



DIRECTIVE
FINANCIAL SERVICES BOARD
REPUBLIC OF SOUTH AFRICA

LONG-TERM INSURANCE ACT, 1998 (ACT 52 OF 1998)

Addressee:	Long-term insurers		File:	10/17/1 & 10/11/2/1	
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2 nd	-	-	-	-	-
3 rd	-	-	-	-	-
Subject:	Section 54 of the Long-term Insurance Act, 1998: Limitations on provisions of certain long-term policies				

1. Purpose

This directive is aimed at settling interpretive difficulties and possible anomalies that could arise in the application of Section 54 of the Long-term Insurance Act, 1998 and Part 4 of the Regulations. It does not amend Section 54 or Part 4 of the Regulations, but merely serves to clarify a number of aspects which may result in the irregular or incorrect application of this legislation. Insurers must adhere to the rulings contained in this directive so as to ensure that neutrality prevails in the industry and that uniform practices are adopted.

2. Construction

Paragraph 3 of this directive concerns those aspects raised by insurers that arise from interpretive difficulties with Section 54 and Part 4 of the Regulations. Paragraph 4 deals with apparent misconceptions insurers displayed in the input which they submitted to the Registrar and which is responded to for the sake of clarity.

3. Interpretive difficulties

3.1 Non-forfeiture provisions

Certain long-term insurers, supported by legal opinion, maintain that where premiums are not paid by a policyholder in respect of a long-term policy and non-forfeiture benefits are applied by the insurer, there is no question of a loan or an advance of a premium as legally understood, nor can any interest be recovered on such a loan or an advance, unless agreed to, between the parties. On the other hand, a body of opinion exist, and policy documentation provide, that such benefits are indeed provided as a loan or an advance. This directive is not intended to settle the legal debate, but to ensure that the provision of non-forfeiture benefits are not restricted by Section 54 and Part 4 of the Regulations, nor used as an avenue for the circumvention of its restrictions.

(a) Approach 1

Where non-forfeiture benefits are provided under a loan construction, *i.e.* where the policyholder has in terms of the policy the premium advanced to him/her/it and the same is forthwith applied to the policy, that policyholder accrues a premium debt (which is a loan). It follows that the premium under the policy is actually paid on his behalf. This means that premiums due on the policy were in fact paid, the amount being the aggregate of the actual amounts lent and advanced, excluding interest on the debt. When such an accumulated debt is settled, it follows that a loan is redeemed and no premium is being paid. Hence the settlement payment should not be considered to be a “premium” as defined, as this is specifically exempted (refer to Regulation 4.2(5) of the Regulations).

For purposes of Section 54 and Part 4 of the Regulations the premium thus paid by means of a loan to the policyholder is the premium used in the calculation of an excess premium and not the amount of the debt being redeemed.

It is possible that this construction could lead to abuse with simulated recurring premium policies, which accrue “premium debts” and which are then redeemed shortly before maturity, creating a short-term instrument. For this reason such advances will only be considered appropriate if the following criteria are present:

- The loan and advance of the premium must be *bona fide* and must conform to Section 52 of the Long-term Insurance Act, 1998.

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- The values of the policy must be adjusted in accordance with the premium received (under the construction) as and when it is received, with suitable adjustments for accrued interest.
- Fair and market related interest must be charged on unpaid premiums.
- The insurer must be able to show that the policy will contractually and in practice lapse if the accrued debt exceeds the surrender value (adjusted for any loans outstanding).

(b) Approach 2

Where a construction is applied under which moneys are not advanced to a non-paying policyholder, the following should be done:

- The insurer must keep record of the actual premiums not paid, and their aggregate value, as well as the reducing value of the policy as a result of the non-payment of the premium.
- A separate or (separately identifiable) record must be kept of the additional premiums that the insurer would require to restore the policy to full value.
- Upon the policyholder effecting payment of the total or any part premiums due, only the aggregate of the unpaid premiums may be deemed to have been received as and when they fell due contractually, for purposes of calculating whether an excess premium has been paid. All additional premiums (due or received) are ignored for this purpose.

In addition the following criteria must be met under a construction referred to in this approach:

- The system must be *bona fide* and must in substance conform to intention underlying Section 52 of the Long-term Insurance Act, 1998.
- The values of the policy must be adjusted in accordance with the unpaid premiums as and when they become due but remain unpaid, with suitable adjustments for the additional premiums required to restore the policy.
- The additional premiums, when expressed as a percentage of outstanding premiums, must be of a magnitude equivalent to a fair and market related interest.
- The insurer must be able to show that the policy will contractually and in practice lapse by reason of the reduction in the value of the policy as a result of the non-payment of premiums, (adjusted for any other loans outstanding as well).

3.2 Pre-payment and excess payment of premiums

A number of insurers have policyholders who pay premiums in advance on recurring premium policies. In addition, certain insurers find that premiums are sometimes overpaid as a result of, for instance, stop-order errors. The problem foreseen is that where such premiums are received at an inopportune time, they may amount to an excess premium for purposes of Section 54 and Part 4 of the Regulations, resulting in a restriction period being applied to the policy. (The words used refer to a premium “received” or “to be received” which indicates that such pre-payment or excess payment would result in a restriction period becoming effective).

In order to allow for *bona fide* cases where good reason exists for the pre-payment of premiums, the word “received” or “to be received” should not be interpreted to refer to a pre-payment or overpayment of premiums where the following criteria are met:

- The pre-payment of premiums may not be a pre-agreed contractual term. It must result from a written request by the policyholder after effecting the policy and a good reason must be advanced. Without giving an exhaustive list, examples of good reason include changing from mode of payment A to mode of payment B, involving a time delay or being away from home for a period of time, (6 months overseas study).

In judging the reason advanced, consideration should be given as to why the pre-payment could not reasonably be prevented by depositing the premiums in a bank account with a debit order to effect payment.

- The pre-payment of premiums must be temporary in nature and not be a permanent feature of the policy. If it is to be a permanent or long-term feature, a different interval for the payment of premiums should be agreed upon, eg. annually instead of monthly.
- In the case of an overpaid premium, it must be as a result of a *bona fide* error by a person other than the policyholder, and must be corrected as soon as it becomes apparent.
- Monies thus paid in both instances must be kept in a suspense (or similar) account by the insurer and may not be applied to the policy until payment thereof falls due contractually, and should be refundable to the policyholder on request.
- No interest, bonus or any other form of investment return may be added to the monies in the suspense account or to the policy by virtue of the monies in the suspense account.

3.3 Premium payment history

Part 4 of the Regulations requires that premiums received in any year be compared to the higher of the premiums received during the preceding two years. This presupposes that insurers are able to source the premium history from their records. It would appear that this may be problematical in certain instances for insurers.

Insurers must ensure that their systems are adjusted to keep record of this information for future purposes. For interim purposes insurers should follow the following guidelines as far as old policies are concerned:

- Where the premium history is available or can be determined by exercising reasonable effort, it must be used.
- Where the premium history is not available and cannot be ascertained by exercising reasonable effort, the oldest available premium record should be used, the oldest premium reflected therein should be applied as being the premium in the premium period(s) concerned.
- Where the use of the immediately preceding method appears inappropriate, a “best estimate” of the premium, as certified by the statutory actuary, must be used.

4. **Misconceptions**

In this paragraph, a number of issues raised are listed and replied to either because they arise from incorrect assumptions or because they imply an amendment to Section 54 and Part 4 of the Regulations, but which amendment cannot be effected in a directive of this nature.

4.1 Surrenders

It is contended that Regulation 4.2(1)(b) of the Regulations is incorrect, in that it does not explicitly provide for the calculation of the restricted amount by having regard to redemption of a prior loan made during the restriction period concerned, e.g. if the restricted amount is say R10 000, and a prior loan of say R4 500 was granted, it follows that the policy may surrendered in full or in part for up to R5 500. If however, R2 000 of the loan capital has been redeemed before surrender is contemplated, it is argued that the surrender value should be adjusted upward by the R2 000 capital redemption, allowing a residual surrender value of up to R7 500 to be paid.

The Regulation in question is not defective, as it was originally intended to preclude the use of such a redemption in the calculation of the residual value of the restricted amount. If it were not so, it would follow that the restricted amount, properly calculated at R10 000 in the example, could indirectly be increased to R12 000. It also means that the same money may be accessed twice during a restriction period.

4.2 Premium increases on dates other than policy anniversaries

It has been pointed out that the permissible 20% premium increase may be exceeded when a premium increase of less than 20% takes place halfway through a premium period, and is repeated in the following year. This follows from the fact that a premium period is defined as a rigid 12 month period which remains constant (in terms of starting and ending) during the term of the policy.

The alternative approach was to define a premium period also as a “floating” 12 month period which commences as soon as a premium is increased and which then gives rise to a comparison between more than one of these “floating” premium periods in order to apply the 20% rule. It would have resulted in a very complex enactment with concomitant room for abuse, which goes against the object of having a simpler, clearer enactment than the old 6th Schedule, and to also have an enactment which cannot easily be circumvented. This problem was discussed at length during the design stage and it was held that the possible hardship that could follow is preventable since:

- In those cases where premium increases are agreed to at the commencement of the policy, policyholders (acting on the good advice of their insurers in intermediaries) should cause premium increases to be effected on policy anniversaries.
- The act of increasing a premium after the inception of a policy, follows from a voluntary and informed decision by the policyholder. The policyholder’s decision must henceforth take this aspect into account. The problem can be resolved by either making the increase effective from a future policy anniversary or by effecting a smaller increase for the remainder of the premium period concerned and again increasing appropriately on the subsequent policy anniversary.

4.3 NON-PAYMENT OF PREMIUMS AND PAID-UP POLICIES

Comments were received that the non-payment of premiums during a premium period, which is resumed during the next premium period with the payment of all arrear premiums, may give rise to a restriction period coming into operation. The same would apply to a policy being made paid-up, with the resumption of premium payments later.

If the policy in question has non-forfeiture benefits applying to it, the matter has been dealt with earlier on in the directive.

If such benefits are not applicable, the following would seem to be the position.

(a) Situation 1

The policy in question has lapsed, in which event it has legally ceased to exist. The policy is not “revived” but a new contract is in fact entered into when premiums are again paid, albeit on the same terms and conditions and under the same policy number. It is not intended to alter this common law position in this enactment, not even implicitly, by referring to the resumption of premiums for “revival” purposes. The Act is, and should remain silent on this issue. To approach the matter correctly, a new restriction period should in fact apply from the date on which any lapsed policy is reinstated. Insurers may, however, reinstate policies as if they are the original contracts, provided the reinstatement remains within the limits as enacted with regard to arrear premiums. Any excesses over this, will on proper analysis force reinstated policies into restriction periods.

In this situation substantial room for abuse also exists when a policy is deliberately allowed to lapse, and all arrear premiums are paid at the end of the minimum 5 year term. Even if this were allowed for a 12 month period, it could effectively reduce the 5 year period to 4 years. Whilst it is granted that there is some room for manipulation as matters now stand, (effectively 11 months reduction of the minimum term) it is felt that the present dispensation is about as relaxed as it could be in relation to those policyholders where hardship may be an important consideration. Any further relaxation will give rise to manipulation.

Finally, no good reason exists to advantage a non-paying policyholder over a paying policyholder.

(b) Situation 2

In this situation, the policy is made paid-up, viz. still in force for reduced benefits, or remains in force for another reason, eg. extended days of grace to pay premiums.

The same rationale applies to this situation. Again room for manipulation exists, eg. where the insurer would grant a 24 month period of grace for the payment of a premium. If arrear premiums were to be allowed and not taken into account for purpose of determining the commencement of a restriction period, they could be paid towards the end of the term, thereby violating the minimum term prescribed.

In this instance it would seem appropriate to allow a policyholder the remainder of the premium period concerned to effect payment of arrear premiums without violating the 20% rule. Premiums paid after expiry of the premium period will have to be taken into account for this purpose.

In the design stage of the enactment a strong point of view was adopted in this general regard, and it was even held that even where the non-payment of premiums is due to the fault of a third party, such as a stop-order agency or a bank, or even the insurer itself, the broader policy considerations involved outweigh the risk of an innocent being penalised, as a result of applying this rule without exception.

4.4 Cession of policies

Some insurers raised questions as to the effect of cessions of policies on extinguishing or causing restriction periods to come into existence.

Cessions have no effect whatsoever on restriction periods, or their duration. Whether or not a restriction period applies is determined in accordance with the criteria stipulated in the Regulation, and policies are ceded subject to or free from such restriction periods as may apply to each individual case.

The only situation where a cession may affect the coming into effect of a restriction period, is where a policy funding a pension fund, provident fund, retirement annuity fund, friendly society or benefit fund is ceded to a member of the fund. Such policies are exempted from Part 4 of the Regulations prior to such cession, and the cession removes the exemption.

4.5 General

- (a) It is not permissible for insurers to contract for "... a premium to be agreed in future ..." so as to avoid the provisions of Part 4 of the Regulations. The Regulation concerns itself with premiums actually received or to be received. Transactions using such mechanisms to avoid the effects of the Regulation will be viewed seriously and acted against.

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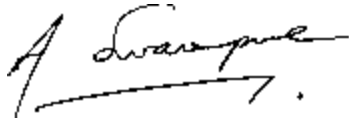
- (b) Insurers wanted some form of guarantee that policy proceeds will not suffer any tax other than trustee tax. Such a guarantee should be sought from the Commissioner for Inland Revenue, not the Financial Services Board.
- (c) Not only the 20% rule on premiums, but the entire Section 54 applies to policies used for purposes relating to Section 11(w) of the Income Tax Act.

5. Application

I trust that the contents of this directive will enable a uniform and smooth application of Section 54 and Part 4 of the Regulations. Where significant difficulties exist, discussions will be held with the industry on an ongoing basis to resolve them. Insurers are therefore requested to conduct their business not only within the bounds of Section 54 and Part 4 of the Regulations but also within their spirit.

6. Information sharing

This directive is available on the website (www.fsb.co.za) of the Financial Services Board. Insurers must bring this directive to the attention of their appointed auditors and statutory actuaries.



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