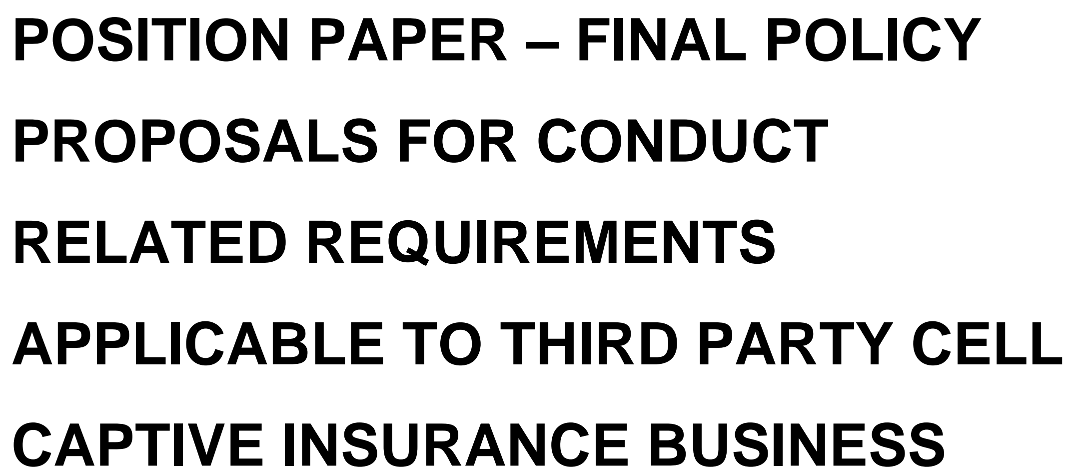
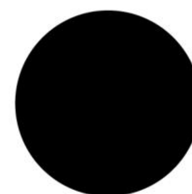


POSITION PAPER – FINAL POLICY PROPOSALS FOR CONDUCT RELATED REQUIREMENTS APPLICABLE TO THIRD PARTY CELL CAPTIVE INSURANCE BUSINESS

December 2019



FSCA
Financial Sector
Conduct Authority

1 BACKGROUND

On 11 June 2013, the former Financial Services Board ("FSB") published for public comment a Discussion Paper titled *Review of Third-party Cell Captive Insurance and Similar Arrangements* ("Discussion Paper"). The objective of the Discussion Paper was to explore how the regulatory framework for third party cell captive insurance could be enhanced to best achieve the objectives of insurance supervision, namely to promote 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.

On 3 July 2018, the Financial Sector Conduct Authority ("FSCA") and the Prudential Authority ("PA") issued a Joint Communication titled *Update on regulatory policy proposals mooted in the Third-party Cell Captive Insurance and Similar Arrangements Discussion Paper, 2013*[1] ("Joint Communication"). The Joint Communication confirmed that certain of the regulatory policy proposals put forward in the Discussion Paper have been accommodated in the Insurance Act, 2017 (Act No. 18 of 2017) ("Insurance Act"), the Financial Soundness Prudential Standards for Insurers issued under the Insurance Act and the Policyholder Protection Rules issued under the Long-term Insurance Act, 1998 (Act No. 52 of 1998) ("LTIA") and Short-term Insurance Act, 1998 (Act No. 53 of 1998) ("STIA") ("PPRs").[2] In addition, the Joint Communication highlighted which of the regulatory policy proposals set out in the Discussion Paper relate primarily to conduct of business matters, to be dealt with by the FSCA. This included limitations relating to who may be the owner of a cell structure.

On 20 July 2018, the FSCA released for public comment the draft *Conduct Standard: Requirements for the conduct of cell captive insurance business in relation to third party risks* ("draft Standard").

The draft Standard was aimed at:

- Alleviating potential risks to the delivery of fair outcomes to policyholders inherent in the third party cell captive insurance business model;
- Addressing conduct related supervisory and oversight challenges emanating from the proliferation of third party cell captive arrangements with non-mandated intermediaries (NMIs) by ensuring that products offered through cell structures are suitably tailored and offer consistently fair value to policyholders;
- Protecting policyholders by ensuring that potential or actual conflicts of interest that arise in instances where the cell owner is an NMI are properly mitigated and managed;
- Preventing possible regulatory arbitrage arising from the fact that NMIs who are cell owners are entitled to earn commission for the selling of policies and also share in underwriting profits without necessarily having a material interest or role to play in the technical underwriting functions of the business, unlike Underwriting Managers ("UMs") who are entitled to a share in underwriting profits but are prohibited from earning commission for the selling of policies; and
- Recognising the significant role to be played by third party cell captive insurers in promoting the transformation of the insurance sector where it can be shown that a proposed cell structure is intended to serve as an incubation hub for an emerging insurer.

[1] Published as "Insurance Act, 2017: Joint Communication 2 of 2018". Available at: https://www.fsca.co.za/Regulatory%20Frameworks/Temp/Joint%20Communication%202%20of%202018.pdf.
[2] In as far as it relates to the Policyholder Protection Rules, specific reference is made to the requirements relating to white labelling and the identification of the insurer in all types of advertising.

The following limitations were proposed in the draft Standard in instances where the cell owner is a NMI or an associate of an NMI:

- An NMI, or an associate of an NMI, that is a cell owner may only render services as intermediary (including advice) related to policies underwritten in the cell structures of that cell owner;
- An affinity relationship must exist between the main business of the NMI (cell owner) and the insurance business conducted through the cell structure of the cell owner; and
- The main business of the NMI (cell owner) must not be the rendering of services as an intermediary or the performance of any functions on behalf of an insurer.

This, in the context of the draft Standard meant that an NMI, or an associate of an NMI, may only have a third party cell arrangement with one life insurer and one non-life 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.

There were 10 industry commentators that submitted 127 comments on the draft Standard, raising a number of critical issues reflecting varying perspectives. 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 May 2019, the FSCA undertook further data analysis of various sets of information reported to the FSCA over the past few years 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.

In addition, the FSCA and PA established a joint regulatory working group in April 2019 with an aim to consider three remaining issues related to the regulatory framework applicable to cell captive insurance business. These issues relate to:

- The need for a limitation on ownership through cell structures where particular conduct risks have been identified;
- risk sharing between the cell owner and the cell captive insurer and a cell captive insurer doing so-called “direct business” on a promotor cell; and
- a prohibition on “similar arrangements”.

The joint working group met with a number of insurers between April and July 2019 that conduct third party cell captive insurance business, and issued an additional information request to specific identified insurers operating in this market, in order to obtain data on risk sharing arrangements and the potential impact that stricter requirements around risk sharing would have on this segment of the industry. The information was due to the PA by the end of August 2019.

Following the above developments, the FSCA (“the Authority”) has formulated further policy proposals aimed at addressing the conduct risks identified in insurance business conducted through cell structures. The purpose of this position paper is therefore to set out the risks identified particular to this segment of the insurance industry and policy proposals on how these risks can be addressed through changes to the regulatory framework.

2 CONDUCT RISKS IDENTIFIED RELATED TO THIRD PARTY CELL CAPTIVE BUSINESS

The following risks emanating in particular from third party cell captive insurance business models have been identified through, amongst others, the work done by the joint working group and supervisory experience:

- Potential conflicts of interest, including the risk of biased advice to policyholders, the risk of mis-selling, the risk of unfair decision-making related to the payment or repudiation of claims and the risk of inappropriate and conflicted motivation to an intermediary to move a book of business into a cell structure where it may derive additional benefits as a cell owner;
- Possible regulatory arbitrage;
- Lack of appropriate governance and oversight by cell captive insurers over the business operated in the cell structures in general, and over new product development in particular;
- Shortage of skills and resources in some cell captive insurers to administer products and a lack of knowledge and understanding of the intimate workings of the various businesses operating within their cell structures (“rent-a-license” type models); and
- Unnecessarily complex complaints processes and escalation procedures within the cell structures, especially identified where the cell owner is a bank or another large institution, causing unfair barriers to policyholders.

2.1 Conflict of Interest Risk

2.1.1 Risk of biased advice

The fundamental risk that was first identified in the 2013 Discussion Paper, which remains of concern, is the risk of biased advice to policyholders. 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 as this motive may bias the advice and sales process of the NMI in a way that is at odds with the NMIs primary duty to act in the interests of the policyholder in terms of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002) (“FAIS Act”). This is especially the case where the NMI purports to provide independent advice to the policyholder.

If a cell structure is profitable, a cell owner can earn dividends based on the cell owner’s shareholding in the insurer. Where such a cell owner is also an NMI that provides financial advice to a policyholder, the NMI may promote 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. This may lead to biased advice to a policyholder, which is in conflict with an adviser’s legislative 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. Although the FAIS General Code of Conduct[3] 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 risk of

[3] 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.

biased advice, 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.

2.1.2 Risk of mis-selling

Where the cell owner is an NMI, the profitability motive referred to above may also drive the selling of products that are not appropriate or not the most appropriate for a particular policyholder (commonly referred to as "mis-selling"). This risk could materialise, even if the NMI does not give advice and sells the policies on a so-called "non-advice basis". Mis-selling most often arises from misleading information and/or conflicts of interests in the distribution channel. Currently data on products sold through non-advice channels indicate some of the lowest loss ratios in the market, which could be an indication of mis-selling and/or misleading disclosures. Appropriate disclosures as are already required in terms of Rule 11 of the PPRs may to a certain extent address mis-selling which occurs due to misleading information, but similar to the risk of biased advice, disclosures may be insufficient to adequately mitigate this risk. Examples of such mis-selling could be where a scratch-and-dent product is sold on a second hand vehicle, and the product is designed with extensive limitations around when the customer may claim (e.g. customer may only claim if damage is a scratch that is more than 10 cm and the product has a large excess structure) and such a product is sold in addition to a comprehensive motor insurance product. Such a product would not be appropriate for a customer that also has comprehensive cover. Another example would be where a customer that is self-employed is sold a credit life product with retrenchment cover, where it is clear that the customer would never be able to claim.

2.1.3 Risk of unfair decision-making related to claims and other management decisions.

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. This coupled with instances where the NMI cell owner is also involved in the day-to-day management of the cell structure gives the NMI cell owner significant influence in the decision-making process related to payment or repudiation of claims. 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.

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. 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.

2.1.4 Additional concerns relating to decision making

Concerns over conflict of interest with regard to decision making extends beyond product selection and claims repudiations, and includes issues relating to rating, application of averages (in non-life insurance claims) and influencing procurement by promoting the use of specific suppliers if the cell owner stands to benefit.

Concerns over conflicts of interests as explained above apply equally if the cell owner has an associate relationship with an NMI that sells policies offered by the cell structure.

2.1.5 Risk of inappropriate motivation to an NMI to move a book of business

Supervisors have encountered instances where some cell captive insurers would, when issuing a new cell structure to an NMI cell owner, enter into a type of loan arrangement with the new cell owner in terms of which the cell captive insurer in effect advances the capital for the cost of the shares to that NMI to allow the NMI to become a cell owner. This occurs especially in cases where the NMI does not have access to sufficient capital to set up the cell structure. In return the NMI "moves" the policies of all its existing policyholders into the cell structure, which benefits the cell captive insurer. The loan account remains active, but is never settled by the NMI cell owner, and the cell captive insurer eventually writes off the "loan", which effectively equates to an indirect sign-on bonus which is prohibited under the FAIS Act. Again, these types of arrangements 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. Such arrangements also point to regulatory arbitrage in structuring arrangements around legislative prohibitions, which is discussed in more detail below.

2.2 Risk of 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 UMs. The existing regulatory framework allows UMs to earn a share in the underwriting profits of the insurer, but prohibits them from marketing or selling policies directly to policyholders and earning commission for these activities. Outside of cell structures, NMI binder holders on the other hand may market and sell policies and earn commission, but may not share in the underwriting profits of insurers. An NMI binder holder is therefore in essence a "dual agent" in that it acts on behalf of the policyholder as an adviser and/or intermediary, and acts on behalf of the insurer when performing binder functions. This already creates an inherent conflict of interest and allowing an NMI to earn profit share through dividends has the significant potential of exacerbating this conflict of interest. Therefore, the prohibition on profit sharing for NMI binder holders primarily aims to protect the interests of policyholders by preventing actual or potential conflicts of interest. Such conflicts would arise if NMI binder holders had a vested interest in the profitability of an insurer, which is directly influenced by policy volumes and loss ratios. The distinction in the types of fees and income that may be earned by NMI binder holders and UMs respectively is necessary to ensure the maintenance of a level playing field across the various role players in the insurance value chain based on their unique areas of expertise, to promote competition in the market and ultimately to ensure the sustainability of the industry as a whole.

Criticism of the fact that cell captive insurers have been allowed to issue cell structures to cell owners that are NMIs include concerns over unlevel playing fields between cell captive and non-cell captive insurers, and between NMI cell owners and other typical NMI binder holders. The unlevel playing field concern relates to the fact that NMI's are not allowed to share in profits, but NMI cell owners can earn dividends and premium investment income.

The argument from cell captive insurers is that there is a difference between 'dividends' and 'profit sharing'. The key difference, in their opinion, is that with dividends the cell owner is required to capitalise the cell structure and the cell owner may earn dividends based on shareholding in the cell, whereas profit-sharing by a UM does not require any capital input by the UM. The UM typically only shares in the profits of the cell structure whereas the NMI cell owner shares both in the profits and the losses of the cell structure. As explained above, many instances have been identified where the cell captive insurer advances/loans the capital for the cost of the shares in a cell structure to an NMI. These loans are never settled and are eventually written off by the insurer. In these instances it cannot be argued that the NMI cell owner is really required to put 'skin-in-the-game', as the industry sometimes refers to the requirement of upfront capital input. The argument regarding why a distinction should be made between the earning of dividends and profit share is, in this context, largely artificial.

On the other hand, it could also be argued that the conflict of interest driven by the incentive of sharing in the profitability of a cell could be aggravated if the cell owner is required to capitalise a cell structure, (and based thereon earn dividends). In such instances the cell owner does not only stand to forego profit if the cell structure is not profitable, but stands to expose its capital if a cell structure needs to be recapitalised following losses.

The arguments around the difference between 'dividends' and 'profit sharing' boil down to substance over form, as the same conflicts of interest arise and the same inappropriate incentives exist, whether the earnings are in the form of dividends or profit shares. Accordingly, concerns 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.

2.3 Risks exacerbated by the nature and business models of cell captive insurers

The following prevailing risks have been identified through supervisory experience as particularly prominent in third party cell captive insurers:

- 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 may result in an increase in inappropriate or low value products, exacerbated by a proliferation of cell structures, without the Authority having direct oversight over product governance.
- 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.

Most of these risks can be attributed to the unique characteristics of third party cell captive insurance business models which can give rise to a number of conduct related risks potentially 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 oversight required to ensure that every cell owner is consistently adhering to the standards of conduct expected of the insurer itself. In such cases the responsibility for ensuring fair policyholder treatment falls almost exclusively to the cell owner. For this reason it is critical that the Authority, as well as the insurers who choose to distribute their products through cell structures, have sufficient comfort that cell owners will have a material interest in ensuring that these products are appropriately tailored and deliver fair value to policyholders. Such interest would, for example, either be because the cell owner plays a significant role in the technical underwriting functions of the business or because of the need to protect the reputation or brand of their primary business.

2.4 Supervisory and Oversight Challenges

The conflict of interest risk in respect of cell owners who are NMIs could be substantially mitigated if the NMI were restricted to rendering services as intermediary (including advice) in relation to policies within its own cell structures only. However, this does not adequately address the broader supervisory and oversight challenges relating to the cell owner’s consistent adherence to the levels of conduct expected of the insurer in delivering fair outcomes to policyholders, specifically through offering insurance products that are suitably tailored and offer consistent fair value to policyholders. These challenges could be addressed by prescribing 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.

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 cells.

3 PROPOSALS

This section sets out the policy proposals on how to address the risks identified in section 2. The specific mechanism or regulatory instruments to be used to give effect to these proposals will be confirmed in due course, and the intention is that the Authority will publish an updated draft conduct standard for public comment early in 2020. Regardless of the specific regulatory instruments to be utilised, these proposals are the outcomes of research and investigation undertaken by the Authority and will form the basis of the planned regulatory interventions.

3.1 Limitation on who may be a cell owner

We propose that an NMI or an associate of an NMI, that is a cell owner, will be restricted to rendering services as intermediary (including advice) only in respect of policies underwritten in the cell structure of that cell owner. The NMI cell owner may therefore not provide services or advice in relation to policies outside of the cell structure/s it owns.

We also propose that an NMI, or an associate of an NMI, may only have one third party cell arrangement in place with one life insurer and one non-life insurer, and may only render services as an intermediary (including advice) in respect of policies underwritten in the specific cell structures of which it is the cell owner.

Note on alternative proposal made as comment on the 1st draft Standard published in July 2018:

Through the public comments process on the draft standard there was an alternative proposal from the industry that an NMI should be tied (or linked) to the insurer and tied to the cell structure per class of business or sub-class of business (as set out in Schedule 2 to the Insurance Act) for e.g. by permitting a cell owner to have one cell structure for motor class of business with a cell captive insurer and another cell structure for property class of business with another insurer. This means that theoretically an NMI cell owner can have different cells in different insurers, for different classes of business, up to eight different life insurance cells structures, and sixteen non-life cell structures, and even more if the limitation were linked to the sub-classes of business.

We acknowledge that in allowing this the risk of biased advice may be mitigated, but these scenarios will still not mitigate the inherent conflict when a cell owner has an interest in the profitability/underwriting results of the cell structure, which could impact payment of claims, benefits offered, etc.

We do not agree with this proposal as it will not assist in curbing the proliferation of cell structures owned by NMIs which, due to the risks set out above, we want to limit by ensuring that cell captive insurers have appropriate control over the business written in the cell structures. Allowing this proposal may further support the regulatory arbitrage that has been created by certain industry players trying to structure businesses around the regulatory limitations on profit sharing by intermediaries, and in turn, perpetuating the conflicts that exist in allowing even more NMI's to become cell owners and earn profits / dividends.

3.2 NMI cell owner must be a registered FSP under FAIS Act

Another proposal that was made through the public comments process on the draft Standard was to propose more direct oversight by the FSCA over cell owners who are also NMIs. This can be done by strengthening requirements on cell owners who are NMIs by not allowing NMI cell owners to be representatives (as defined in the FAIS Act) on the insurer's FSP license, and instead requiring the NMI cell owner to have its own FSP licence. This would mean that the NMI cell owner will be required to meet the full FAIS fit and proper requirements for FSPs, including having a Key Individual, compliance officer and training programmes for staff members. This would also by implication mean that the NMI cell owner has a direct interest in ensuring the regulatory requirements are met and maintained. Effectively this proposal would mean that an NMI cell owner may not be a representative in terms of FAIS, and must be a licensed FSP. This approach is consistent with proposals related to the categorisation of financial advisers under consideration in terms of the Retail Distribution Review (RDR), including the RDR proposal to limit the use of juristic representatives. We are considering how the proposed prohibition on NMI cell owners from being juristic representatives of the cell captive insurer can be most appropriately implemented through the current FAIS regulatory framework, and any proposed changes to the FAIS regulatory framework will follow the necessary public consultation process.

This proposal will also support potential incubation models where a cell structure serves as an incubator to ultimately develop a cell owner into a micro insurer or insurer. The cell owner will already have been introduced to and become accustomed to the regulatory requirements applicable to FSPs, which may make it easier to transition into a micro insurer or insurer. It could also serve as an additional layer of protection for policyholders by ensuring that the NMI cell owner itself is directly regulated and accountable under the FAIS Act. This requirement, together with the below proposal on stricter oversight and risk management by the cell captive insurer would go a long way in managing the risks identified earlier in this paper.

The principle as entrenched in Rule 1 of the PPRs applicable to all insurers is particularly relevant in this segment of the market in that a cell captive insurer will remain accountable for all aspects of the products offered through cell structures, including the product design, marketing and advertising, ensuring disclosure requirements are met, and regarding claims and complaints handling. The cell owner will be accountable for the obligations as required in terms of the FAIS Act by virtue of being licensed as an FSP. This will ensure appropriate accountability by both the cell captive insurer and the cell owner.

3.3 Strengthening governance and oversight requirements

In addition to the above, it is proposed that further stringent governance and oversight requirements be imposed on cell captive insurers to mitigate the specific risks described under section 2.3 above which have been identified as particularly prominent in third party cell captive insurance models.

These governance and oversight requirements will include:

(a) That a cell captive insurer, prior to entering into a new cell structure, must undertake a due diligence of the cell owner and confirm that:

(i) The cell owner -
- has the systems and processes in place to ensure and evidence that all relevant requirements in the PPRs and the Regulations will be met;
- 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;
- meets all requirements around fitness and propriety as required of Financial Service Providers under the FAIS Act, and
- has all necessary technical skills and expertise.

(ii) 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
- appropriate governance arrangements, risk and compliance management processes and internal controls.

(b) The cell captive insurer should be required to undertake a due diligence on any outsourced party or binder holder prior to entering into such an agreement and may not delegate this to the cell owner. The motivation for this is that the insurer remains accountable for all outsourced relationships and that all such agreements must be entered into directly between the insurer and the outsourced party. Accordingly, the cell captive insurer may not delegate the due diligence or such contracting to the cell owner.

(c) A general overarching ongoing oversight requirement will be included to place a positive obligation on cell captive insurers to have the necessary oversight over the ongoing business being operated under its license.

(d) With regards to oversight over complaints handling, it is suggested that in addition to PPR requirements on complaints handling, it be made a specific requirement that the escalation of complaints should be made directly to the insurer (with the exception of complaints related to advice as these will be dealt with in terms of the complaints handling obligations under the FAIS Act). Consideration is also being given to explicitly requiring cell captive insurers to hold a central complaints register of all complaints to all cell structures.

3.4 Specific requirements related to product design

Supervisors have encountered some uncertainty in the industry as to whether an insurer may delegate the approval and sign off required in terms of PPR Rule 2 (which refers to sign off on product design, confirmation of distribution methods and disclosure documents). We confirm that no such delegation to cell owners or third parties is allowed, and senior management of the cell captive insurer remains accountable for all new products and product enhancements, including excess structures set in non-life insurance products.[4] This will be clarified in the conduct standard, and possibly further enhanced through amendments to the PPRs.

3.5 Additional disclosure requirements

We propose, in addition to PPR Rule 11, that further specific disclosure requirements will be imposed on NMI cell owners, or associates of such NMIs to confirm to policyholders the exact nature of the relationship and remuneration arrangements (including profit share and dividends) between the cell owner and the insurer. These disclosures must be made to the policyholder prior to the inception of any policy and if and when any of these arrangements change.

3.6 Specific reporting requirements

The first draft of the conduct standard published for comment in 2018 contained certain direct reporting requirements. As an alternative to the initial positioning in the draft standard it is proposed that a general reporting obligation should be placed on cell captive insurers in the conduct standard to report the information as determined by the Authority, in the medium and form, by the date, or within the period, as determined by the Authority. The template for the additional reporting by cell captive insurers will be determined by notice on the Authority's website and will allow flexibility around the details required in the cell captive specific reporting.

The Authority will establish a dedicated workgroup to develop a detailed report for notification prior to entering into any new third party cell arrangements and prior to the termination of a cell structure agreement. This reporting will further assist the Authority to monitor the workings of cell structures more closely.

3.7 Exemption powers

[4] Consideration will also be given to extending this clarification beyond cell captive insurers through amendments to the PPRs, to apply to all insurers.

The proposal in the initial draft standard was to allow for an exemption process from the limitations in the draft standard to facilitate an inclusive insurance market and to promote the transformation of the insurance sector. This was to address concerns that limiting NMI cell ownership only to cell structures where there is a so-called affinity relationship[5] (which was broadly associated with brand affinity), as was the proposal in the initial draft standard, would stifle the incubation process, as new entrants into the market would not necessarily have an established affinity relationship or brand.

The benefit of the existence of an affinity relationship in terms of potentially mitigating the risks set out in this paper has been closely interrogated. The Authority has concluded that the existence of an affinity relationship would not necessarily mitigate the conflicts of interest that the Authority had raised as a conduct risk. In light of this, the proposal to limit NMI cell captive ownership to where the cell owner has an affinity relationship and the proposal prohibiting an NMI from being a cell owner where their primary business is rendering services as intermediary, will not be proceeded with. Accordingly, the previously proposed exemption powers linked to transformation and inclusion will no longer be relevant as the affinity requirement has been removed.

One of the proposals from the comments process was that a more general exemption application process be allowed from any of the limitations in the legislation, including allowing for associate relationships with cell structures with different cell captive insurers within a group where it can be demonstrated that conflicts of interests are mitigated. Given the broad general exemption powers under section 281 of the Financial Sector Regulation Act, 2017 (“FSR Act”) it is in our view unnecessary to allow for such specific exemption powers in a standard.

3.8 Transitional arrangements

The enhanced conduct requirements relating to cell captive insurance will potentially apply to both new and existing cell structures. If they were to only apply to new cell structures this would perpetuate the unlevel playing fields and support the regulatory arbitrage evident from the research done by the Authority. Consideration is being given to appropriate transitional arrangements in order to ensure that the alignment of existing cell structures owned by NMI’s to the new requirements be done in a practical manner and ensuring that it does not have an inappropriate adverse impact on the industry.

With regards to existing businesses where, for example, an NMI cell owner is the cell owner of more than one cell structure in more than one insurer, there will need to be an interim dispensation. An appropriate transitional period will be provided for to facilitate the consolidation of existing cell structures. Any cell agreements entered into with an NMI after the stipulated effective date will be required to immediately align to the limitations in the conduct standard once the standard takes effect.

The proposals that require NMI cell owners to be registered as FSPs (as opposed to being structured as representatives on the cell captive insurer’s FAIS representative register) and meet fitness and propriety requirements applicable to FSPs, will also allow for appropriate transitional arrangements to allow existing NMI cell owners to register as FSPs. As alluded

[5] In the draft standard an “affinity relationship” was defined to mean- (a) the primary business of the cell owner is not insurance business, (b) the broader business relationship between the cell owner and the policyholder results in an overall better value proposition through the offering of suitable insurance products, (c) the insurance business may not impede delivery of fair outcomes to policyholders, and (d) the primary business may not be rendering services as intermediary / binder / outsourcing arrangements.

to above, consideration is underway on how the proposal relating to prohibiting NMI cell owners from being representatives can be most appropriately incorporated through the current FAIS regulatory framework, also taking into consideration the proposals under the RDR.

In principle the proposal is that the requirements must apply to both new and existing cell structures, and that existing cell structures will be allowed an appropriate transitional period to align to the requirements. The transitional period, together with the powers the FSCA has to exempt any entity from the requirements, should allow for mitigation of possible disruption for the industry and where it cannot be mitigated and exceptional circumstances exist, an exemption can be considered.

4 WAY FORWARD

This position paper serves as confirmation to interested parties and regulated entities on the policy direction taken by the Authority regarding the regulation of conduct in third party cell captive insurance business. It is intended to give certainty to the industry around the policy views on conduct related requirements specific to cell captive insurance to be introduced in order to mitigate any further regulatory arbitrage. In light of the pending conversion of licenses under the Insurance Act it is vital that the final conduct related regulatory proposals be communicated to the industry to inform the strategies of insurers.

The document is issued for communication purposes and does not invite public comment, as the intention is for the Authority to update the previous draft Standard to incorporate the proposals set out in this document. The updated draft conduct standard, along with the relevant supporting documents will be published for public comment in terms of the consultation requirements in the FSR Act and interested parties will have an opportunity to raise comments and views on the proposals through that process. The Authority is of the view that the policy approach as set out in this paper is an appropriate alternative to outright prohibiting NMIs from being cell owners, which would be the most decisive way of avoiding the conflict of interest and regulatory arbitrage as described.

Given the fact that the finalisation of the conduct framework applicable to third party cell captive insurance business has been pending since the first regulatory proposals in this regard were made in 2013 and the market has, despite these proposals, continued to issue cell structures to NMI's, it is suggested that the finalisation of this conduct standard be expedited. The drafting and publication of the second draft of the conduct standard will therefore be prioritised.