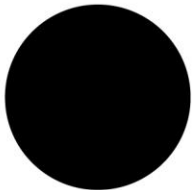


**STATEMENT SUPPORTING THE DRAFT
CONDUCT STANDARD – REQUIREMENTS FOR
THE CONDUCT OF CELL CAPTIVE INSURANCE
BUSINESS IN RELATION TO THIRD PARTY
RISKS**



DATE OF ISSUE: 20 JULY 2018

1 BACKGROUND AND PURPOSE OF THE STATEMENT

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 to 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 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 52 of 1998 (“LTIA”) and Short-term Insurance Act 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 includes the proposals relating to who may be a cell owner.

This statement relates to the publication of the draft Conduct Standard to be made in terms of section 106(1)(a) read with section 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. The draft Conduct Standard is aimed at:

- Alleviating potential risks to the delivery of fair outcomes to policyholders inherent in the 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 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 in instances 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.fsc.co.za/Regulatory%20Frameworks/Temp/Joint%20Communication%20%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 purpose of this statement is to explain the need for, expected impact and intended operation of the draft Conduct Standard as required by section 98 of the FSRA.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

Business Model Risks to Fair Customer Outcomes

The unique characteristics of the third party cell captive insurance business model 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 customer treatment falls almost exclusively to the cell owner. For this reason it is critical that the supervisor and 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, for example, either because they play a significant role in the technical underwriting functions of the business (UMs) or because of the need to protect the reputation or brand of their primary business (NMIs with affinity relationships).

Conflict of Interest Risk

In addition to the above, the ownership structures inherent in third-party cell captive arrangements can give rise to significant conflicts of interest, depending on who the cell owner is. Where the cell owner is a UM there is no conflict of interest as the UM 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. However, where the cell owner is an NMI, the profit share motive inherent in a cell arrangement gives rise to serious conflicts of interest given that this 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 best interests of the client in terms of the Financial Advisory and Intermediary Services Act 37 of 2002 (“FAIS Act”), specifically the General Code of Conduct for Authorised Financial Services Providers and Representatives. This is especially the case where the NMI is meant to be providing independent advice to the client.

Although the FAIS General Code requires NMIs to disclose to the client 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 conflict of interest, particularly given the extent of information asymmetry between a policyholder and an NMI, coupled with the level of financial literacy of the average policyholder.

Supervisory and Oversight Challenges

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. 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 the offering of insurance products that are suitably tailored and offer consistent fair value to policyholders. In order to ensure this, the cell

owner must have a material interest in the insurance value proposition to the policyholder, beyond the financial interests arising from the sale of the product (irrespective of its suitability) or the incentive created by the NMI's ability to earn a profit share within the cell structure.

The existence of an affinity relationship ensures that the NMI cell owner has an interest in the suitability, performance and overall value of the insurance product by virtue of the broader relationship between the primary business of the cell owner and the policyholder. This way the NMI cell owner is incentivised to ensure the consistent delivery of fair outcomes to the policyholder in order to protect the brand or reputation of its primary business. This would provide significant comfort to the supervisor and the insurer of the cell owner's commitment to the fair treatment of policyholders.

Possible Regulatory Arbitrage

The ability of NMIs to earn profit share within a cell structure creates the potential for regulatory arbitrage resulting in uneven playing fields between NMIs and UMs. The existing regulatory framework allows for 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, NMIs on the other hand may market and sell policies and earn commission, but may not share in the underwriting profits of insurers. This is primarily to protect the interests of policyholders by preventing actual or potential conflicts of interest that would arise if NMIs had a vested interest in the profitability of insurers, which is directly influenced by policy volumes and loss ratios. The distinction in the types of fees and income that may be earned by NMIs 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. The ability of NMIs to be cell owners, thereby earning a profit share, will therefore only be allowed within the limited context of an affinity relationship.

Transformation of the 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 inclusive insurance growth and the transformation of the insurance sector in South Africa. To this end there is a recognition that certain limitations specifically in respect of the ownership of cell structures may be relaxed 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 microinsurer within a defined period of time.

3 SUMMARY OF THE DRAFT CONDUCT STANDARD

3.1 Limitation on who may be a cell owner

In order to address the potential risks to fair customer outcomes inherent in third party cell captive arrangements and to minimize the possibility of regulatory arbitrage as set out above, 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;
- 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.

A tied agent for purposes of third party cell captive arrangements means that an NMI, 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, 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.

What will qualify as an affinity relationship?

A relationship for purposes of the draft Conduct Standard would constitute an affinity relationship if -

- The primary business of the cell owner is not insurance business;
- The broader business relationship between the cell owner and the policyholder results in the offering of suitable insurance products and consistently offers fair value to the policyholder; and
- The conducting of insurance business through the cell structure does not otherwise compromise the delivery of fair outcomes to the policyholder.

The draft Conduct Standard also contains a requirement that the exact nature of the relationship and remuneration arrangements (including profit share) between the cell owner and the insurer must fully be disclosed to the policyholder prior to the inception of any policy, and if and when any of these remuneration arrangements change.

3.2 Exemption to promote transformation of the insurance sector by enabling “incubator” cells to access the insurance market

To facilitate an inclusive insurance market and to promote the transformation of the insurance sector, the draft Conduct Standard provides for an exemption process whereby the cell captive insurer could apply for an exemption from the cell ownership limitations. In assessing an exemption application, the FSCA will consider whether the granting of the exemption will –

- facilitate an incubation process leading to the cell owner becoming a microinsurer or insurer, within a specified time period;
- substantively contribute to the achievement of transformation in the insurance sector (as defined in the Insurance Act);
- not be contrary to the public interest; and
- not compromise the fair treatment of or continuous and satisfactory service to policyholders.

3.3 Reporting requirements

The reporting requirements relating to the notification of any new third party cell arrangements as required in terms of *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 proposed 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 of the proposed arrangement to be entered into or the termination thereof.

4 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

It is envisaged that the draft Conduct Standard will not have an adverse impact on consumer choice, quality of insurance products or the efficiency of insurance provisioning by existing cell structures. 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 act as tied agents of the cell captive insurer. The existence of an affinity relationship is likely to lead to the offering of more appropriate insurance products that offer fair value to policyholders as a result of the cell owner's interest in protecting its broader business relationship with policyholders.

The requirement that an affinity relationship must exist between the main business of the NMI and the insurance business conducted through the cell structure will have an impact on a limited number of existing cell captive structures where an affinity relationship does not currently exist. However it is our view that the benefits to policyholders outweigh the impact on these existing cell captive arrangements. We are of the view that requiring an affinity relationship will ensure that policies that are underwritten in a cell structure could potentially provide a better value proposition (such as cost of premium and extent/suitability of policy benefits) to policyholders compared to what they may be able to secure in the absence of an affinity relationship. Consideration will be given to allow for transitional arrangements to lessen the impact on existing cell structures where an affinity relationship does not exist, if it proves to be necessary.

We recognise that there are instances where a cell structure can be used to allow for new entrants into the insurance market, and in such instances there would not necessarily be an existing affinity relationship between the cell owner and the insurance business intended to be conducted within the cell structure. Cell captive structures are ideally positioned to serve as incubators for new entrants who wish to become fully-fledged microinsurers or insurers and could be an invaluable tool that could be utilised to promote the transformation of the financial sector. Given the imperative instilled by Government to facilitate the transformation of the financial sector and to diversify insurance provisioning, the draft Conduct Standard allows for a specific exemption process from the limitations in the draft Conduct Standard where it can be shown that a proposed cell structure is intended to serve as an incubation hub, within a defined time period, for an emerging insurer.

The FSCA 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 answer the questions set out under Section C of 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 a cell captive insurer is licensed under the Insurance Act, 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.

Affinity relationships will not require pre-approval but will be assessed by the FSCA on a case by case basis through a "file and use" notification process.

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.

The exemption applications provided for in the draft Conduct Standard will be assessed on a case by case basis, according to the criteria set out in section 4 of the draft Conduct Standard.

6 WAY FORWARD

The draft Conduct Standard is published in terms of section 98(2) of the FSRA for a period of 6 weeks for public comment, and comments are due to the FSCA on or before Friday, 31 August 2018. 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 under Section C of the comment template.