

The role of cell captive insurance in the development of the South African microinsurance sector

Terms of Reference

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1. Introduction

The Centre for Financial Regulation and Inclusion (Cenfri) is a non-profit research centre, established in March 2008 with support of the FinMark Trust. Cenfri's mission is to support financial sector development and financial inclusion through facilitating better regulation and market provision of financial services. We do this by conducting research, providing advice and developing capacity building programmes for regulators, market players and other parties operating in the low-income market.

Cenfri was appointed to manage the FinMark Trust's research on microinsurance. Created with initial funding from the UK's Department for International Development, FinMark Trust is an independent trust whose business is controlled by five trustees from countries in Southern Africa. Its mission is summarised in its slogan: "Making financial markets work for the poor". In pursuit of this objective, FinMark Trust supports and promotes institutional and organisational development towards the objective of increasing access to financial services by the un- and under-served of Africa.

This project will be funded by the FinMark Trust and managed by Cenfri on behalf of the FinMark Trust. More information on Cenfri and the FinMark Trust can be found at www.cenfri.org and www.finmark.org.za.

2. Background

Access to insurance is an important strategy for reducing poverty. Inability to manage vulnerability caused by sudden death of a family member, illness, loss of income or property perpetuates poverty. Financial markets – and insurance services in particular – can play an important role in mitigating welfare losses resulting from such risks. Despite the growing importance and rapid expansion of microinsurance (insurance services geared to low-income people), many microinsurance schemes are quite small in coverage, leaving the vast majority of poor people without adequate protection.

The penetration of insurance in the low-income market in South Africa is among the highest in the world, particularly of funeral insurance. More than 30% of all LSM1-5 individuals¹ have some kind of funeral cover, of which more than 50% is from burial societies. Of the rest, about half have a policy through a funeral parlour whereby the funeral service provider also provides insurance as a means of securing clientele². Often, such funeral parlours would self-insure their book without underwriting by a registered insurer, thereby essentially providing insurance "illegally".

In two aspects, the need for *formalisation* therefore exists in the South African insurance market:

¹ The commonly accepted definition of the "low-income" market in the South African financial sector – though it is also recognised that market development and expansion may entail first reaching the "middle market" of LSMs 6-7, before breaking open the lower income market segments. It is also recognised that the poorest of the poor, LSM1-2, are as a rule outside the reach of the insurance market.

² Bester et al, 2008. Making insurance markets work for the poor: microinsurance policy, regulation and supervision. South African Pilot Study. Prepared for the IAIS/CGAP Joint Working Group on Microinsurance as one of five country case studies. Available at: www.cenfri.org

- for large burial societies wishing to formalise their risk pooling into insurance provision beyond the currently limited space under the Friendly Societies Act³; and
- for hitherto self-insuring insurance providers that want to regularise and grow and expand their product offering.

In both cases, such entities may not have the capacity (in terms of minimum upfront capital, operational capabilities, skills, etc) to register as a fully-fledged long-term or short-term insurer under either the Long-term Insurance Act (52 of 1998) or the Short-term Insurance Act (53 of 1998). The same holds for organisations such as microfinance providers, retailers, or affinity groups that want to introduce insurance for the first time as part of the general process of further extending the reach of the insurance market in South Africa.

While partnerships with existing insurers provide a way for such entities to offer insurance products, it is not always an acceptable solution to them. The key advantage that such institutions have is that have large client basis to which they control access. In partnering with insurers they fear being bypassed once the insurer establishes contact with their clients. Recent amendments to insurance legislation entrenches this by insisting that the relationship should be between policyholder and insurer and that the aggregator must disclose relevant contact details of their clients to allow insurers to communicate directly with them. The cell captive route have been seen by aggregators as an attractive route allowing them to maintain more control over the process and their client base and also offering the opportunity for them to benefit from any profits on the risk. The *path to formalisation* provided by the cell captive route may, therefore, attract more players into this market.

In its April 2008 discussion paper titled “The Future of Microinsurance Regulation in South Africa”, National Treasury amongst others considers the need for such a path of formalisation. It suggests the creation of a dedicated microinsurance license, but also posits a number of other options for providing microinsurance⁴. One such option is the **cell captive mechanism**. It is relevant for entities that:

- seek to offer microinsurance and want to share in the profit of the risk management;
- do not have the capacity to register as an insurer in their own right; and
- desire more autonomy in product design and management than under an underwriting arrangement.

What is a cell captive? In the insurance context, a cell captive, also called the “promoter-cell”, is a registered long- or short-term insurer that is registered to sell individual cells (in the form of separate classes of shares) to groups or organisations that then do not need to obtain a license of their own. A cell owner thus in effect buys or “rents” a part of the cell captive’s insurance licence. In this way, the insurance risk is transferred into a cell and is ultimately borne by the insurer. This allows cell owners to sell their own branded products⁵.

³ The Insurance Acts exempt registered Friendly Societies from registration as an insurer as long as they only provide insurance products with benefits of less than R7,500.

⁴ The rest of this section draws heavily on the Discussion Paper and the sources quoted therein.

⁵ The most important application of the cell captive mechanism from the microinsurance point of view is known as “third party cells” (as opposed to 1st party cells). They are used to write “volume business” where insurance is sold to the man on the street, rather than to a corporate (which is the case for 1st party cells). So, for example, a mobile phone company that wants to offer cell phone insurance to its clients could buy into a cell captive to have its own branded insurance. Cell owners can include micro-lenders, furniture retailers, and also burial societies.

The cell captive insurer is responsible for compliance with the provisions of either the Long-term Insurance Act or the Short-term Insurance Act.

The insurer has arrangements in place to ensure that each and every cell is solvent and enters into a shareholder agreement with each cell-owner to notionally ring-fence cells. In the final instance the cell captive insurer is however liable for all prudential risk and other cells may therefore ultimately be affected by losses made in one cell. As part of the shareholder agreement, the cell captive may impose capital requirements on the cell in relation to an assessment of its underlying risk.

How are cell captives regulated? International best-practice in the regulation of cell captives is to define it as a specific type of company in company legislation. Two main types of cell captive legislation have developed: Protected Cell Companies (PCCs) and Incorporated Cell Companies (ICCs). PCC and ICC legislation ring fence individual cells, implying that if one cell should go insolvent, creditors would not be able to lay claim to any assets belonging to other cells. In South Africa, there is however no PCC or ICC regulation. Rather, cell captive insurers are subject to special insurance licensing conditions. So, for example, no cross-subsidisation is allowed across cells and each cell is required to be individually sound.

The FSB is now considering developing specific guidelines for cell captives. This should be regarded against the background of the proposed new regulation on binder agreements introduced by the Insurance Laws Amendment Bill of 2008. As a first step, the FSB has issued an information letter to all short and long-term insurers to request information on cell arrangements.

Opportunities and challenges. The cell captive mechanism holds at least two advantages for the development of the insurance market:

- *It allows provision of insurance while building up skills and capital.* The cell captive mechanism is a way for low-income groups and other entities to offer insurance to their members/clients. It is an alternative to obtaining underwriting that allows entities to build up the capital, scale and skills to potentially become an insurer in their own right. It also allows for formalisation of informal or illegal insurance provision. Examples can include funeral parlours that opt for the cell captive route as the first step to legalise their insurance business, or microfinance institutions that choose the cell captive route in order to offer insurance to their clients.
- *Centralised operations reduce cost and minimum capital required.* Apart from carrying the prudential risk, the cell captive insurer centralises compliance and reporting, as well as pricing and other skills, thereby reducing operational cost and risk for the cell. The individual cell capital holding, which is determined as part of the shareholder's agreement based on internal risk assessment, is much lower than for full insurers.

There are however also a number of challenges, such as:

- *Scale.* Cell captive insurers often require a minimum scale for cells to be viable. This means that small entities may be excluded from buying into a cell captive.
- *Friendly society hurdles.* There are certain investment restrictions under the regulations to the Friendly Societies Act (the legal form of choice for burial societies) that in effect

prevent friendly societies from buying into a cell captive. One of the recommendations from the Discussion Paper was the removal of these restrictions.

- *FAIS (Financial Advisory and Intermediary Services Act)*. The cell captive does not control the cell's agents, yet remains liable for all actions related to policies that it underwrites. This implies that the cell captive is ultimately liable for FAIS digressions by the cell's intermediaries and should have the requisite monitoring system to ensure that FAIS is adhered to.

This begs the question: is the cell captive mechanism an appropriate tool for the development of the insurance market in South Africa? What is its role alongside other options for microinsurance provision? What are the particular opportunities and challenges?

In light of this background, we invite proposals for considering the role of cell captive mechanisms in the development of the South African insurance sector.

3. Project objectives, scope and deliverables

3.1. Objectives

The project has three main objectives:

1. to review the cases where the cell captive mechanism has been used for microinsurance in South Africa: the characteristics, challenges and future opportunities as well as the reasons for choosing the cell captive route over other options;
2. to provide an information base to inform the process of revising the regulation of cell captives in South Africa to ensure that any regulatory reforms accommodate and facilitate their role in the development of the low-income market; and
3. to develop a case study on the use of cell captives in SA that can serve as an input into the international debate.

These objectives serve the broader goals of market development and financial inclusion in the insurance sector in South Africa.

3.2. Scope

The consultancy will cover:

- A review of the utilisation of, performance and risks of cell captives in the South African insurance sector. Specific emphasis will be placed on the potential role of cell captives in market development to serve the lower-income market, and the opportunities and challenges for doing so – both in terms of the policyholders reached and the ability to bring previously self-insuring and other entities into the formal/registered insurance sphere.
- A brief overview of the regulatory challenges facing cell captives, the options for cell captive regulation (no detailed proposals on appropriate regulation however need to be developed) and the factors that regulators should take into account in considering this market.

This will require:

- **Desktop research** to better understand the cell captive mechanism and its application in the South African insurance sector. The consultants can draw on international best practice and examples, but no in depth international review is required.
- **Consultations with cell captive insurers** and, if relevant, cell owners to build case studies. Specific issues to investigate regarding the use of the cell captive mechanism for microinsurance include:
 - What affinity it is that defines the group/client base (e.g. is it a burial society, funeral parlour, MFI, other group, etc)
 - The functions of respectively the cell captive insurer, the cell owner and any intermediary/administrator, the relationship between the parties and the remuneration arrangements.
 - To what extent the insurer has access to the records and information of the cell owner.
 - The particular risks that are introduced in third party cells.
 - What other, similar arrangements (outside of the cell captive mechanism) are being or could be employed in the microinsurance space.
- **Consultations with the National Treasury and especially the FSB⁶** to discuss current regulation and future plans.

Note that, as this is a fairly small project, consultants will not be required to embark on a detailed scoping study. Rather, existing information should be pulled together, informed by a few core discussions and more in depth thinking regarding the structure of regulation.

3.3. Deliverables

1. A concise draft report should be submitted to Cenfri for comment by **mid January 2010**. Cenfri will then provide comments before the end of January.
2. The report should cover at least the following topics:
 - a. Case studies of use of cell captives in the low-income market, highlighting the opportunities and challenges to the effective and enhanced use of the cell captive mechanism in the development of the South African insurance market.
 - b. Current regulatory framework for cell captives, the proposed changes (or the likely direction that will be taken) and the implications thereof for the role that cells can play in the low-income market.
3. A final publishable report addressing comments on the draft report should be submitted to Cenfri by **mid-February 2010**.
4. A Powerpoint presentation of the results to be presented at either a FinMark Forum or a stakeholder or regulator's workshop. This will most likely take place towards the end of

⁶ Individuals at the FSB to consult include Ms Jacky Huma (Head: Compliance), Mr Billy Clarke (Senior Insurance Specialist) and Ms Melonie van Zyl (Insurance Specialist).

February/early March 2010. The consultant will not be required to organise the workshop.

The consultants will be required to take part in progress teleconferences with Cenfri from time to time to provide feedback on progress made and to allow for inputs and guidance.

4. Contents of proposal

These TORs do not seek to provide a definitive list of issues to be covered as this will be pre-empting the outcomes of the project. We strongly encourage consultants to propose other issues or different frameworks which they believe essential to meet the core objective of the study. The evaluation process will reward originality and the substance of approach suggested. Individual consultants or consulting firms may submit proposals.

Proposals to undertake this project must include:

1. Statement of qualifications of firm(s)
2. Name & CV of staff members responsible (i) for overseeing the work; (ii) for undertaking the work.
3. The key issues that consultants think should be covered. This should be based on the issues highlighted above, but should ideally expand on them or highlight other issues to be considered.
4. The methodology to be followed.
5. Fee proposal & costs estimate, indicating the basis of calculation of fees.
6. Affirmative action scorecard.

5. Budget and proposal timeline

Budget. We foresee an indicative project budget of R150,000 (VAT *inclusive*). Consultants are encouraged to tailor the scope and required analysis to work within this budget.

Proposal deadline. Proposals to undertake this work should be received by close of business on **12 October 2009**. Proposals should be forwarded electronically to Christine Hougaard at christine@cenfri.org, copied to tessa@cenfri.org.

Commencement of project. It is envisaged that the project will be awarded by 20 October 2009, with work commencing as soon as possible thereafter.

6. Basis of award

Cenfri will award the contract according to FinMark Trust procedures, based on:

Indicator	Weight
Relevant, demonstrated competence of firm/consultant in this area	25%
Demonstrated expertise of key individuals to be involved in this project	30%
Content, quality and originality of proposal	20%

Affirmative action scorecard: ownership, management, staff development <i>Note:</i> FinMark and Cenfri take the need for affirmative action seriously and reserve the right to compel the researcher to address this component in one form or other. We would of course wish to ensure that any arrangement works for all and would be flexible in agreeing the structure.	10%
Fee basis	15%

7. Contact

Questions or comments in respect of these terms of reference should be submitted to Christine Hougaard (christine@cenfri.org or 084 548 8296 up to 1 October 2009, thereafter on +255 78 499 5438).

8. Recommended reading

FSB, 2009. Information Letter 3/2009 (LT & ST). Available at: www.fsb.co.za.

National Treasury, 2008. Discussion Paper: The future of microinsurance regulation in South Africa. Report prepared by Genesis Analytics. Available at:

<http://www.treasury.gov.za/public%20comments/The%20Future%20of%20Microinsurance%20Regulation%20in%20South%20Africa.pdf>

Republic of South Africa, 2008. Insurance Laws Amendment Bill. Available at:

<http://www.treasury.gov.za/legislation/bills/2008/Default.aspx>

An understanding of the FinMark “Making financial markets work for the poor” approach, including the emphasis on financial inclusion, will be required. See, for example:

Porteous, D., 2004. *Making Financial Markets Work for the Poor*. Available at: <http://www.finmarktrust.org.za>.