Outsourcing by insurers

There are good reasons why insurers enter into outsourcing arrangements. There are many things that big and small insurers, for cost or efficiency, can or want to outsource rather than increasing their own staff or infrastructure. The reasons are many but should not be solely to put extra money in the pockets of intermediaries.

The Financial Sector Regulation Act, 2017 defines an "outsourcing arrangement". For present purposes it includes a function that is integral to the nature of insurance policies or insurance business that is outsourced to a third party but not to staff members or secondees.

The do's and don'ts are in Prudential Standard GOI 5 which relates to outsourcing by insurers. Crucially GOI 5 refers to a service or activity that would normally be performed by the insurer. That means normally performed by the insurer as a necessary part of the insurer's business. That does not mean only insurance business in a narrow sense. Outsourcing IT functions for instance creates risk for the insurer's business and its relationship with policyholders because functions like this materially increase the risk to the insurer and insured if they fail. On the other hand, outsourcing functions which insurers might, but don't necessarily, do like arranging car hire, loss adjusting or getting legal advice would not be outsourcing. Outsourcing claims administration on the other hand would fall within the requirements.

Insurers must avoid or mitigate any conflicts of interest. Where outsourcing to an intermediary means that the intermediary such as a broker will be acting for both insurer and insured, the client as policyholder must be made aware of the dual role played by the broker. This is the position under our common law as well. The insurer retains responsibility for all regulatory obligations when they are outsourced and proper due diligence and monitoring of the outsource service provider and the services provided is essential. Besides the substance of the outsource, GOI 5 contains a list of necessary contractual requirements in the required written outsourcing agreement. Where material business activities are outsourced the FSCA must be notified of the proposed outsource in advance. It is not an approval process, but the FSCA has the authority to object to any arrangement or its details.

Activities and functions should not be outsourced unless the costs or benefits of the outsourcing makes business sense for the insurer. It does not mean that the cost of outsourcing always has to be less than it would have cost the insurer had they done it themselves. The insurer cannot be told how to run its business in every respect nor what infrastructure and staff should be in-house rather than outsourced, save for core functions. It does mean that the cost of the outsourcing must be market-related and at least create greater efficiencies than if the insurer did it themselves or if better expertise can be obtained by outsourcing.

Interaction with the FSCA mostly relates to the remuneration paid for outsourcing, particularly to intermediaries. Not only must the remuneration be reasonable and commensurate with the function or activity outsourced but it must not result in paying remuneration for which commission or binder fees are already being paid. If it is an intermediary service it should be outsourced as an intermediary service subject to the commission regulations. If it is a binder function that is the place for it.

These discussions are difficult and nuanced. For instance a binder holder may as an ancillary part of their functions issue policies. But if a broker who is not a binder holder issues policies that is not an intermediary service but a service that the insurer would otherwise perform itself, carrying costs and risks which need to be compensated, including a reasonable margin for doing the work. There are no formulas for when remuneration for an activity is being duplicated and the discussions are always based on the particular facts. All of these aspects have to be dealt with in the insurer's outsourcing policy under the auspices of the board of the insurer. The outsourcing policy and the functions and activities outsourced and the outsourced services providers must be regularly assessed and outsourcing improved or terminated where necessary.

Outsourcing is a necessary part of financial services and the way in which the insurance industry operates with considerable expertise and input from intermediaries and other service providers which is of importance in treating customers fairly.

Patrick Bracher
Norton Rose Fulbright South Africa