



**REVIEW OF  
THIRD-PARTY CELL CAPTIVE  
INSURANCE AND SIMILAR  
ARRANGEMENTS**

**DISCUSSION PAPER**

**11 June 2013**

## EXECUTIVE SUMMARY

This discussion paper explores how the existing regulatory framework may be enhanced to best achieve the objectives of insurance supervision (i.e. to promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders) in respect of cell and similar arrangements, while supporting broader national policies on financial inclusion.

This discussion paper:

- summarises the main findings of an assessment conducted in 2012 to review existing arrangements;
- evaluates the risks (to both financial soundness and fair conduct of business) for insurers, policyholders and effective supervision that may arise from such structures and business models; and
- provides the FSB's regulatory policy proposals with respect to third-party cell captive insurance and similar arrangements.

### *Key proposals:*

- Cell captive insurance will need to be conducted under a dedicated insurance licence, and may not be combined with other forms of insurance business.
- "Similar arrangements" will no longer be permitted. Existing similar arrangements must be converted to third-party cell captive insurance arrangements in a dedicated licence.
- Third-party cell captive insurance arrangements may only be entered into with a binder holder. The binder holder must either be an underwriting manager or alternatively a non-mandated intermediary in terms of an approved affinity scheme.
- The Registrar will consider on a case by case basis whether an arrangement qualifies as an affinity scheme for the purposes of being a cell owner.
- For an arrangement to qualify as an affinity scheme for the purposes of being a cell owner, the following criteria must be met:
  - An existing client/member relationship outside of the insurance relationship must be in place, and the nature of the relationship must be such that the risk cover is primarily provided to protect the reputation and brand of the primary business activity of the cell owner; and

- The customer must be under no misapprehension that they are receiving independent advice, and consequently the intermediary forming part of a qualifying affinity scheme must act in the capacity as a tied agent of the cell captive insurer.
- Enhanced regulatory requirements will be put in place for third-party cell captive insurers with respect to:
  - Adequate governance and risk management, including prescribed provisions in “shareholder” / cell agreements;
  - Financial soundness of individual cells (including a minimal capital requirement of R1 million) as well as the cell captive insurer;
  - Market conduct, including enhanced disclosure and restrictions on “white-labeling”; and
  - Reporting to the regulator on each cell arrangement.
- Prior approval from the Registrar will be required for all cell arrangements entered into with affinity schemes.
- Prior notification to the Registrar will be required for all other cell arrangements.
- Ongoing monitoring of “shareholder” / cell agreements will be undertaken by the Registrar, to ensure compliance with all regulatory requirements.
- Existing licensing conditions will be amended to give effect to the proposals in this part and to ensure that the same standard registration conditions apply in respect of third-party cell captive insurers that follow similar business models.

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# 1. INTRODUCTION

The Financial Services Board (FSB) has become increasingly concerned that certain aspects of third-party cell captive insurance business models, as well as business models that approach third-party cell captive arrangements in nature (similar arrangements), create risks for insurers, policyholders and effective supervision.

This discussion paper explores how the regulatory framework for third-party cell captive insurance (and similar arrangements) may be strengthened to best achieve the objectives of insurance supervision, namely promoting the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders, while supporting broader national policies on competition and financial inclusion (i.e. facilitating access to insurance and avoiding inappropriate barriers to entry into the insurance market).

## 1.1 Background

### 1.1.1 *The South African landscape*

The South African insurance sector is unusual in the extent of the cell captive insurance business that is conducted. While there are a number of jurisdictions around the world with regulatory frameworks that cater for cell captive insurance business, this appears to be mainly limited to first-party cell captive business<sup>1</sup>.

In South Africa, 7 long-term insurers and 11 short-term insurers have been registered to conduct cell captive insurance business (both first-party and third-party). Data collected by the FSB indicates that at least 130 active short-term insurance third-party cell arrangements currently exist, together with an estimated 50 or so long-term insurance third-party cell arrangements.

Under the existing regulatory framework, cell arrangements are regulated through pre-registration requirements and conditions of registration and limited reporting requirements imposed under the Long-term Insurance Act No. 53 of 1998 (LTI Act) and Short-term Insurance Act No. 52 of 1998 (STI Act), respectively, and indirectly regulated by the provisions of the Companies Act No. 71 of 2008 relating to shareholding. The conditions of registration have evolved over time as new registrations took place and existing registrations were varied.

In a number of jurisdictions internationally the conduct of cell captive business is governed by Protected Cell Company (PCC) legislation. PCCs were originally developed in Guernsey in 1997, and now exist in other territories such as Jersey, Cayman Islands, Irish Republic, Bermuda, various U.S. locations, and other domiciles around the globe. A PCC is its own legal entity which is a trait it shares with a traditional insurance company. However, unlike a traditional insurance company the structure of a PCC is subdivided into the core, which contains the capital for the whole of the entity, and individual cells, which have the option to be capitalized individually and separate

<sup>1</sup> An arrangement under which the cell owner insures its own risks in the cell.

from the core or use the core funds to meet its capitalisation requirements. The assets of each individual cell are statutorily segregated to ensure that a claim against one cell cannot be covered by the assets of another cell.

By contrast, in South Africa cell captive arrangements are governed by contractual arrangements. The contractual arrangements with cell owners provide for separation of funds and limitation on cross-subsidisation between cells. Despite these contractual arrangements, there is no legal ring-fencing of funds in the case of liquidation, as the current insurance legislative framework regards all the assets and liabilities of third-party cells as part of the assets and liabilities of the insurer.

### **1.1.2    Process of regulatory review**

In 2009<sup>2</sup>, the Registrar requested information from insurers on first and third-party cell arrangements, and similar arrangements, to –

- assess the prevailing situation regarding the interpretation and application of conditions of registration for cell arrangements;
- assess similar arrangements that have outcomes that are comparable to cell arrangements;
- identify conditions that could inform the capital adequacy requirements for cell arrangements; and
- inform regulatory reviews that were underway at that time, which included draft regulations on binder arrangements and capital requirements for cell arrangements.

The information secured in 2009 *inter alia* highlighted that:

- different standard registration conditions apply in respect of different third-party cell captive insurers, despite the fact that these insurers conduct the same classes of insurance and follow similar business models; and
- registration conditions may not be fully effective in addressing the conflicts of interest inherent in third-party cell arrangements in cases where the cell is issued to an intermediary<sup>3</sup> or related party of an intermediary.

In 2011<sup>4</sup>, the Registrar, in light of the then imminent promulgation of the binder regulations<sup>5</sup>, progress made with the development of the new Solvency Assessment and Management (SAM) regime and to further address concerns highlighted by the information secured in 2009 in respect of conditions of registration, deemed it

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<sup>2</sup> Information Letter 3/2009 – Request for information on cell arrangements and similar arrangements.

<sup>3</sup> For purposes of this discussion document, “intermediary” refers to “independent intermediary” as defined in section 1 of the STI Act and to “independent intermediary” as defined in Part 3 of the Regulations made under the LTI Act.

<sup>4</sup> Information Letter 2/2011 - Legislative and other developments affecting third-party cell captive arrangements.

<sup>5</sup> Part 6 of the Regulations made under the STI Act and Part 6 of the Regulations made under the LTI Act, respectively.

appropriate to undertake a detailed assessment of third-party cell captive arrangements and similar arrangements. The detailed assessment was undertaken during the course of 2012, as outlined below.

## 1.2 Purpose and Scope

### 1.2.1 Purpose

The objective of the detailed assessment conducted in 2012 was to inform the Registrar's understanding of –

- the existing ownership structures and business models of third-party cell captive arrangements (including affinity cell captive arrangements) and arrangements that have the same effect as a third-party cell captive arrangement;
- the financial soundness and market conduct risks that may arise from such structures and business models;
- in particular, the conflicts or potential conflicts that may arise from these ownership structures and arrangements;
- if and how these risks and conflicts or potential conflicts may be managed or mitigated; and
- which structures, arrangements or activities result in such a significant conflict or potential conflict, or risk of unfair practice, that they should be prohibited.

The assessment was undertaken in consultation with third-party cell captive insurers and insurers that enter into similar arrangements, as well as industry associations, and was concluded at the end of September 2012.

This discussion document summarises the main findings of the assessment and provides the FSB's regulatory policy proposals with respect to third-party cell captive insurance and similar arrangements.

### 1.2.2 Context and scope

In making these proposals, consideration was given to other regulatory framework reform processes underway such as –

- the Solvency Assessment and Management (SAM) project;
- market conduct regulatory reform initiatives that will introduce an outcomes-based approach to treating customers fairly (TCF);
- the micro-insurance policy statement;
- binder regulations; and
- the retail distribution review (RDR) focusing on remuneration practices.

There are certain common principles that inform many of these regulatory reforms:

- *Accountability of the insurer*: The insurer, as the licensed entity, remains responsible for complying with all statutory requirements, irrespective of the fact that the insurer outsources some of its functions, or provides underwriting capacity, to third parties;
- *Responsible outsourcing*: The insurer must ensure, where it outsources functions to a third party (such as binder functions), that the contractual arrangements, and oversight and management of the contractual arrangements, facilitate and do not impede the insurer's compliance with the statutory requirements and the fair treatment of policyholders;
- *Policyholder protection*: Policyholder interests and the fair treatment of policyholders may not be prejudiced by the business model of the insurer – including the outsourcing of certain underwriting functions by the insurer, or the entering into of cell captive or similar arrangements; and
- *Avoidance of conflicts of interest*: Any potential conflicts of interest that may arise where functions are outsourced to an intermediary (who has a primary duty to the policyholder) must be avoided.

As such, a common theme of current regulatory reforms in the insurance sector is to strengthen good governance and risk management by the insurer, thereby managing solvency risks and facilitating fair treatment of customers.

From a market conduct perspective, the FAIS Code of Conduct<sup>6</sup> was expanded in April 2010 to enhance the management of conflicts of interest provisions of the Code by –

- defining what constitutes a conflict of interest;
- requiring a conflict of interest management policy to be in place;
- increasing disclosure requirements; and
- imposing certain prohibitions and limitations in respect of financial interests that may be received or paid by or to financial services providers.

The binder regulations build on this in that the regulations provide that where an intermediary performs a binder function on behalf of an insurer ((i.e. certain underwriting functions are outsourced to an intermediary), the binder agreement must contain certain provisions that are designed to address the potential conflicts of interest inherent in the intermediary simultaneously acting as an agent of the insurer and an agent of the policyholder. These include a prohibition on certain activities and a ban on profit sharing arrangements in relation to the binder function.

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<sup>6</sup> The General Code of Conduct for Authorised Financial Services Providers and Representatives as published in Board Notice No. 80 of 2003, and amended from time to time, under section 15 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002)

Third-party cell captive arrangements and similar arrangements are generally designed as a means of sharing profits arising from underwriting activities – as such, the principle of avoidance of conflicts of interest by intermediaries must be similarly observed. It is also recognised that there are broader ownership structures that may give rise to conflicts of interest. As regulatory provisions around third-party cell captive insurers are tightened, there is the risk that intermediaries may attempt to derive additional profits through cross-ownership provisions. For these reasons, a review of broader ownership structures has been identified as a topic for future regulatory review by the FSB, with particular focus on potential conflicts of interest.

This discussion paper is limited to third-party cell captive insurance and similar arrangements. The paper does not address first-party cell captive arrangements, as the risks in terms of solvency and fair treatment of customers are generally regarded to be lower, but that said there may be certain proposals contained in this discussion paper (such as those related to governance, risk management and solvency calculations) that could be equally applied to the regulation of first-party cell captive arrangements.

## 2. ASSESSMENT OF CURRENT ARRANGEMENTS

### 2.1 Business models

#### 2.1.1 *Cell Captive Arrangements*

In this business model a cell owner holds a specific type of shares in an insurer (the shareholding) and performs certain functions on behalf of the insurer in respect of specific insurance products underwritten by the insurer (the business). Put differently the cell owner has a shareholding relationship and a business relationship with the insurer. The shareholding and business relationship are inextricably linked.

*Shareholding:*

The detailed assessment conducted in 2012 (the assessment) indicated that specific types of ordinary shares or preference shares are issued by insurers to cell owners in respect of cell arrangements. The voting rights that attach to these shares tend to vary. In certain types of preference shares, voting rights attach only when dividends are in arrears. In most cases the shareholding of a particular cell owner represents a very small percentage of the total shareholding of the insurer, negating any potential control being exercised over the total business of the insurer in the event that these voting rights are exercised.

*The business:*

The business is managed by the cell owner in a ring-fenced manner on behalf of the insurer. The assessment revealed that the exact activities performed by the cell owner in relation to the business can vary. In some of the more traditional models, the cell owner tends to perform certain outsourced functions, including binder functions (i.e. has the authority to underwrite business) on behalf of the insurer. In other cases, the cell owner's functions are limited to intermediary services (i.e. the cell owner does not perform the underwriting on behalf of the insurer, but simply acts as an intermediary in facilitating the business being underwritten by the cell captive insurer).

The legal, financial and operational relationships between the insurer and cell owner are usually explained in a “shareholders agreement” (although, legally speaking, this agreement cannot be classified as, nor treated as, a traditional shareholders agreement as it addresses the operational aspects of the business relationship in addition to the shareholding), save where the binder regulations require a separate agreement if the business constitutes the rendering of binder functions on behalf of the insurer. The detailed assessment conducted in 2012 revealed that the “shareholder agreements” are in a number of instances vague and not detailed.

#### 2.1.2 *Similar arrangements*

In this business model an entity holds a specific type of shares in the direct or indirect holding company of an insurer (the shareholding) and performs certain functions on



behalf of the insurer in respect of specific insurance products underwritten by the insurer (the business).

*Shareholding:*

Generally, a specific type of preference share is held by the shareholder in the direct or indirect holding company of the insurer. These preference shares tend to have no voting rights.

*The business:*

The business intention is essentially the same as a cell captive arrangement: the business is managed by the shareholder in a ring-fenced manner on behalf of the insurer. The business can constitute an outsourced function (including a binder function) or intermediary services.

Generally, a shareholder agreement regulates the shareholding relationship between the entity and the holding company and another agreement regulates the business relationship between the insurer and the entity.

The detailed assessment conducted in 2012 revealed that these “shareholder agreements” are likewise in a number of instances vague and not detailed.

## **2.2 Insurers**

As discussed in Chapter 1, a number of insurers conduct third-party cell captive insurance business or similar arrangements. However, there is a difference in the extent to which cell or similar arrangements are the focus of the various insurers. There are a relatively small number of insurers with a dedicated focus on cell arrangement (such as Guardrisk and Centriq) or similar arrangements (such as Hollard). There are a number of other insurers that combine cell captive insurance or similar arrangements with traditional insurance business in the same entity. For some insurers, offering a cell captive arrangement is simply a defense mechanism designed to retain clients where the business partner insists on some form of share participation (share of profit and losses).

Most insurers that have third-party cell captive arrangements also have first-party cell captive arrangements.

It was worrying to note that the assessment revealed that there are some (pure) captive insurers that are also conducting third-party business. For example, one captive insurer has third-party cell arrangements in place with subsidiaries of its sole shareholder. The captive insurer underwrites the risks of customers of the sole shareholder of the captive insurer, while the subsidiary conducts outsourced functions (including binder functions) or intermediary services on behalf of the captive insurer.

## 2.3 Shareholders / Cell owners

Cell owners and shareholders in similar arrangements appear to be diverse and include the following:

- Underwriting managers;
- Intermediaries linked to affinity schemes;
- Intermediaries not linked to affinity schemes;
- Other insurers;
- Pension funds; and
- Other companies.

Conditions of registration in certain instances dictate with whom third-party cell arrangements may be entered into.

Most cases where the cell owner is an intermediary relate to affinity scheme business<sup>7</sup>. However, it was worrying to note that the assessment identified some cases where the cell owner is an intermediary not linked to an affinity scheme. This is of serious concern from a supervisory perspective because of the significant potential for conflicts of interest that arise between the intermediary's general duty to act in the bests interests of the client and the financial incentives that the shareholding in the cell present.

It was also worrying to note that the assessment revealed a case where an insurer was a first-party cell owner in a cell captive insurer for the purposes of reinsuring its third party business. This is a loose interpretation of the requirement that an insurer may only insure its own (operational) risks through a first-party cell.

Lastly, the assessment revealed that other entities, such as pension funds and even corporates, were in some cases also cell owners. It appears that in these cases the cell arrangement is being utilised in a way akin to a “cash-back bonus”, with profits shared in the event of a low claims ratio, as opposed to a means of sharing profit on outsourced underwriting functions.

## 2.4 Liability of insurer versus shareholder / cell owner

Typically, the cell owner will become liable to make good losses incurred in the cell (i.e. typically no claims limitation<sup>8</sup> is provided for). The shareholder agreement normally makes provision that the cell captive insurer will determine whether to call for a

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<sup>7</sup> Affinity schemes are defined for the purposes of this discussion paper as insurance business that is ancillary to the product/service/membership provided by the cell owner in its capacity as a non-insurer enterprise.

<sup>8</sup> Claims limitation refers to where policyholder claims are limited to the available capital within the third-party cell.

recapitalisation. If the cell captive insurer does deem it necessary and calls for a recapitalisation, the cell owner has to respond within a specified period of time (normally not more than a month). If the cell captive insurer advances funds to the cell owner to recapitalise the cell, a penalty fee is usually applied (see below). In some cases, the cell captive insurer may decide to stand in for any shortfall in the solvency of the cell, but this is usually only the case where the business is profitable and it is expected that the cell will be solvent again within a short period of time.

In all instances cross subsidisation between cell arrangements are limited through contractual arrangements. However, no such limitations are legally enforceable should the losses in one cell arrangement exceed the capital available in respect of the cell arrangement and the capital of the insurer that is not linked to cell arrangements. Where the losses exceed the capital available in respect of the cell arrangement, the capital available in respect of other arrangements is at risk.

*Similar arrangements:*

With respect to similar arrangements, in all instances the insurer is liable for losses incurred in respect of its business.

## 2.5 Capitalisation

The assessment revealed that in most cases the cell owner pays up-front for the shareholding, which funds are then ring-fenced as capital in respect of the business. However, it appears that in not all instances is the capitalisation amount required calculated by applying the financial soundness requirements of the LTI Act or STI Act to the business to be conducted in the cell arrangement. At the extreme, the assessment revealed that there are cases in which the little or no up-front capitalisation is required and the cell promoter's capital is advanced to start up the cell arrangement (sometimes referred to as a “rent-a-cell” arrangement).

The assessment also revealed that different methods of recapitalisation are utilised in the event that the business in the cell arrangement incurs losses. In some instances additional cash must be injected or additional shareholding has to be purchased. In other instances the insurer provides or advances funds against payment of a fee (the penalty fee usually relates to the required rate of return plus a risk factor as agreed between the insurer and the cell owner). In certain instances no recapitalisation is required; losses incurred are carried forward to future financial years and set off against future profits.

*Similar arrangements:*

A major distinction between similar arrangements and cell captive arrangements is that similar arrangements do not generally provide for “capitalisation” of the ring-fenced business – i.e. there is generally no up-front payment for the shareholding in the direct or indirect holding company of the insurer. The shareholder therefore provides no additional capital buffer against losses in the business.

Similar arrangements also do not cater for recapitalisation. Generally, losses incurred in the insurer are not carried forward to future financial years and set-off against future

profits that the shareholder may become entitled to by virtue of its shareholding in the direct or indirect holding company of the insurer.

In most instances the insurer capitalises and recapitalises the business that the shareholder conducts on behalf of the insurer. In limited instances a percentage of the profits attributable to the business is retained in the insurer to meet its regulatory requirements or strengthen the sustainability of such business.

## 2.6 Governance

The assessment pointed to concerns that there is a wide range of practice in the level of governance exercised by insurers with respect to cell captive arrangements or similar arrangements. In many cases, no or limited governance requirements are imposed on the cell owner by the cell captive insurer. However, the assessment did reveal some examples of better oversight and governance arrangements. In one example, a management board with equal representation from the insurer and the cell owner manages the cell arrangement.

In all instances insurers indicated that cell owners (or shareholders in respect of similar arrangements) are responsible for compliance with legislation, despite the fact that services rendered are performed on behalf of the insurers.

In limited instances insurers assist cell owners to comply with legislation by making self-assessment tools available to the cell owners.

## 3. RISKS IDENTIFIED

### 3.1 Risks relating to insurers

From the analysis, the following risks were identified in respect of the characteristics of the existing business models for third-party cell captive insurance and similar arrangements:

#### 3.1.1 *Contractual and exit strategy risk*

The “shareholder agreements” are vague and lack detail.

It appears that insurers may in a number of instances not be able to enforce the “shareholder agreements” with the cell owners or shareholders.

Furthermore, the “shareholder agreements” often do not adequately provide for the circumstances under which, and the consequences of, a change in shareholding in the cell owner or the sale of shares held by the cell owner in the insurer or holding company. This risk is further increased by the inextricable link between the shareholding and the business relationship.

#### 3.1.2 *Operational risk*

The operational risks of an insurer will increase if certain functions (including underwriting) are outsourced to a third party without adequate oversight and controls in place. Insurers should ensure that cell owners or partners in similar arrangements have adequate processes, people and systems in place to manage the business.

The assessment revealed a wide spectrum in the quality of oversight and controls by insurers with respect to cell arrangements and similar arrangements. Operational risk tends to further increase in circumstances where cell captive insurance is not a focus area of the insurer (i.e. the insurer enters into cell captive arrangements in addition to traditional insurance business), given the lower level of expertise and attention applied.

#### 3.1.3 *Insurance risk*

Insurance risk is defined as risk arising from the potential for claims or payouts to be made to policyholders or beneficiaries. Exposure to this risk results from adverse events occurring under specified perils and conditions covered by the terms of an insurance policy. Insurance risk includes uncertainties around:

- The ultimate amount of net cash flows from premiums, commissions, claims, payouts, and related settlement expenses;
- The timing of the receipt and payment of these cash flows; and
- Policyholder behavior (e.g. lapses).

The assessment revealed that in many cases the existing business models employed do not facilitate adequate access by the insurer to the policyholder data and systems of the cell owner or shareholder in order to inform an effective assessment of the insurance risks associated with the business.

### **3.1.4 Credit risk**

In the event of losses being incurred as a result of the business conducted by cell owners the insurer either has to absorb/fund the losses or rely on the cell owner to recapitalise the business.

The insurer is thus exposed to credit risk associated with the cell owner's failure to meet contractual obligations or the deterioration of the creditworthiness of the cell owner.

### **3.1.5 Reputational & market conduct risk**

Insurers have a responsibility to ensure that their products and insurance business are in accordance with legislation and that they can demonstrate that they deliver on fair outcomes for customers.

It is of concern that many insurers expressed the view that cell owners and partners in similar arrangements are primarily responsible for compliance with legislation, despite the fact that the services rendered are performed on behalf of an insurer. Compliance requirements and treating customers fairly principles encompass not only the behaviour of the insurer, but also the conduct of those that act on behalf of the insurer.

It therefore appears that many insurers are not adequately ensuring that –

- cell owners meet fit and proper requirements, consistent with those applicable to the insurer;
- the conduct of cell owners or partners in similar arrangements are consistent with the overall standards of the insurer or the stated practices (ethical or otherwise) of the insurer, due to the ring-fenced manner in which the business is conducted and managed due to a lack of adequate governance and oversight;
- cell owners or partners in similar arrangements comply with applicable legislation and have adequate compliance systems and controls in place; and
- fair outcomes for customers are entrenched in the business models of cell owners and partners in similar arrangements.

The above risks are further increased by insurers effectively allowing the “white labelling” of their insurance products.

## 3.2 Risks relating to policyholders

### 3.2.1 Risks to fair conduct of business

The fact that many insurers are not taking sufficient responsibility for, and exercising adequate control over, compliance and fair treatment of customers by cell owners and partners in similar arrangements (see section 3.1.5) presents risks to appropriate policyholder protection. This will, over time, impact on confidence in the insurance sector and trust among current and potential policyholders.

### 3.2.2 Conflicts of interest

The ownership structures and business models inherent in third-party cell captive and similar arrangements can give rise to significant conflicts of interest<sup>9</sup>, depending on who the cell owner/shareholder is.

Where the cell owner is an underwriting manager<sup>10</sup> no conflicts of interest arise as the underwriting manager acts solely as an agent of the insurer, may not sell or market directly to policyholders and is already entitled to a profit share in terms of the business conducted through a binder agreement.

Where the cell owner is an intermediary, the profit share motive inherent in a cell arrangement or similar arrangement gives rise to serious conflicts of interest given that this may bias the advice and sales of the intermediary in a way that is at odds with the intermediary's primary duty to act in the best interests of his/her client in terms of the Financial Advisory and Intermediary Services Act (specifically the General Code of Conduct for Authorised Financial Services Providers and Representatives). This is especially the case where the intermediary is meant to be providing independent advice to the client.

These conflicts of interest may be difficult to mitigate. It appears that these conflicts of interest are not always adequately disclosed, despite the requirements of the FAIS General Code. It is also not clear that such disclosure will be sufficient in adequately mitigating the conflicts of interest, particularly given the level of information asymmetry present and the financial literacy of the average policyholder.

#### *Affinity schemes:*

Most instances of where the cell owner or partner in a similar arrangement is an intermediary are related to affinity schemes.

<sup>9</sup> For purposes of this discussion document “conflict of interest” has the meaning as defined in section 1 of the General Code of Conduct for Authorised Financial Services Providers and Representatives published in Board Notice No. 80 of 2003 under section 15 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002).

<sup>10</sup> As defined in regulation 1 of Part 6 of the Regulations made under the LTI Act, as published in GN R1492 of 1998 and amended by GN R197 of 2000, GN R164 of 2002, GN R1209 of 2003, GNR.1218 of 2006, GN R186 of 2007 and GN R952 of 2008GN R1493 of 1998, and substituted by GN R1077 of 2011, and Part 6 of the Regulations made under the STI Act, as published in GN R1493 of 1998 and amended by GN R462 of 2008 and substituted by GN R1076 of 2011.

It has been argued that affinity scheme arrangements can be positive for policyholder protection for the following reasons:

- The cell owner/shareholder has the reputation of the primary business (underlying primary product) to protect, and hence will ensure that policyholders are treated fairly;
- Affinity schemes can allow for cost-effective and convenient delivery of the insurance product to the customer, hence supporting financial inclusion; and
- Greater innovation in product design, costing and distribution.

However, for these benefits to be realised, it is argued that the following conditions need to be in place:

- There should be a clear and direct relationship between the sale of the insurance and the protection of the underlying brand; and
- There should not be a reasonable expectation in the customer's mind that they are being provided with independent advice in the purchase of the insurance, as in fact the advice and sale by the intermediary will be clearly directed towards a particular insurance product.

### ***3.2.3 Risks to ability to pay claims***

In respect of third-party cell captive insurers, the risk to policyholders clearly increases if the cell owner may be at risk of not having the capital necessary to recapitalise the cell in respect of losses, or is not adequately managing underwriting risks. Accordingly, it is important that there are clear capital requirements and risk management requirements that apply at both the level of the cell owner and the cell captive insurer.

## **3.3 Risks relating to regulation and supervision**

### ***3.3.1 Conditions of registration***

The assessment *inter alia* highlighted that different standard registration conditions apply in respect of different third-party cell captive insurers, despite the fact that these insurers conduct the same classes of insurance business and follow similar business models. This is clearly not consistent with creating a level playing field and regulatory certainty.

The assessment also revealed that some insurers were conducting third-party cell captive insurance despite this being at odds with their primary business (such as captive insurers that have third-party cell arrangements) or not a primary focus of the business (such as traditional insurers engaged in cell captive arrangements as a defensive model).

### 3.3.2 *Supervisory oversight*

The supervisor expects that the Board and senior management of an insurer to be accountable for oversight of the business of the insurer, whether managed internally or outsourced. However, the supervisor also requires adequate reporting on, and access to, the business of the insurer to be able to evaluate the effectiveness of the governance and risk management of the insurance business by the Board and senior management.

Key concerns in this regard include:

- There is currently no regular reporting to the regulator on the number and type of third-party cell captive arrangements and similar arrangements in place;
- Similar arrangements lack transparency and are not subject to the same level of regulatory safeguards proposed for cell captive arrangements;
- The co-mingling of cell captive insurance business with other business (such as captive business or traditional insurance business) hampers the meaningful comparison of similar businesses by the supervisor;
- The governance, risk management and internal control requirements for cell captive arrangements are not sufficiently clear, which hampers effective assessment by the supervisor; and
- There is a current proliferation of third-party cell captive arrangements and similar arrangements. This not only presents challenges from a supervisory oversight perspective, but there are also concerns about the ability of insurers to practice adequate oversight over these arrangements. It is not clear that all of these arrangements are currently consistent with fair outcomes for customers, nor whether the risk pools in the various cells are sufficiently large and diversified enough to reduce the volatility of underwriting results.

## 4. PROPOSALS

### 4.1 Who may conduct third-party cell captive insurance?

In order to support adequate reporting and effective supervision, it is proposed that all cell captive insurance (both first-party and third-party cell arrangements) will need to be conducted under a dedicated insurance licence. In other words, cell captive insurance business will only be able to be conducted through a licensed cell captive insurer and may not be combined with other forms of insurance business (such as captive business or traditional insurance business). Insurers currently conducting cell captive insurance business in addition to other forms of insurance business will need to apply for a separate licence under which the cell captive insurance will be conducted.

Licence conditions of cell captive insurers will be aligned to ensure consistency.

### 4.2 How should similar arrangements be treated?

Similar arrangements will no longer be permitted. In order to achieve improved transparency, consistent application of regulatory requirements and ease of supervision, all existing similar arrangements must be converted to third-party cell captive arrangements (subject to meeting the proposals as set out in this part).

### 4.3 Who may be a cell owner?

Third-party cell arrangements may only be entered into with a binder holder. This is consistent with the concept that cells are arrangements designed to share in the profit and losses arising from insurance business. A cell owner must have a material interest and role to play in the underwriting performance of the business conducted in terms of the cell arrangement.

A cell arrangement is not considered to be an appropriate mechanism for the sharing of profits with parties whose functions, or contribution to the business, do not relate to outsourced underwriting functions. For example, remuneration for access to retail space or use of an affinity brand should not be in the form of dividends arising from a cell captive arrangement in cases where the third party plays no part in the underwriting decisions that form part of binder functions.

Consistent with the need to minimise conflicts of interest, the following types of binder holders (as defined in the Binder Regulations) may be a cell owner:

- An underwriting manager; or
- A non-mandated intermediary in terms of an approved affinity scheme (subject to the conditions outlined below).

Third-party cells may not be owned by intermediaries outside of an affinity scheme arrangement. The profit share incentive of a third-party cell arrangement is not consistent with the duty of independent advice that the intermediary owes to the client. This approach is also consistent with the prohibition on profit share arrangements in any binder agreement entered into with a non-mandated intermediary.

Insurers may only be cell owners to the extent that they are insuring their own (operational) risks. A cell may not be used to reinsure third-party risks.

#### **4.4 What will qualify as an affinity scheme?**

The Registrar will consider on a case by case basis (see section 4.6 below) whether an arrangement qualifies as an affinity scheme for the purposes of being a cell owner. To be approved as a qualifying affinity scheme, the following key criteria will be considered by the Registrar:

- Insurance business is ancillary to the primary business activity of the cell owner, where:
  - “primary business activity of the cell owner” means the product / service / membership provided by the cell owner in its capacity as a non-insurer enterprise; and
  - “ancillary to the primary business activity of the cell owner” means insurance risk cover that is placed in the cell is directly connected to the product / service / membership provided by the cell owner in its capacity as a non-insurer enterprise.
- An existing client/member relationship outside of the insurance relationship must be in place, and the nature of the relationship is such that the risk cover is primarily provided to protect the reputation and brand of the primary business activity of the cell owner. (As such, an affinity scheme will not be deemed to be in place in cases where the cell owner cannot demonstrate that there is an established underlying brand or member bond with substantial value; for example, an association of independent motor dealers will not qualify as an affinity scheme).
- The customer must be under no misapprehension as to the cell owner’s interest in the insurance product and the sale. Consequently, to avoid doubt, the intermediary forming part of a qualifying affinity scheme must act in the capacity as a tied agent of the cell captive insurer. The exact nature of the relationship with the insurer and the remuneration arrangements in place must be disclosed (see section 4.5.4 below), and there should be no risk that an illusion of independence of advice is created.

As discussed in section 4.3 above, the non-mandated intermediary that forms part of an affinity scheme must be a binder holder, subject to the restrictions which apply to a

binder holder with limited authority (such as the prohibition on rejecting claims on the insurer's behalf).

## 4.5 What are the responsibilities of third-party cell captive insurers?

It is proposed that the following responsibilities be made clear in the licensing conditions and regulatory requirements that apply to third-party cell captive insurers:

### 4.5.1 Governance

- Insurers are accountable for the financial soundness of each third-party cell arrangement that they put in place and the market conduct of cell owners.
- Insurers will be required to put in place appropriate control and oversight measures to ensure the financial soundness of cell arrangements and appropriate market conduct by cell owners. Further guidance on good practice in this regard will be published by the regulator.
- Insurers will be required to assess the fit and properness of cell owners prior to entering into a third-party cell arrangement.
- Insurers will be required to enter into written “shareholder” / cell agreements with cell owners, which agreements must, in precise terms, regulate the shareholder and business relationship with the cell owner. The agreements must give effect to the requirements set out in this part. Minimum requirements in respect of matters that must be addressed or may not be provided for in these agreements will be prescribed.

### 4.5.2 Risk management

- Insurers will be required to provide for effective risk mitigation procedures, including requiring adequate governance and risk management arrangements within the cell owner. The insurer will have to require appropriate information and data management in the cell arrangement. Further guidance on good practice in this regard will be published by the regulator.
- Insurers will be required to assess the credit worthiness of the cell owner prior to entering into the cell arrangement and to provide for appropriate and proportional risk sharing.
- The investment strategy and investment mandate in respect of assets backing each cell will have to be approved by the insurer and be consistent with the regulatory framework (such as the outsourcing directive). Investments in the cell owner or a related party of the cell owner will be prohibited.
- Reinsurance arrangements and the management thereof will be the sole responsibility of the insurer. Furthermore, “pay as paid” rules in respect of reinsurance arrangements will be prohibited.

- The insurer will have to require the cell owner to regularly report to the insurer on the insurance business conducted through the cell arrangement.

#### **4.5.3 Financial soundness**

- A minimum capital requirement (MCR), as prescribed, will apply to each cell. It is proposed that an absolute MCR of R1 million will apply.
- In terms of the solvency capital requirement (SCR), cell captive insurers will be required to calculate an SCR for each cell. They will however not *necessarily* be required to hold capital equal to the total SCR for each cell. The total SCR for the insurer may recognise diversification benefits between cells. This diversification will however be limited to the extent that capital is available at the insurer level (i.e. in the promoter cell). This treatment from a capital perspective recognises that the surplus assets in a cell are effectively regarded as “encumbered” (i.e. they are not under normal conditions available to meet losses in other cells in the insurer). This is effectively the approach which was tested in SA QIS2 (Approach B). It is however worth noting that, from an SCR perspective, further consideration is being given to whether or not the fact that the cell provider may call on the cell owner to provide capital in stressed conditions should be recognised or not, and if so, how it should appropriately be recognised.
- In terms of the capital required for new cells, over-and-above the MCR, the cell owner will have to provide capital sufficient to ensure that the insurer as a whole maintains its SCR. In the case of no capital being available at the promoter cell level, this will mean that the cell owner will be required to provide capital equal to at least the full SCR for the cell. In the case where capital is available at the promoter level, the insurer may reduce the capital required by the owner by the allocation of an appropriate diversification benefit (as per the above point).
- Limitations will be placed on the extent to which the cell captive insurer can act as a financier of the cell arrangement. Rent-a-captive arrangements will be prohibited. The cell owner must have sufficient capital at risk to align incentives.
- Provisions that limit policyholder liabilities arising from the insurance business conducted through cell arrangements to the capital or profits available in respect of a specific cell arrangement (claims limitation) will be prohibited.
- The shareholder agreement must be explicit about the risk sharing arrangements between the insurer and the cell owner – specifically under what circumstances recapitalisation by the cell owner will be required in the event that the regulatory capital requirement determined by the insurer (subject to the MCR) is not being met, as well as the extent to which the insurer may provide financial support to the cell owner (and the conditions that apply). The insurer will be required to undertake a credit risk assessment of the cell owner – specifically the risk that the cell owner will not be in a position to recapitalise the cell if the need arises.

- The extent to which a cell owner is made liable, as per the above point, for losses in severely distressed conditions should be clearly prescribed and subject to defined limits. Shareholder agreements should thus reflect this amount specifically – i.e. the amount up to which the cell owner is liable.
- Promoter support to a cell should be subject to prior approval of the supervisor and the extent of such support should be explicitly reported on in the statutory returns.

#### **4.5.4 Market conduct**

- Insurers will be required to put in place appropriate control and oversight measures with respect to the market conduct by cell owners, designed to ensure fair outcomes for customers throughout the product life-cycle. Further guidance on good practice in this regard will be published by the regulator as part of implementation of the TCF regime. Additional market conduct requirements may be imposed in respect of cell captive arrangements subsequent to the finalisation of the FSB's retail distribution review (RDR) and the joint National Treasury/FSB/NCR consumer credit insurance review.
- Specific requirements in respect of the “white labelling” of products will be prescribed, to make it clear to the customer which insurer is ultimately on risk. The name of the insurer will need to be prominently disclosed in all marketing material and policy documents. The insurer details must be given for all queries, complaints and other recourse.
- In respect of affinity schemes, the exact nature of the relationship between the cell owner and the insurer, and between the cell owner and the intermediary (if not the same party) must be disclosed, as well as the remuneration arrangements (including profit share). Disclosure should be such that there is no risk that an illusion of independence of advice is created.
- Writing of first-party business and third-party business within the same cell will be prohibited.

#### **4.5.5 Reporting**

Reporting requirements in respect of each cell arrangement will be provided for. Some information will be required to be reported in the statutory returns of insurers; other information will be collected by the regulator by means of *ad hoc* information requests or as part of the regulator's ongoing market conduct reporting requirements.

### **4.6 What supervisory approach will apply to third-party cell captive arrangements?**

- Prior approval from the Registrar will be required for all cell arrangements entered into with affinity schemes.
- Prior notification to the Registrar will be required for all other cell arrangements.

- Ongoing monitoring of “shareholder” / cell agreements will be undertaken by the Registrar, to ensure compliance with all regulatory requirements.
- Existing licensing conditions will be amended to give effect to the proposals in this part and to ensure that the same standard registration conditions apply in respect of third-party cell captive insurers that follow similar business models.
- Enforcement action will be taken against cell captive insurers that fail to demonstrate compliance with the regulatory requirements applicable to third-party cell captive insurance. Enforcement action against the insurer will be for both contraventions by the insurer and/or by the cell owner that is conducting business on behalf of the insurer. Enforcement action in terms of the FAIS Act may also be taken against intermediaries that contravene the regulatory requirements applicable to third-party cell captive insurance business in a way that reflects negatively on their ability to meet the FAIS fit and proper requirements or the FAIS General Code.