



**STATEMENT SUPPORTING THE DRAFT  
CONDUCT STANDARD – REQUIREMENTS  
RELATING TO THIRD PARTY CELL CAPTIVE  
INSURANCE BUSINESS**

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Financial Sector  
Conduct Authority

## 1 PURPOSE OF THE STATEMENT

This statement relates to the publication of the draft Conduct Standard to be made in terms of section 106(1)(a) read with sections 106(2)(b) and 108(1) of the Financial Sector Regulation Act 9 of 2017 (FSRA) setting out requirements for the conduct of cell captive insurance business in relation to third party risks.

This statement is published in terms of section 98 of the FSRA and explains the need for, expected impact and intended operation of the draft Conduct Standard.

## 2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

### *Background*

Enhancements to the regulatory framework for third-party cell captive insurance business has been under consideration for a number of years. Since 2009, the predecessor to the Financial Sector Conduct Authority (FSCA), the former Financial Services Board, has consistently raised concerns around the third-party cell captive insurance business model and particular risks that have been identified from a regulatory and a supervisory perspective. Extensive consultation with the industry has informed research and consideration on how best to achieve the objectives of conduct of business supervision of insurers and protecting policyholders by ensuring fair treatment by insurers, while supporting broader national policies on competition and financial inclusion specifically insofar as it relates to third-party cell captive insurance business.

In 2018, a licensing framework and prudential requirements for cell captive insurance business was introduced by way of the Insurance Act, 2017 (Act No. 18 of 2017) (Insurance Act). Shortly after the enactment of the Insurance Act, the FSCA published for public comment the first draft of the Conduct Standard setting Requirements for the conduct of cell captive insurance business in relation to third party risks.

The FSCA received comments from 10 industry commentators who submitted a total of 127 comments on the draft Standard, raising a number of critical issues reflecting varying perspectives. In addition, as part of the public consultation, the FSCA hosted an industry workshop at the end of October 2018 to allow the industry to present on their views on the proposals.

Between January 2019 and October 2019, the FSCA undertook further research on conduct risks in the cell captive insurance industry, which was informed by data analysis of various sets of information reported to the FSCA to obtain an overview of size of the cell captive insurance industry, understand the ownership status of the existing cell structures and consider the continued relevance of the identified risks which informed the previous proposals around ownership. There were extensive engagements during this time between the FSCA, the Prudential Authority, insurers that conduct third party cell captive insurance business, and various types of cell owners (including motor dealerships, retailers and fintech-start-up companies).

Informed by the above research and engagements, the FSCA then formulated its final policy proposals aimed at addressing the conduct risks identified in insurance business conducted through cell structures. In December 2019, the FSCA published a position paper setting out its final policy proposals for conduct requirements applicable to third party cell captive insurance business (the

position paper).<sup>1</sup> The objective of the position paper was to clearly set out the risks identified particular to this segment of the insurance industry and articulate the FSCA's policy position on how these risks will be addressed through enhancements to the regulatory framework applicable to third-party cell captive insurance business. The position paper confirmed that a revised draft Conduct Standard will be published for consultation during the course of 2020.

Below we discuss specific risks that have been identified in the third-party cell captive insurance industry which informed the decision to proceed with the publication of a draft conduct standard.

### 2.1 *Business model risks increasing the likelihood of unfair outcomes for customers*

The unique characteristics of the third-party cell captive insurance business model can give rise to a number of conduct related risks resulting in adverse outcomes for policyholders. Insurers are ultimately accountable for ensuring that the products they underwrite are designed, distributed and serviced in a manner that consistently delivers fair outcomes for policyholders, irrespective of their chosen business model.

The ring-fenced and sometimes "arm's length" nature of third-party cell captive arrangements gives rise to the risk of insurers not taking sufficient responsibility for, or exercising adequate oversight of, the conduct of cell owners insofar as this relates to the fair treatment of policyholders. This risk is exacerbated in instances where an insurer has a large number of third-party cell captive arrangements but, due to budgetary and other factors, is constrained by the number and adequacy of internal resources available to exercise the level and frequency of effective oversight required to ensure that every cell owner is consistently adhering to the standards of conduct expected of the insurer itself.

The following risks were highlighted in the position paper as particularly prominent in third party cell captive insurers' business models:

- Lack of appropriate governance and oversight by the cell captive insurer over the business operated in the cell structures, which results in a lack of meaningful monitoring of the delivery of fair outcomes to policyholders.
- Lack of oversight by the insurer over new product development which is likely to result in an increase in inappropriate or low value products, exacerbated by a proliferation of cell structures.
- Shortage of skills and resources in some cell captive insurers to administer products sold through the cell structures, coupled with a lack of knowledge and understanding of the intimate workings of the business operated within the cell structure ("rent-a-license" type models).
- Unnecessarily complex complaints and escalation procedures within certain cell structures especially identified where the cell owner is a bank or another large institution.

### 2.2 *Conflict of interest risks*

A cell owner in a third-party cell captive arrangement qualifies for financial incentives (in the form of dividends and other similar means) if the cell structure is profitable. Where the cell owner also plays an integral part in the decision-making process relating to the conducting of insurance business in

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<sup>1</sup> Available on the FSCA website at <https://www.fsc.co.za/Regulatory%20Frameworks/Temp/Position%20paper%20Conduct%20policy%20proposals%20applicable%20to%20Third%20party%20Cell%20Captive%20Insurance%2011%20December%202019.pdf>

the cell structure,<sup>2</sup> including the distribution of the insurance products,<sup>3</sup> such financial incentives can give rise to significant conflicts of interest as the “profit motive” could significantly drive and influence the cell owners’ decision making process. We acknowledge that the risk of unfair decision-making around claims is not limited to cell structures and all insurers stand to benefit from low claims ratios. However, in a traditional insurer there are requirements around governance and claims management processes which result in more independent decision-making by the claims function and more robust oversight over sales practices. These governance and oversight processes, however, are often not implemented at a cell structure level in a suitable or acceptable manner. Supervisory experience has shown that many cell captive insurers cannot evidence the independence of the claims processes at cell structure level, especially in smaller businesses.

The aforementioned conflict of interest risks materialise in several ways as discussed below.<sup>4</sup>

### 2.2.1 *Mis-selling and biased advice*

Where the cell owner is an NMI, the motive to ensure profitability of a cell structure in order to earn dividends inherent in a cell arrangement gives rise to serious conflicts of interest in the sales and distribution processes. In particular, the “profit motive” often drives the selling of products that are not appropriate or not the most appropriate for a particular policyholder (commonly referred to as “mis-selling”) and could even materialise on policies sold on a so-called “non-advice basis”.<sup>5</sup> The consequences of mis-selling may include a misalignment between the expectation of the policyholder in respect of the product performance and/or benefits and the actual product. It may also lead to excessive lapsing of products or misunderstanding of restrictions and exclusions applicable to certain products.

The situation is further aggravated where the NMI purports to provide independent advice to the policyholder. In such an instance the policyholder is under the impression that that intermediary is considering a range of products and is advising the policyholder to purchase the product that is most suitable in the context of the policyholders’ needs and objectives. The reality, however, is that the NMI is likely to promote and sell the product belonging to the cell structure over other products that do not belong to the cell structure, not because it is necessarily the best or most appropriate product for that policyholder, but because of the benefit the NMI may derive if the cell structure is profitable. Apart from the mis-selling risk and all the adverse consequences associated therewith, this conflict situation also creates the risk of biased advice which is likely to result in a significant breach of the NMI’s fiduciary duty towards the policyholder.

<sup>6</sup>Although the FAIS General Code of Conduct<sup>7</sup> requires NMIs to disclose to the policyholder the existence of any personal interest in the relevant services, or of any circumstance which may give rise to an actual or potential conflict of interest in relation to such service, it appears that these conflicts of interest are not always adequately disclosed. It is also not clear that such disclosure will be sufficient to adequately mitigate the aforementioned risks, particularly given the extent of information asymmetry between a policyholder and an NMI coupled with the level of financial literacy of the average policyholder. Structural intervention is therefore necessary.

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<sup>2</sup> For example, where the cell owner is a binder holder and makes decisions that bind the insurer.

<sup>3</sup> For example, where the cell owner renders services as intermediary in relation to the cell structure’s policies.

<sup>4</sup> For purposes of this document the risks are summarised with reference to the full details expanded on in the position paper.

<sup>5</sup> As explained previously, mis-selling most often arises from misleading information and/or conflicts of interests in the distribution channel and indicators of mis-selling and examples thereof are described in more detail in the position paper.

<sup>6</sup> Including the duty to act honestly and fairly, and with due skill, care and diligence, in the interests of policyholders and the integrity of the financial services industry.

<sup>7</sup> General Code of Conduct for Authorised Financial Services Provider and Representatives as published under Board Notice 80 in *Government Gazette* 25299 of 8 August 2003 and amended from time to time.

### 2.2.2 *Risk of unfair decision-making related to claims and other management decisions*<sup>8</sup>

Often a cell owner or associate of the cell owner enters into a binder agreement with the cell captive insurer in terms of which the cell owner or its associate, in its capacity as binder holder, may settle claims under policies provided through the cell structure. If such a cell owner is also an NMI rendering services as intermediary with regards to such policies, the NMI cell owner may also perform other claims related services including receiving, submitting or processing claims under such policies.

The motive of the NMI cell owner to ensure the profitability of the cell due to the benefit that it may derive from owning shares may drive biased decision making related to claims, which may result in higher repudiation of claims to support the profitability of the cell structure.<sup>9</sup> This bias in decision-making also has the potential to spill over into other areas of the insurance business over which the NMI cell owner has the ability to exert influence, e.g. decisions relating to ratings, application of averages, contract terms, influencing procurement by promoting the use of specific suppliers if the cell owner stands to benefit and the like. As is the case around other conflicts of interests, even though similar conflicts may arise in so-called traditional insurers, there are requirements around governance and oversight processes which support managing these conflicts and insurers are subject to robust regulatory requirements, which are not extended to cell structures level.

### 2.2.3 *Risk of inappropriate motivation to an NMI to move a book of business*

Certain shareholder loan arrangements have been identified that drive inappropriate behaviour in that the policies are moved into the cell structure, not necessarily because it constitutes a better offering to the policyholders, but because the NMI cell owner stands to benefit from more policies being underwritten in the cell structure of which it is an owner, which again links to the profitability of the cell structure.<sup>10</sup> Such arrangements also point to regulatory arbitrage in structuring arrangements around legislative prohibitions.

## 2.3 *Possible Regulatory Arbitrage*

The ability of an NMI to be a shareholder and earn dividends within a cell structure creates the potential for regulatory arbitrage resulting in uneven playing fields between NMIs and Underwriting Managers (UMs) as explained in detail in paragraph 2.2 of the position paper. Further to the risks of unfair outcomes to policyholders brought about by mis-selling, conflicted advice, inappropriate products, lack of sufficient governance and oversight concerns also remain over the existence of regulatory arbitrage in that cell captive insurers have structured their business in a way that circumvents the legislative prohibition on profit sharing by NMI binder holders, thereby driving unfair competition in the insurance market.

The clearest way to address these risks and concerns would be to outright prohibit NMIs from owning cell structures. However, the fact that there are existing cell structures of which the cell owners are NMIs has to be acknowledged, and regulatory requirements should be crafted in such a way to balance the rights of these cell owners against the protection to policyholders and the public at large. The FSCA is of the view that the conflict of interest risk in respect of cell owners who are NMIs is substantially mitigated if the NMI is a tied agent of the cell captive insurer and only sells policies within its own cell structures. This largely informed the regulatory proposals in the draft conduct standard. Other challenges to address the broader supervisory and oversight challenges relating to the cell owner's consistent adherence to the levels of conduct expected of the insurer are addressed by

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<sup>8</sup> The position paper highlights that concerns over conflict of interest with regard to decision making extends beyond product selection and claims repudiations to risk rating and influencing procurement. See paragraphs 2.1.3 and 2.1.4 of the position paper.

<sup>9</sup> See paragraph 2.1.3 of the position paper.

<sup>10</sup> More detail on supervisory experience in this regard is provided in paragraph 2.1.5 of the position paper.

introducing stricter governance and oversight requirements on cell captive insurers, to ensure that they have the relevant checks and balances in place to mitigate these risks and ensure fair outcomes.<sup>11</sup>

Requiring that an NMI cell owner be limited to only rendering services as intermediary in relation to policies within cell structures of which it is the owner, may also have the added benefit of limiting the proliferation of cells. This is necessary as supervisory experience has shown through the data submitted in the Conduct of Business Returns (CBRs) that cell captive insurers have poor quality data on the business operated in the various cell structures and lack strong and direct oversight over the business operated in these cell structures.

### *An inclusive and transformed Insurance Sector*

The nature of third-party cell captive arrangements creates a unique opportunity for cell captive insurers to play a significant role in promoting an inclusive and transformed insurance sector in South Africa. To this end there is a recognition that certain limitations specifically in respect of the ownership and of cell structures may be relaxed on application to the FSCA,<sup>12</sup> if it can be demonstrated that a proposed cell structure is intended to serve as an incubation hub for the progressive growth of the cell owner into a fully-fledged licensed insurer or micro insurer within a defined period of time.

## **3 SUMMARY OF THE DRAFT CONDUCT STANDARD**

### **3.1 Enhanced governance and oversight requirements**

The draft conduct standard proposes appropriate governance and oversight requirements on cell captive insurers to mitigate the specific risks which have been identified as particularly prominent in third party cell captive insurance models.

These governance and oversight requirements include:

- A general overarching ongoing oversight requirement that places a positive obligation on cell captive insurers to have the necessary oversight over the business being operated under its license;
- A specific requirement that the escalation of complaints should be made directly to the insurer and the upkeep of a central complaints register;
- A requirement that the cell captive insurer conducts a due diligence on a cell owner and any outsourced party or binder holder prior to entering into such an arrangement or agreement;
- Setting minimum requirements for the due diligence conducted in respect of the cell owner to ensure that:
  - The cell owner has the systems and processes in place to support the cell captive insurer in complying with the relevant requirements in the Policyholder Protection Rules (Short-term Insurance, 2017), Policyholder Protection Rules (Long-term Insurance, 2017), the Short-term Insurance Regulations and the Long-term Insurance Regulations;
  - the cell owner has the systems and processes in place to support the cell captive insurer in complying with any regulatory reporting requirements, including the CBRs;
  - the cell owner has the financial and operational ability to comply with applicable laws and contractual obligations arising from all agreements between the cell owner and cell captive insurer;

<sup>11</sup> See paragraph 2.2 of the position paper.

<sup>12</sup> Application for exemption in terms of section 281 of the FSRA.

- the NMI cell owner meets all requirements around fitness and propriety as required of Financial Service Providers under the FAIS Act;
  - where the cell owner is a non-mandated intermediary and/or binder holder has all necessary technical skills and expertise;
  - the cell structure has sufficient financial and operational capability to conduct its business in a prudent manner that will ensure fair outcomes to policyholders; and
  - the cell structure has appropriate governance arrangements, risk and compliance management processes and internal controls.
- Ongoing oversight and governance requirements applicable to all insurance business in cell structures to ensure among others that products from these structures result in products that are fairly priced, suitably designed and distributed and provide value to the policyholder.

### **3.2 Additional disclosure requirements**

The conduct standard proposes that a general disclosure obligation should be placed on cell captive insurers in the conduct standard to disclose to the potential policyholder, before it enters into a policy, details regarding the nature of the relationship between the cell captive insurer and the cell owner and the fees and remuneration borne from this relationship.

### **3.3 Reporting requirements**

The reporting requirements relating to the notification of any new third-party cell arrangements as communicated in terms of *FSB Information Request 5 of 2016* is perpetuated in the draft Conduct Standard. This will aid in the effective monitoring of all cell arrangements with the purpose of ensuring compliance with the Conduct Standard by cell captive insurers in the interest of ensuring the consistent delivery of fair outcomes for policyholders.

In addition, and for the same reasons, the reporting requirements will be extended to require notification prior to the termination of a cell structure agreement to monitor the impact that such a termination could have on policyholders. It is therefore stipulated that all cell captive insurers must, at least 30 days before entering into any cell structure or at least 60 days before terminating a cell structure, notify the FSCA in writing, in the form and manner prescribed, of the proposed arrangement to be entered into or the termination thereof.

The draft standard establishes a process whereby the FSCA can by notice to the cell captive raise objections following these notifications to the FSCA and instruct that the objections be resolved, to the satisfaction of the FSCA.

### **3.4 Limitation on who may be a cell owner**

In order to address risks inherent in third party cell captive arrangements that impede fair outcomes for policyholders, as extensively set out in the position paper and summarised above for purposes of this statement, and to minimise the possibility of regulatory arbitrage as highlighted, the draft Conduct Standard proposes the following limitations in instances where the cell owner is an NMI or an associate of an NMI:

- An NMI, or an associate of an NMI, that is a cell owner must be a tied agent of the cell captive insurer and may only offer policies underwritten in the cell structures of that cell owner;
- a tied agent or an associate of an NMI, may only have a third-party cell arrangement in place with one life insurer and one non-life insurer, or with one micro insurer, and may only render services as an intermediary for purposes of those insurers and in respect of policies underwritten in the specific cell structures of which it is the cell owner; and

- the NMI cell owner or associate of a cell owner that is an NMI will be required to be a registered FSP and meet all requirements around fitness and propriety as required of FSPs under the FAIS Act, including having a Key Individual, compliance officer and training programmes for staff members.

The draft Conduct standard proposes that any cell captive arrangement entered into, where the cell owner is an NMI or an associate of an NMI, may only be entered into where the cell captive insurer can demonstrate that there was a comprehensive assessment of risk. Where risks are identified, the cell captive insurer will be required to take steps taken to avoid or where avoidance is not possible, mitigate the risks so identified. Furthermore, the cell captive insurer will have to ensure that adequate resources with the necessary skills in respect of the control functions of the insurer has been allocated.

#### 4 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

It is envisaged that the draft Conduct Standard will have a positive impact on the quality of insurance products offered through cell structures and on the efficiency of insurance provisioning by cell structures while improving governance and oversight over cell structures by cell captive insurers. It is expected that the conflicts of interest, mis-selling and regulatory arbitrage that has beset this segment of the insurance sector to date, will significantly reduce.

The draft Conduct Standard is likely to lead to improved outcomes for policyholders due to the absence of conflicted or biased advice by NMI cell owners who will only be able to sell and earn commission on policies that are written in the cell structure for which they are the cell owner, and act as tied agents of the cell captive insurer that underwrites that cell. This, coupled with the enhanced disclosure requirements will ensure that policyholders will not be led to believe that they are receiving independent advice and understand that the NMI cell owner only offers products underwritten in a cell structure of which it is the cell owner, and that the cell owner standard to benefit from the profitability of the products being sold.

It is our view that the benefits to and enhanced protection of policyholders outweigh the possible impact on these existing cell captive arrangements that will no longer be allowed to offer products underwritten by other insurers or outside of the cell arrangement.

The FSCA acknowledges that the impact of the draft Conduct Standard may be more pronounced in certain sectors of the industry, for example the motor dealership business. In these industries many of the motor dealerships are cell owners but also sell other insurers' products at the point of sale. The risk of conflicted advice and mis-selling and the offering of low-quality products seems to have materialised in particular when it comes to sales practices in this sector.

Arguments have been made by the industry that the proposed limitations may impact consumer choice, in particular in the motor dealership market. The FSCA holds the view that the limitations around cell ownership *per se* would not impact consumer choice. The effect of the cell owner being 'tied' to the cell structure effectively would mean that where the motor dealer is an NMI cell owner and sells policies, at point of sale (of the motor vehicle) the consumer will not be given a choice of options for insurance and will be limited to the product of that NMI cell owner. However, the consumer is still free to purchase *any insurance product* or make use of any intermediary and therefore consumer choice is not limited. If an NMI cell owner who is a motor dealer chooses to retain a cell,<sup>13</sup> it is the motor dealer that is taking the decision not to be able to offer other products from different

<sup>13</sup> It is likely that where such decision is made, the decision was driven by the "profit motive". As discussed above, this would then also give rise to all the risks highlighted above.



insurers at the point of sale. Where the intermediary relinquishes the profit-sharing motive and chooses to function as a truly independent intermediary, all products can be offered to the customers at the point of sale.

Regarding the limitation around only owning a cell structure in one life and one non-life cell captive insurer, indications from engagements with cell captive insurers are that there is only a small amount of NMI cell owners that own cell structures in more than once cell captive insurer. To accommodate these existing cell structures appropriate transitional provisions are included in the conduct standard to allow for these arrangements to be restructured in an appropriate manner.

The FSCA further acknowledges that there may be instances in which the implementation of the draft Conduct Standard could have a cost implication for cell captive insurers. In recognising this, all stakeholders and in particular cell captive insurers are requested to elaborate on the extent thereof on the comment template published with this statement. The responses will be analysed to understand the anticipated cost impact, if any, of implementing the draft Conduct Standard once it becomes effective. This includes the extent to which transitional provisions are required in respect of some of the requirements proposed in the draft Conduct Standard.

## **5 STATEMENT OF INTENDED OPERATION OF THE CONDUCT STANDARD**

The draft Conduct Standard is consistent with the objective of the FSRA, and specifically the mandate of the FSCA to protect financial customers by promoting the fair treatment of financial customers (including policyholders) by financial institutions.

Once the final Conduct Standard has been published, all new third-party cell captive arrangements will be required to comply with the Conduct Standard immediately. Specific transitional periods will be allowed for the alignment of all existing arrangements and arrangements entered into between the publication date of the draft Conduct Standard and the effective date of the final Conduct Standard, if required.

The reporting requirements that third-party cell captive insurers must, at least 30 days before entering into any cell structure and 60 days before terminating a cell structure notify the FSCA in writing of the proposed cell structure will also follow a “file and use” notification process.

## **6 WAY FORWARD**

The draft Conduct Standard is published in terms of section 98(1) of the FSRA for a period of 8 weeks for public comment, and comments are due to the FSCA on or before 22 September 2020. After careful consideration of all submissions received on the draft Conduct Standard, the FSCA will make any necessary changes to the draft Conduct Standard and submit the updated draft Conduct Standard to Parliament for a period of at least 30 days while Parliament is in session.

Please note that this statement supporting the publication of the draft Conduct Standard may be updated to better reflect the expected impact of the draft Conduct Standard based on the submissions received in the comments template.