50	51-60	60+	TOTAL
NUMBER	0	10	30	25	10	75
PERCENTAGE	0%	13.33%	40%	33.33%	13.33%	100%

While the majority of the compliance officers are middle aged (41-50 years) the distribution according to age group is skewed as illustrated in Figure 6.12.

**FIGURE 6. 12 DISRTIBUTION ACCORDING TO AGE GROUP**



The distribution according to age of respondent is skewed towards older age groups. Almost 47% of the respondents are over the age of 50 and almost 87% of the respondents are over the age of 40. There were no respondents that are younger than 30 years of age.

The biographical data analysed so far is now interpreted against the backdrop of a letter that was voluntarily forwarded to the researcher. Accompanying one of the returned questionnaires was a note that read as follows: “Your next survey should be conducted to enquire as to how much the insurance industry has changed; as far as management positions are concerned, still dominated by whites and whether mindsets have changed in payment of claims and calculation of premiums.”

Although not the focus of this study, the dominance of middle aged, White males in compliance practices should be an area of concern. Given the history of South Africa

regarding apartheid, the compliance function could be interpreted as the perpetuation of White dominance. Such interpretations could only serve to hinder organizational efforts to inculcate a compliance culture.

#### **6.3.4 Academic Qualifications of Compliance Officers**

The highest academic qualification held by compliance officers is illustrated in Table 6.26

**TABLE 6.26 HIGHEST ACADEMIC QUALIFICATION HELD BY COMPLIANCE OFFICERS**

QUALIFICATION	POST MATRIC DIPLOMA/ CERTIFICATE	UNDER- GRADUATE DEGREE	POSTGRAD. DEGREE	TOTAL
NUMBER	10	5	60	75
PERCENTAGE	13.33%	6.67%	80%	100%

**The majority of compliance officers hold post graduate degrees.**

#### **6.3.5 Professional Qualifications of Compliance Officers**

The professional qualifications of compliance officers were categorized into the categories of: legal qualification, financial/insurance related qualification or both. The results are presented in Table 6.27

**TABLE 6.27 PROFESSIONAL QUALIFICATIONS OF COMPLIANCE OFFICERS**

	Legal Qualification only	Financial/insurance Related Qualification only	Legal and Financial/Insurance relate Qualification	Total
NUMBER	34	38	3	75(3)
PERCENTAGE	45.3%	50.1%	4%	100%

Just under half of the compliance officers (45.3%) hold a legal qualification and just more than half (50.1%) hold a financial/insurance related qualification. Very few (4%) hold both legal as well as financial/insurance related qualifications. Compliance officers holding legal qualifications only would not have the practical experience of having worked as a financial advisor and would therefore have a very limited insight into the client and financial advisor dynamics. The monitoring of the compliance function by such compliance officers would therefore be characterized by a heavy emphasis on documentary evidence.

### 6.3.6. Experience as a Compliance officer

The total number of years that respondents have been a compliance officer for is presented in Table 6.28.

**TABLE 6.28 NUMBER OF YEARS RESPONDENTS HAVE BEEN COMPLIANCE OFFICERS**

YEARS	<5	5	6	7	8	>9	TOTAL	Mean	Std Dev
NUMBER	0	5	31	28	11	0	75(3)	6.6	0.82
PERCENTAGE	0%	6.7%	41.2%	37.3%	14.7%	0%			

The average number of years that respondents have been compliance officers for is 6.6 years. It is understandable that there are no compliance officers with greater than 9 years of experience as the need for compliance officers was warranted only after the implementation of the FAIS Act (2002). What should be of concern is that none of the respondents have less than 5 years of compliance experience. The standard deviation is 0.82 indicating the data is grouped close to the mean as opposed to being spread out. Although not the focus of this study, the lack of dispersion around the mean signals that in future years the cohort of compliance officers would continue if new compliance officers are not nurtured by compliance practices. This also should be seen as an

opportunity for compliance practices to address the issue of middle-aged, White male dominated compliance practices.

**6.3.7 Compliance Officers’ Perceptions Regarding the Disclosure of Fees that are Charged by Financial Advisors.**

The responses to statements regarding disclosures of fees charged by financial advisors are presented in Table 6.29.

**TABLE 6.29 COMPLIANCE OFFICERS’ PERCEPTIONS REGARDING DISCLOSURE OF FEES CHARGED**

	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree	TOTAL	AVERAGE	MEDIAN	MODE
	1	2	3	4	5				
Most financial advisors verbally bring to the attention of the client the fee that would be charged.	9	41	10	15	0	75	2.2	2	2
When a client purchases a policy it is most often left to the client to discover the fee charged from the scrutiny of the policy.	0	25	9	35	6	75	3.7	4	4
Financial advisors most often offer to negotiate with the client the fee that would be charged.	9	31	19	16	0	75	2.4	2	2
Most often the financial advisor’s fee is set to the maximum chargeable.	0	13	12	40	10	75	3.6	4	4
Clients do not shop around for a financial advisor on the basis of the fee that would be charged.	0	0	0	66	11	75	4.3	4	4
Financial advisors would rather recommend a new policy than the use of the facility within an existing policy to satisfy the same need.	3	33	5	33	4	75	3.0	3	3,3

The statements put forward to the compliance officers, in the questionnaire mailed to compliance officers, regarding the disclosure of fees charged by financial advisors, were very similar to those put forward to consumers, in the questionnaire administered to consumers in the malls.

The results in Table 6.29 are interpreted and compared (where appropriate) to the results obtained from the questionnaire administered to consumers (see page 114).

In general, Compliance officers disagree (average-2.2; median-2; mode-) with the statement “Most financial advisors verbally bring to the attention of the client the fee that would be charged”. This result is in keeping with the previously obtained result where only 27% of the consumers agreed with the statement “The financial advisor verbally brought to my attention the fee that was charged”.

Compliance officers largely tend to agree (average-3.7; median-4; mode 4) that it is most often left to the client to discover the fee charged from the scrutiny of the policy. This result concurs with the previously obtained result of 58% consumers discovering the fee charged from the scrutiny of the policy document. On average, Compliance officers disagree (average-2.4; median-2; mode-2), that financial officers most often offer to negotiate with the client the fee that would be charged. This result confirms the previously obtained result that only 12% of the consumers were advised that the financial advisors fee is negotiable.

Compliance officers tend to agree (average-3.6; median-4; mode-4) that most often the financial advisor’s fee is set to the maximum chargeable. A similar question was not posed to consumers. However, this result may be interpreted against the result that 72% of the consumers have the impression that the financial advisor’s fee charged is a standard for the industry. The majority of the compliance officers (average-4; median-4; mode-4) have the view that clients do not shop around for a financial advisor on the basis of the fee that would be charged, confirming the earlier result where only 9% of the consumers indicated that they shop around for a financial advisor. Compliance officers seem to be divided on whether they think that financial advisors would rather recommend a new policy than the use of the facility within an existing policy to satisfy the same need.

The results from the survey of compliance officers support the results obtained in the survey of consumers of insurance products. The conclusion that **Financial Advisors do not make sufficient disclosures regarding the financial advisors fee that is charged** is further strengthened.

### 6.3.8 Compliance Officers’ Perceptions of Clients’ Knowledge Regarding the Features of Life Insurance products.

The responses to the statements regarding Compliance officers’ perceptions of Clients’ knowledge regarding the features of Life insurance products are summarized in Table 6.30.

**TABLE 6.30 COMPLIANCE OFFICERS’ PERCEPTIONS OF CLIENTS’ KNOWLEDGE REGARDING THE FEATURES OF LIFE INSURANCE PRODUCTS.**

	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree	TOTAL	AVERAG	MEDIAN	MODE
	1	2		3	4	5			
The majority of clients know the key features that differentiate a Term-life policy from a Whole-life policy.	14	41	4	16	0	75	2.3	2	2
Majority of the clients understand that there is a limit to the amount of disability cover that can be purchased.	16	25	19	15	0	75	2.4	2	2
Majority of the clients understand that for the same premium a greater amount of Term-life cover can be purchased than Whole-life cover.	13	52	6	4	0	75	2.2	2	2
Majority of clients understand that a Term-life policy does not incorporate a savings component.	14	19	12	30	0	75	2.8	3	4
Majority of clients understand the flexibilities of a Universal-life policy	24	30	16	5	0	75	2.0	2	2
Majority of clients understand that a Universal Retirement Annuity caters for a lump-sum cash injection	19	30	20	6	0	75	2.2	2	2

The statements put forward to the compliance officers in the questionnaire mailed to compliance officers, regarding clients' knowledge of features of basic insurance products, were very similar to those put forward to consumers in the questionnaire administered to consumers in the malls. The results in Table 6.29 is interpreted and compared (where appropriate) to the results obtained from the questionnaire administered to consumers (see page 115)

It was earlier established (see page 122) in this study that **consumers of insurance products have a low to very low level of understanding of the features of basic insurance products.** The results that follow largely confirm the earlier finding. In general, compliance officers disagree (average-2.3; median-2; mode-2) with the statement that the majority of clients know the key features that differentiate a Term-life policy from a Whole-life policy. Compliance officers also disagree (average-2.4; median-2; mode-2) with the statement that the majority of clients understand that there is a limit to the amount of disability cover that can be purchased. Furthermore, Compliance officers disagree that the majority of the clients understand that for the same premium a greater amount of Term-life cover can be purchased than Whole-life cover. Compliance officers also disagree (average-2; median-2; mode-2) that clients understand the flexibilities of a Universal-life policy and disagree (average-2.2; median-2; mode-2) that clients understand that a Universal Retirement Annuity caters for a lump-sum cash injection.

The exception is that Compliance officers seem to be somewhat divided on whether the majority of the clients understand that a Term-life policy does not incorporate a savings component (average-2.3; median-3; mode-4) while 69% of consumers believe that a Term-life cover can include a savings element.

### 6.3.9 Compliance Officers' Perceptions regarding the Premature Termination of Policies

Compliance Officers' Perceptions Regarding the Premature Termination of Policies are illustrated in Table 6.31.

**TABLE 6.31 COMPLIANCE OFFICERS' PERCEPTIONS REGARDING THE PREMATURE TERMINATION OF POLICIES**

	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree	TOTAL	AVERAG	MEDIAN	MODE
<b>Premature termination of policies is most often initiated by the financial advisor.</b>	0	14	16	25	20	75	3.7	4	4
<b>Financial advisors fully explain the disadvantages of premature terminations of policies to clients.</b>	0	40	23	12	0	75	2.3	2	2
<b>Financial advisors often facilitate a premature termination of one product and simultaneously recommend a substitute product.</b>	0	10	15	40	10	75	3.7	4	4
<b>A prematurely terminated policy is seldom substituted by a policy from the same product supplier.</b>	0	10	5	45	15	75	3.7	4	4
<b>A prematurely terminated policy is most often substituted by a policy from a different product supplier.</b>	0	15	30	20	5	75	2.9	3	3
<b>When a financial advisor changes his contractual relationship from one product supplier to another, clients are encouraged to terminate policies with one product supplier and substitute them with products from the other product supplier</b>	0	20	10	30	15	75	3.5	4	4

On average compliance officers agree (average-3.7; median-4; mode-4) that premature termination of policies is most often initiated by the financial advisor. Majority of the Compliance officers disagree (average-2.3; median-2; mode-2) that financial advisors fully explain the disadvantages of premature terminations of policies to clients. Compliance officers tend to agree (average-3.7; median-4; mode-4) that financial advisors often facilitate a premature termination of one product and simultaneously recommend a substitute product. There is a general agreement (average-3.7; median-4; mode-4) amongst compliance officers that a prematurely terminated policy is most often

substituted by a policy from a different product supplier. These findings are in resonance with previous findings (see pages 125 and 126).

### 6.3.10 Compliance Officers’ Perceptions Regarding some General Practices Amongst Financial Advisors

The perceptions of Compliance Officers regarding some general practices amongst financial advisors are presented in Table 6.32.

**TABLE 6.32. COMPLIANCE OFFICERS’ PERCEPTIONS REGARDING SOME GENERAL PRACTICES AMONGST FINANCIAL ADVISORS.**

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	TOTAL	AVERAGE	MEDIAN	MODE
N = 75	1	2	3	4	5				
<b>It is common practice for financial advisors to verbally inform their clients of any limitations regarding the range of products they are able to offer due to restrictions by contractual obligations to certain product suppliers.</b>	5	35	15	15	5	75	2.7	2	2
<b>Financial advisors frequently get clients to sign application forms that are partially completed.</b>	5	25	5	35	5	75	3.1	4	4
<b>Financial advisors most often sufficiently describe the features of financial products</b>	0	25	15	35	0	73	3.1	3	4
<b>Financial advisors seldom calculate whether a client’s disability cover exceeds the maximum allowed by law.</b>	5	15	30	20	5	75	3.1	3	3

On average compliance officers disagree, (average-2.7; median-2; mode-2) that it is common practice for financial advisors to verbally inform their clients of any limitations regarding the range of products they are able to offer due to restrictions by contractual obligations to certain product suppliers. Compliance officers are somewhat divided on whether financial advisors frequently get clients to sign application forms that are partially completed and neutral on whether financial advisors most often sufficiently describe the features of financial products and whether financial advisors calculate whether a client’s disability cover exceeds the maximum allowed by law.

## **6.4 Interview at the Financial Services Board.**

In April 2010, the researcher met Charene Nortier (Manager - Supervision) and Lawrence Horner (Manager) at the FSB head office in Mega Watt Park, Pretoria. The interview was unstructured with the representatives of the FSB agreeing to highlight challenges experienced as a starting point to be followed by questions posed by the researcher.

### **6.4.1 Challenges Recognised by the FSB.**

Rather than presenting the individual contributions of the managers mentioned above a summary is provided below that captures their collective views.

- The FAIS Act is a one-size-fits-all piece of legislation that is ideally suited to First World markets – South Africa comprises a hybrid of First World and Third World markets.
- There are major challenges experienced by the different categories of FSPs to adhere to the FAIS Act.
- The regulatory requirements are not considered to be fair amongst all categories of FSPs. – a joint project between the FSB and the National Treasury is at an advanced stage to address these imbalances.
- Representatives of the major FSPs such as Old Mutual, Sanlam, Liberty Life and Momentum do follow the step by step process as required by the FAIS Act.
- Many financial advisors do not understand the FAIS Act.
- Financial advisors are unable to fulfill the requirements of clause 8(1) of the Code of Conduct (RSA, 2003) with regards to disclosures regarding replacement products.

- Financial advisors are unable to clarify contractual details of a recommended financial product at the time the product was recommended.
  
- With regards to funeral policies:
  - (i) Funds collected from the policyholders do not reach the insurer.
  
  - (ii) There is a widespread practice of FSPs issuing funeral policies that are not underwritten by life insurance companies.
  
  - (iii) Disclosures are not made regarding the composition of fees.
  
  - (iv) Combining complex products with simple distribution channels may not be in the customer's interest.

#### **6.4.2. Questions Raised, Responses and Comments.**

The questions that were presented by the researcher is followed by responses from the representatives of the FSB. As part of the analysis of the information, the researcher adds a comment where applicable.

**Question: How was the FSB able to conclude that representatives of the major product suppliers comply with the step by step process required by the legislation?**

**Response:** The FSB conducts random on-site visits and inspects customer files to determine whether the files contain the relevant documents and whether the documents are correctly and appropriately completed. Furthermore compliance officers are obliged to submit compliance audit reports according to due dates. The smaller financial service providers tend to have difficulty in meeting due dates resulting in several extensions being granted. The large FSPs have their filing systems embedded within the day to day functioning of

the FSP. The filing systems of the smaller FSPs tend to be very vulnerable and at times give the impression that the system has been put together just for audit purposes. An extreme case of one small FSP was cited where the filing system was maintained in the boot of a car.

**Comment:** The merits of a good filing system augur well for the industry. However, documents contained therein may offer evidence of disclosures but not necessarily proof that disclosures have been really made to the client.

**Question:** **Why are financial advisors unable to fulfill the requirement of disclosure regarding replacement products?**

**Response:** When an existing product is replaced by another product, a number of disclosures are required (already discussed in some detail in Chapter 2). Obtaining information becomes a challenge because product suppliers only deal with financial advisors that are contracted to them. When the replacement product is from a product supplier that is different from the original product supplier, the financial advisor is unable to fulfill all the disclosure requirements.

**Comment:** The researcher is of the view that the financial advisor fee that was incurred through the acquisition of the original product entitles the client to an on-going advice. In keeping with this, should a client wish to terminate a product prematurely, the original financial advisor that sold the product should be called upon, to request from the product supplier, and furnish the client with relevant information required. The researcher cannot find any valid reason that prevents the client from exercising such a right. However, it is readily acknowledged that there is some residual doubt about the enthusiasm of such a financial advisor, investing time and energy in a task that has no future benefit for the financial advisor. The Code of Conduct (RSA, 2003) requires various disclosures to be made regarding replacement

products and places the onus of these declarations on the financial advisor that is providing the replacement product. What would solve the problem if certain parts of the disclosure are made by the financial advisor who provided the product being replaced and other parts of disclosure by the financial advisor that is providing the replacement product.

**Question:** Why are financial advisors unable to clarify the contractual details of the recommended product at the time the product is recommended?

**Response:** After the financial advisor recommends a financial product to the client and the client decides to acquire the product, an application form is completed to initiate the purchase. Contained within the application are various declarations made by the client such as health status, smoking and drinking habits, etc. Dependent on the declarations the risk is evaluated and the premium is calculated. The policy document is then drawn up to specify the benefits, terms, conditions, exclusions, endorsements and premium. The policy is then forwarded to the client much later. The client is entitled to a cooling off period within which he/she can cancel the policy if she/he is not satisfied with the terms and conditions.

**Comment:** Although not specifically mentioned in the response, emanating from the discussion, the researcher gained the impression that had it been possible for the policy document to be available at the time the product is recommended, then the financial advisor would be put in the position to discuss the details previously mentioned. In the future, with advances in technology and development of application specific software, it would be possible to have the policy document at the time the product is recommended. However, the researcher would like to point out that the policy document is a contract between the client and the product supplier (not the financial advisor). The duty of the financial advisor is to recommend the most appropriate product that suits the client's needs. The researcher is of the view that the financial

advisor's duty is limited to product description, and if he/she takes on the responsibility of interpreting the contract for the client, then he does so at his own peril, as he may not be a legal expert.

**Question: How does the FSB plan to address the lack of understanding of the FAIS Act among representatives?**

**Response:** In order to meet the fit and proper requirements in terms of competence representatives have to complete first and second levels regulatory examinations, based on the FAIS Act, within prescribed dates. These examinations include a set of core examinations which focus on the role and responsibilities of the representatives (known as the first level regulatory exams) and specific examinations (known as second level regulatory examination) relating to the product category in respect of which the FSP is authorized to render financial services. All representatives appointed prior to 31 December 2009 have until 31 December 2013 to complete the first and second level regulatory examinations. From 2010 onwards, all representatives must complete the relevant first level regulatory examination within two years of appointment and the second level within six years of appointment. If the representative fails to meet the deadlines, the representative will be debarred.

**Question: Is it fair for consumers to be provided with advisory service by representatives who have not passed regulatory examinations?**

**Response:** Representatives who have not passed the regulatory examinations are required to act only under supervision. The disclosure document or letter of introduction must reflect that the representative is working under supervision. It was emphasized that representatives will only be allowed to work under supervision if their FSP can satisfy the Registrar that they have the operational capacity to do so. The supervisor can be a key individual or a representative as long as the supervisor meets the competency requirements. A representative

can act under supervision for up to six years (2 months direct supervision and the balance of the period on-going).

Supervisory activities include:

- co-attending advice-giving meetings between the representative and clients for two months.
- signing-off advice given to the client.
- signing-off transactions to ensure that the product recommended is in line with the mandate given by the client.
- conducting follow up calls to clients after the rendering of financial services by the representative working under supervision.
- Obtaining samples of the representative's work to monitor finalized transaction.

**Comment:** The researcher holds the view that the consumer may have reservations with regards to receiving advice from a representative working under supervision. The key issue here would be whether the consumer has been made aware that the representative is operating under supervision.

**Question:** How does the FSB ensure that supervisory activities take place as required?

**Response:** There must be a written supervision agreement that details the procedures regarding rendering of the services under supervision. The Supervisor must be able to produce evidence of supervision actions undertaken, which must be properly documented, including the method followed and frequency of

supervision. Such evidence must be available for scrutiny by the registrar or representatives of the FSB during on-site visits.

**Comment:** Supervisory activities would tie up resources (representative or key individual) that could have been more productively engaged elsewhere. This being the case, supervisory activities could run the risk of being initially intense and then being gradually reduced over a period of time. This would be an undesired outcome. The written supervision agreement entails the plan for supervision and not evidence that supervision has taken place as planned.

**Question: How does the FSB ensure that representatives meet the fit and proper requirement of honesty and integrity on an ongoing basis?**

**Response:** FSPs are required to update their register of representatives and forward the same to the FSB every fifteen days. These registers are used to update a central register held by the FSB. A representative that has been struck off the register for failing to meet the fit and proper requirement of honesty and integrity will be reflected in the register that is forwarded to the FSB and included in the central register. When such an individual is added to the register of another FSP, the FSB will be able to inform the FSP that the individual have not met the fit and proper requirement of honesty and integrity at a previous FSP.

**Question: What are the consumer education programmes that the FSB has been engaging in?**

**Response:** Mr Lyndwill Clark (Senior project Manager at the FSB) will be tasked to compile a list of current and past activities (the list was forwarded to the researcher and discussed earlier under Chapter 4)

**Question: How does the FSB plan to solve the problems relating to funeral policies?**

**Response:** Regarding the flow of funds, premiums are collected either by funeral parlours or the FSPs, and the monies are deposited into their bank accounts. After deducting expenses the monies are paid over to the Funeral Administrator's bank account. The funeral administrators deduct expenses and commission and pay the balance of the money to the insurer.

A firmer stance is going to be taken against unregistered funeral assistance business. Nestlife Insurance Corporation Limited was fined R100 000 for having entered into agreements wherein it would underwrite funeral policies in respect of clients of certain funeral schemes, that were not issued with a licence for the rendering of an intermediary service. A R40 000 fine was imposed on Ditiro funeral administrators for being contracted to underwrite, administer and market funeral insurance policies in respect of certain funeral parlours who were rendering financial services, while not authorized to act as a financial service provider.

## **6.5 Critical Analysis of the Financial Services Website**

The FSB website is available at [www.fsb.co.za](http://www.fsb.co.za). Upon accessing the website the user will find, amongst others, the FAIS icon, Market Abuse icon and Consumer Education icon.

When the FAIS icon is clicked the user lands on a page where searches can be done for: debarred representatives; approved compliance officers; and financial service providers. Under "debarred representatives" one can establish whether a representative has been debarred by just entering the Identification Number (ID) of the representative. Under "financial service providers" one can search for an FSP either by FSP Number; Name; Postal Code or Representative Identification Number. When a postal code is entered, all the FSPs with a business address under the postal code are displayed. When the Identification Number of a representative is entered the consumer is able to establish which product suppliers the representative is contracted to as well as categories of

products the FSP is authorized to market. When “approved compliance officer” is selected, a list of compliance officers are displayed with their contact details as well as the FSP that is linked to the compliance officer.

When the “Market Abuse” icon is selected the user lands on a page where one can view past investigations and current entities that are being investigated. When the “Consumer Education” icon is selected the user lands on a page entitled “Consumer Education Department”. Listed on this page are various topics that can be accessed by selecting the appropriate topic. The topics listed include:

- Consumer Education Strategy of the Financial Services Board;
- Brochures, Documents and Articles;
- Consumer Education Booklets;
- FSB Publications;
- Events; and
- Conferences

#### **6.5.1 Consumer Education Strategy of the Financial Services Board.**

When “Consumer Education Strategy of the Financial Services Board” is selected, a 32 page document entitled “The Consumer Education Initiative of the Financial Services Board – Final Strategy (October 2001)” appears. This strategy predates the implementation of the FAIS Act (RSA, 2002) and raises the question of relevance and time span. Nonetheless, the strategy recognizes:

- (i) the need to deal with the unbanked (LSM 1-4 category – high degrees of illiteracy and low income) differently to the banked (LSM 5-8 category – literate and higher income);
- (ii) personal finance as a topic is not part of social conversation; and

- (iii) people who “should know better” manage their affairs poorly – so sometimes knowledge does not translate into appropriate behaviour.

The objectives that the strategy aims to achieve, revolve around:

- (i) effective saving and debt management;
- (ii) effects of inflation and compound interest;
- (iii) rights and responsibilities;
- (iv) responsible financial behaviour for specific life events; and
- (v) How to choose the right products

The researcher notes that the past and current consumer education initiatives (see appendix 1) seem to address objectives (i) and (ii) mentioned above adequately. However, objectives (iii), (iv) and (v) does not seem to be addressed adequately.

## **6.5.2 Brochures, Documents and Articles**

When Brochures, Documents and Articles is selected, the user lands on a page with a list of Brochures and Articles.

### **6.5.2.1 Brochures**

There are 5 Brochures listed and one of them entitled “10 Tips for Consumers when Buying Insurance Policies (see Appendix C) was found to be relevant to insurance. This brochure comprises two pages that list 10 tips emphasizing:

- (i) the need to shop around for a policy;
- (ii) the need to make sure that the policy can be afforded;

- (iii) not to engage financial advisors not registered with the FSB;
- (iv) not to make false declarations;
- (v) the need for retirement annuities;
- (vi) the need to read and understand the policy;
- (vii) the provision of a period within which a policy can be cancelled;
- (viii) the grace period for late payments;
- (ix) the need to keep the policy in a safe place; and
- (x) the right to complain and need to seek recourse from the company before submitting a complaint to the FSB.

The researcher finds the tips relevant, but questions its usefulness, as each is followed by only a very brief discussion comprising a few lines only. The discussion should be more elaborate in some of the cases. For example, on the issue of:

- (i) not to deal with unregistered financial advisors, the brochure should give an explanation of how one could establish whether a financial advisor is registered or not. In fact, one could determine this from the information that is already available on the FSB website (as discussed earlier);
- (ii) the need to shop around for a policy could be expanded to include shopping around for a financial advisor on the basis of fees charged. It should also emphasise that shopping around for products may involve engaging more than one financial advisor, as a particular financial advisor is limited by the contractual obligations to specific product suppliers; and

- (iii) making sure that the policy can be afforded, the discussion does not give an indication of how this is to be accomplished. In fact this is the function of the financial advisor who has to ascertain the client's financial position. What should be emphasized is that the more correct the information provided to the financial advisor, the more accurate would be the assessment of the financial situation.

### **6.5.2.2 Articles**

Eleven articles are included, each about one page in length. The discussions in the articles include the topics of saving, debt management, long-term insurance and short term insurance. The researcher considers the extent of the discussions as being no more than one can obtain in other sources of information such as newspapers and advertising material from product suppliers. An exception to this is an article entitled "Financial Advisory and Intermediary Services (FAIS) Act" that does well to summarize the rights of a consumer of financial products. Unfortunately this appears at the end of the article while the other parts of the article contain a discussion of issues, which the researcher doubts will be of particular interest to the typical consumer of insurance products.

### **6.5.2.3 Consumer Education Booklets**

When "Consumer Education Booklets" is selected, the user lands on a page where there are four booklets that are downloadable. They are entitled: Financial Guide for Youth; Making the Most of Your Money; Use your Money Wisely and Make Your money Work for You. The 'Financial Guide for Youth' is a 32 page booklet that covers topics such as personal financial planning, Your Bank and Bank Account, Investment and Insurance. The 30 page booklet "Making the Most of your Money" is in cartoon form covering the themes of planning and drawing up a budget. The last booklet discusses Needs and Wants; The Death Trap, Getting out of Debt and Managing Debt.

### **6.5.3 Advertising**

The FSB website does not carry any paid advertising. It is assumed that the absence of advertising portrays and reinforces the position of the FSB as an independent regulatory body. The researcher is of the view that advertisements on the FSB website would not undermine the independence of the FSB and believes that internet users are sophisticated enough and already well experienced in separating advertising from the matters of the organization hosting the website.

Furthermore, a casual search of the websites of product suppliers and other financial institutions did not evidence any FSB advertising. For example, a consumer visiting a product supplier website might be interested in a FSB message that appears on that website as a 'pop up'. A 'pop up' is a message that may flash on the webpage.

### **6.5.4 Preparation for Regulatory Examinations**

A more recent addition to the FSB website is relevant material that candidates wishing to sit for regulatory examinations can access to prepare for the examinations. Included here are notes as well as typical examination questions which could serve as a valuable resource for candidates.

## **6.6 Conclusion**

Asymmetric information between clients and product suppliers in the insurance industry is the result of the unique features of financial products and services. Financial service providers through financial advisors are supposed to resolve this asymmetry through advice. The advice that is provided is regulated through the FAIS Act and the Code of Good Conduct for Financial Advisors. In lieu of the advice an advisor's fee is applicable. The regulation demands that such fees should be disclosed to the client and the features of the products being sold are clearly explained to the client.

However, in practice clients seem to have a low to very low level of understanding of the features of basic insurance products. This low to very low level of knowledge does not correlate with Race, Age, Place of Educational qualification. It would appear that the asymmetry regarding knowledge of basic insurance products remains unresolved. Furthermore, there seems to be a low level of disclosure regarding fees charged by financial advisors. It would appear that clients are not aware of the disclosures that they are entitled regarding fees charged. A very small percentage of clients do actually read the policy document in detail.

Consumers perceive their financial advisors to be knowledgeable of the numerous products on the markets and believe that financial advisor recommends the best products for them. Consumers are not made aware that contractual limitations to particular product suppliers restrict the products that can be recommended. Furthermore, when financial advisors recommend replacement products, the absence of a relationship with the product supplier makes it difficult for the financial advisor to fulfill all the disclosure requirements. The majority of compliance officers are middle-aged, White, males who hold postgraduate academic qualifications. Just under half hold legal qualifications only, half hold financial/industry related qualifications only and only a very small percentage hold both types of qualifications.

The funeral insurance industry is plagued by numerous problems including the underwriting of funeral policies by providers that are not registered. Furthermore, there are challenges in ensuring the premiums collected from clients reach the insurer. Despite the shortcomings of the FSB website, as perceived by the researcher, the value of the website should not be understated. While the availability of information augurs well for the consumer, it is unfortunate that many consumers do not visit the website as established in this empirical study. An awareness of the website and its usefulness needs to be heightened.

## CHAPTER SEVEN

### CONCLUSIONS AND RECOMMENDATIONS

#### 7.1 INTRODUCTION

Information asymmetry served as the theoretical framework for this study. Financial regulation was explored as a solution to information asymmetry between consumers and financial advisors in South Africa. The consumer education and financial literacy programmes in South Africa were compared to those in the UK and USA. Empirical surveys were conducted with the main focus being to establish the impact of regulation on the levels of disclosure regarding fees charged by financial advisors and the levels of awareness regarding the features of basic insurance products and consumer education initiatives. Other subsidiary focal points related to consumers' perception of their financial advisor's competence. The results of the surveys were analysed and presented. In this chapter, conclusions will be presented and where appropriate, recommendations are offered.

The purchase of Life Insurance products is characterized by asymmetric information due to the complex nature of the financial product and the consumer's lack of opportunity for experiential learning. Intermediation, through financial advisors, is supposed to resolve this asymmetry via relevant disclosures within the regulatory framework of the FAIS Act and the Code of Conduct for Financial advisors. In South Africa the regulatory regime focuses on institutional soundness, competence of financial advisors, compliance and consumer protection. The desired outcomes of consumer education initiatives are supposed to enhance levels of financial literacy amongst consumers so that they would be enabled to make informed decisions. The consumer education initiatives in the USA and the UK have not yielded results that are very promising. The consumer education initiatives in South Africa have been along similar lines to those in the USA and the UK. In South Africa, these initiatives are biased towards the poor. The poor purchase funeral insurance to cover the event of death while the more financially resourced purchase Life Insurance to cover the event of death.

An empirical survey was conducted amongst consumers of Life Insurance products in South Africa to establish the levels of disclosure regarding fees charged by financial advisors, the level of understanding of the features of the basic insurance products and level of consumer awareness. Another empirical survey was conducted amongst compliance officers to capture their perceptions on similar issues. An interview was conducted at the FSB to establish some of the challenges posed in complying with legislation. A critical analysis of the FSB website was undertaken.

The research questions that this study attempted to answer were:

- What are the challenges, recognized by the Financial Services Board, that Financial Service Providers face in complying with regulatory provisions?
- Do financial advisors make the necessary disclosures, as demanded by regulation, to consumers of financial products?
- Do consumers of financial products understand the features of basic insurance products most commonly sold?
- Do consumers of financial products perceive their financial advisors to be knowledgeable on all the products available on the market?
- What are the consumer education initiatives, relating to financial services and products, of the various role players in South Africa?
- How do South African consumer education initiatives, relating to financial services and products, compare with international initiatives?
- Do financial advisors make the necessary disclosures, as demanded by regulation, from a compliance perspective?
- What are the challenges facing funeral insurance in South Africa?

The discussion that follows demonstrates how the results obtained from the empirical study answer these questions and is accompanied by recommendations.

## **7.2 Disclosures Regarding Fees Charged**

The FAIS Act, General Code of Conduct and the Policy Holder Protection Rules makes it mandatory for financial advisors to disclose fees charged in lieu of advisory services rendered. However, the empirical surveys reveal high levels of non-disclosure regarding fees charged. It was therefore concluded that that financial advisors do not make sufficient disclosures regarding the financial advisor's fee that is charged.

Given the compliance function, it is unlikely that such details will be absent from a disclosure document. When the financial advisor's fee is included in a document and not verbally mentioned or pointed out to the client, the client remains unaware of the fee charged, as from among those that read the policy, most just glance through it and just a small percentage actually read the policy in detail.

It is recommended that the manner in which disclosure regarding financial advisors' fees are made be revisited to include:

- The verbal disclosure of the financial advisor's fees charged, over and above any written disclosure, as an important step in the advisory and intermediary process.
- In the written disclosure of the financial advisor's fee charged, bold print or colour or some kind of differentiation should be used to highlight relevant information so that it stands out from the rest of the printed material.
- The client's initials should appear close to the highlighted information to signify that the relevant information has been brought to the client's attention.

For example, it is common practice for sales persons in the cellphone industry to circle pertinent aspects of the contract, which comprises almost entirely of fine print. Consumers are very familiar with the practice of acknowledging the importance of the information by appending their initials thereto.

### **7.3 Disclosure Regarding Contractual Obligations and Consumers' Perceptions of Financial Advisors**

The empirical survey has evidenced that the majority of financial advisors do not disclose to their clients that the range of products that she/he is able to recommend is limited by contractual limitations to specific product suppliers. Consequently, clients seem to be unaware that contractual limitations restrict the range of products that can be recommended. It was further evidenced that, consumers perceive their financial advisors to be knowledgeable of the various products available on the market and that the financial advisor recommends the best product for them.

It is recommended that the manner in which disclosures are made regarding contractual obligations be revisited to include:

- The verbal disclosure, over and above any written disclosure, as an important step in the advisory and intermediary process.
- In the written disclosure of contractual obligations, bold print or colour or some kind of differentiation should be used to highlight relevant information so that it stands out from the rest of the printed material.
- The client's initials should appear close to the highlighted information to signify that the relevant information has been brought to the client's attention.

#### **7.4 Disclosure Regarding Representatives Working Under Supervision**

While it is a requirement that the disclosure document or letter of introduction reflects that a representative works under supervision, consumers' views regarding advice received from representative was not captured. It is recommended that the manner in which disclosure is made regarding a financial advisor or representative working under supervision be revisited, to be disclosed in a similar manner to that recommended for the disclosures regarding financial advisor's fees charged, and disclosures regarding contractual obligations.

It is further recommended that the appropriate authorities at the FSB address the issue of titles that can be used by representatives. For example, a representative working under supervision may be limited to using the title of "Candidate Representative" while a financial advisor that has passed all the regulatory examinations may use the title "Representative". This distinction should manifest itself in all written material received by the client, for example, letters of introduction and business cards. In doing so, over a period of time, consumers should be able to differentiate between the two categories of representatives through the use of specific titles.

#### **7.5 Knowledge of Features of Basic Insurance Products**

Assessments of consumers' knowledge of the features of basic insurance products can be best described as being at a low to very low level, suggesting that the average consumer is not very well informed about the features of basic insurance products. This level of knowledge is independent of gender, age group, race, place and educational qualifications.

It is recommended that:

- The consumer education programmes be refocused to target consumers of Life insurance products (higher LSM categories) as well.

- The FSB, in consultation with product suppliers, design educational material for products that would be appropriate for ‘life changing moments’, for example marriage, birth, death or divorce, of individuals and families.
- The FSB run a column in the mainstream newspapers, where experts with no vested interests, are invited to write on issues relevant to consumers of life insurance products. The experts can be drawn from Universities, the Financial Planning Institute, and the FSB itself.
- The FSB, in consultation with product suppliers, prepare a generic product description differentiation matrix that is made available for the clients’ attention, through the financial advisor. A quick glance through the document should furnish the necessary information that distinguishes the features of basic insurance products. One copy of the product differentiation matrix should bear the signature of the client across the recommended product and be retained amongst the necessary documents in the client’s file.

A simple example is provided for illustration purposes in Table 7.1 below.

**TABLE 7.1 FEATURES OF BASIC INSURANCE PRODUCTS**

<b>Product</b>	<b>Product A: Term Life cover</b>	<b>Product B : Whole life cover</b>	<b>Product C: Universal life cover</b>
What is the duration of cover?	Fixed period: eg 20 years No cover after term expires	Entire life	Entire life
Is savings incorporated ?	No	Yes	Yes
Is there a surrender value?	No	Yes, value depends on savings	Yes, value depends on savings
Can the amount of cover be adjusted?	No	No	Yes
Can the premiums be adjusted?	No	No	Yes
Relative Cost	Less expensive	Expensive	Most Expensive

## 7.6 Premature Termination of Policies

A large number of the consumers terminate their policies prematurely for reasons of lack of affordability and this is understandable if there is a change in their financial circumstances over a period of time. However, more than half of those that terminated products prematurely did so because the product was considered to be inappropriate and about a third replaced it with another life insurance policy from the same product supplier. When products are replaced, a financial advisor's fee is payable. While it is agreed that clients' personal circumstances sometimes change, warranting products to be replaced, churning on the part of the financial advisor would be to the detriment of the client. What lends credibility to this statement is that more than half of the clients were not informed of the disadvantages of premature terminations. When the replacement product is from a product supplier that is different from the original product supplier, the financial advisor is unable to fulfill all the disclosure requirements. Obtaining information becomes a challenge because product suppliers only deal with financial advisors that are contracted to them.

It is recommended that disclosure requirements related to the premature termination of products be revised to the effect that:

- When the product is replaced by another product from the same product supplier, the processing of such a replacement should automatically initiate diagnostic measures at the compliance level to ensure that the premature termination is justified and not tantamount to churning.
- When the product is replaced by another product from a product supplier that is different from the original product supplier, then the disclosure document should comprise two sections. One section should be completed by the original product supplier, facilitated by the financial advisor that sold the product and the other section should be completed through the financial advisor selling the replacement product. Penalties or un-recovered expenses deductible or payable, tax treatment and the vested rights, minimum guaranteed benefits or other guarantees or

benefits that may be lost as a result of the premature termination should be contained in the section that is to be completed by the original product supplier. These sections could appear on separate documents. These documents should ideally be standardized and prepared by the relevant authorities at the FSB.

## **7.7 Consumer Awareness**

The level of consumer awareness can be best described as being low. The majority of the consumers are not aware of the existence of the FSB and very few have actually visited the FSB website. The majority of consumers are not aware of any consumer education initiatives. There was no difference in the level of awareness between the race groups or age groups. The level of awareness in Durban is lower than that in Cape Town and Johannesburg. This anomaly warrants further research. Although the level of awareness is low the mean awareness level increases with increasing levels of qualification.

It is recommended that the FSB:

- advertise its website using radio and television to publicize its functions.
- explore the possibilities of arranging for the major product suppliers to flight important FSB messages on their websites.

## **7.8 Consumer Education Initiatives**

The consumer education initiatives included: radio broadcasts, shopper education in malls, brochures and guides, community based workshops and curriculum development in schools. Majority of the consumers reported that they were not aware of the consumer education programmes. Initiatives in the USA and UK regarding curriculum interventions in schools have not yielded positive results.

The consumer education initiatives in South Africa have focused on the lower LSM categories while consumers of insurance products tend to be from the higher LSM categories. Recommendations are listed under 7.5 above.

## **7.9 Representatives Working Under Supervision**

Representatives that have not passed industry specific regulatory examinations are required to work under supervision. Supervisory activities would tie up resources (representative or key individual) that could have been more productively engaged elsewhere. This being the case, supervisory activities could run the risk of being intense initially and gradually reducing over a period of time. This would be an undesired outcome. The supervisor must be able to produce evidence of supervisor actions undertaken.

It is recommended that representatives working under supervision maintain a logbook that is updated on an on-going basis with regards to supervisory activities to:

- provide evidence that supervisory activity has been taking place on an ongoing basis as planned.
- ensure portability of the record of supervision when the representative joins a new FSP.

## **7.10 Funeral Insurance**

The provision of funeral insurance requires more regulatory intervention, given the widespread practice of:

- (i) FSPs issuing funeral policies that are not underwritten by life insurance; and
- (ii) funds collected from policy holders not reaching the insurer.

It is recommended that:

- Insurers underwriting funeral policies may do so only if it can be ensured that a proper premium collection platform exists or can be provided.

- Benefits under funeral policies should offer the option of a cash payout or the provision of a funeral service where the consumer can elect his or her choice.
- Where funeral insurance is sold through third parties, the insurer must certify that the premium charged has been determined on an actuarial basis.
- Third parties that collect premiums on behalf of the insurer must maintain a separate bank account and monies must be transferred to the insurer at regular predetermined intervals.

### **7.11 Compliance**

Compliance practices are dominated by middle aged White males. Almost half of the compliance officers have legal qualifications and no experience in the insurance industry. Compliance officers that follow the ‘tickbox’ approach to compliance, run the risk of reducing compliance activities to the checking for documents in files, without a deeper insight of practices in the industry.

It is recommended that the FSB:

- extend the requirements for a compliance officer to include at least a year of industry experience.
- to make it mandatory for practicing compliance officers, without industry experience, to attend continuous professional development activities that is aligned to the insurance industry.

### **7.12 Challenges that FSPs face in Complying with Regulation**

The numerous challenges face by FSPs, alluded to by the FSB, has been detailed on page 147. Recommendations made above address some of these challenges.

With regards to the lack of understanding of the FAIS Act among representatives, it is recommended that FSB inform the public, via existing channels of communication, exactly what ‘acting under supervision’ means. Such action on the part of the FSB should create the necessary sense of urgency for representatives to undertake their examination well within the stipulated period.

### **7.13 Limitations of the Study**

The focus of this study has been from a consumer perspective. There is the FSP perspective that has not been explored, in particular matters relating to the capital adequacy requirements of FSPs. The scope of this study was limited to consumers of Life Insurance products and the Short-term and Commercial insurance markets were not included. Within the Life Insurance market, the research did not extend to include direct sales (television, telephone and cell phone) marketing.

### **7.14 Further Research**

Further research needs to be undertaken regarding measures to be taken to:

- Capture consumers’ perceptions on being provided with advice from a representative working under supervision.
- Address the imbalance of the demographics of compliance practices.
- Improve the compliance culture in smaller FSPs.
- Embed the compliance function within the day to functioning of FSPs
- Establish challenges faced by FSPs with regards to demonstrating institutional soundness.
- Establish the reasons for the majority of the FSPs operating as a “one person” FSP.

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