



**The Role of Cell Captive Insurance  
in the  
Development of the South African Microinsurance Sector**

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**Report prepared for FinMark Trust by: Alchemy Consulting**

Derek Pead

Lynn Witten

assisted by Paul Zondagh & Pierre Reineck

## Foreword

The FinMark Trust commissioned Alchemy Consulting to conduct a review of the cell captive mechanism and the potential role that it could play to support the development of the microinsurance market in South Africa. The study aims to catalyse further discussion on this issue and set out with two main objectives:

- to review the cell captive landscape in South Africa, specifically where cell captives have been used in the lower-end of the market; and, in doing so
- to provide an information base to inform the possible future regulation of cell captives in South Africa.

Microinsurance is one of the focus areas of FinMark Trust and over the last 10 years, FinMark has commissioned various studies to better understand the opportunities and challenges for microinsurance in the SADC region. Building on some of the earlier research by FinMark, the South African National Treasury in 2008 published a discussion paper on the future of microinsurance regulation in South Africa. A revised version of this paper is expected later in 2010. In the 2008 discussion paper, the regulators noted that a dedicated microinsurance license will not be the only option for providing insurance to the low-income market and that not all organisations who wish to provide microinsurance would be able to meet the registration and compliance bar for acting as underwriters in their own right.

One of the alternative arrangements that could facilitate the provision of insurance in the low-income market is the *cell captive mechanism*. At first glance, the cell captive vehicle seems attractive as it may encourage new entrants and particularly client aggregators to enter into the insurance space without having to deal with the full burden of regulation. The picture is however not as simple as it would appear at first glance. In practice, the cell captive mechanism faces a number of challenges in the lower-income market. There is also currently no dedicated cell captive regulation in South Africa. This, according to many, creates certain risks and uncertainties in the market. It is therefore essential to build a better understanding of the realities of the cell captive market and how it is regulated in order to consider the role that it may play in the future microinsurance regulatory framework.

We trust that this document will prove informative and will stimulate debate on this matter.

Doubell Chamberlain

Managing director: The Centre for Financial Regulation and Inclusion ([www.cenfri.org](http://www.cenfri.org))

Insurance theme manager: FinMark Trust

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## **1 Introduction**

This study was commissioned by FinMark Trust to investigate the cell captive landscape in South Africa and the potential that cell captives may have in promoting insurance inclusion, through extending the reach of the microinsurance market.

### **1.1 Relevance of the study**

Access to insurance is an important strategy for reducing poverty. The cell captive insurance vehicle may be a convenient vehicle for providing insurance related services to the lower income market. It may also be a stepping stone for new entities wishing to enter the insurance market with the eventual goal of becoming a fully fledged insurer.

As such the object of this report is:

- to set out the cell captive insurance mechanism currently used in the long and short term insurance industry in South Africa;
- to report on how cell captives are being used for the provision of low cost insurance solutions to the low-income market;
- to identify both risks and opportunities for the future use of cell captives in the South African insurance landscape;
- to review the need for cell captive regulation and to serve as an information base to inform regulation.

### **1.2 Approach followed**

In executing the study and preparing this report, the following approach was followed:

- A review of existing literature relevant to the use of cell captive insurance in South Africa and abroad;
- A number of interviews with a broad spectrum of parties involved in the cell captive insurance industry (see list of meetings in Annex A).

One of the difficulties encountered with the interviews was that, although people were willing to speak to us about cell captive related matters, this was done on the strict understanding / request that confidentiality be maintained. Consequently it is not possible to provide information other than in broad or anonymous terms. We would like to express our sincere appreciation to all who co-operated with the preparation of this report.

### **1.3 Structure of the remainder of this report**

The remainder of this report is structured as follows:

Section 2	A general overview of cell captives
Section 3	A brief analysis of current use of cell captives
Section 4	Considering the regulatory environment
Section 5	The current use and challenges of cell captives specifically for microinsurance
Section 6	Conclusions on the future of cell captives in the provision of microinsurance

## 2 A cell captive overview

### 2.1 Basic definitions

A “**cell captive**” is an insurance vehicle created by an insurance company (referred to as the “**cell provider**” or “**promoter**”) whereby its insurance license is extended for use by another organisation (referred to as the “**cell owner**”) for the insurance of the organisation’s own assets (in which case it is referred to as a “**1<sup>st</sup> party cell**”) or the assets and/or lives of its customers or members (in which case it is referred to as a “**3<sup>rd</sup> party cell**”).

### 2.2 Types of cell captives

Expanding on the brief definitions above<sup>1</sup>:

- “**Promoter cell**” is defined by the South African non-bank financial services supervisory authority, the Financial Services Board (“**FSB**”), as representing the following in respect of the insurance company itself (i.e. the cell provider) and will exclude all these items belonging to the first or third party cell owners:
  - Issued share capital including share premium account;
  - Non-distributable reserves;
  - Distributable reserves;
  - Policy liabilities;
  - Current liabilities;
  - Capital Adequacy Requirements; and,
  - All assets covering the above.
- “**1<sup>st</sup> party cell**”
  - **FSB definition:** A cell where the shares issued to cell owners provide the cell owners with the ability to underwrite their own risk and that of their subsidiaries. The cell owner is responsible for the funding of the cell and the cell should be maintained at such levels as may be required to ensure that the required solvency is maintained at all times. Claims are limited to funds available in the cell after providing for solvency;
  - An example would be a company wishing to insure its own fleet of cars, doing so through a first party cell in order to share in the underwriting profit from its own insurance;

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<sup>1</sup> FSB definitions taken from their published *Guidance Manual for the completion of the five-year business plan projections*.

- An important distinguishing factor is that claims in 1<sup>st</sup> party cells are limited to the funds available in the cell captive.
- “3<sup>rd</sup> party cell”
  - **FSB definition:** A cell where the shares issued to cell owners provide the cell owners with the ability to underwrite the risks of third parties. The source of the business underwritten is usually from a captured client base.
  - An example would be a retailer chain that provides branded insurance products to its clients as part of a cell captive arrangement.
  - The difference between a third party and a first party cell is that claims instituted by third parties are not limited to the funds provided by the cell participant, after providing for solvency. The funds provided by the promoters of the cell insurance facility will also be utilised to settle claims, should the cell participant fail to provide additional funds to settle any claims;
  - An important distinguishing factor with 1<sup>st</sup> party cells is thus that claims in 3<sup>rd</sup> party cell are not necessarily limited to the funds available in the cell captive.

### 2.3 The practical operation of a cell captive

In simplified, practical terms, a cell captive operates as follows:

- At the outset the cell provider will assess the business that the cell owner envisages to write in the cell captive and based thereon will advise the level of capital that the cell owner needs to contribute initially in order to establish the solvency of the cell captive;
- Once in operation the profits (or losses) made within the cell captive will be accumulated to (or deducted from) the capital that has been contributed by the cell owner initially;
- The cell provider will continue to assess the level of capital required to ensure the ongoing solvency of the cell captive;
  - If the accumulated capital is more than the required level the cell owner will be allowed to extract up to the full difference (i.e. receive the insurance profits); or
  - If the accumulated capital is less than the required level the cell owner will be required to contribute further capital in order to re-establish the solvency of the cell captive.

### 2.4 The contractual operation of a cell captive

#### 2.4.1 Governed by a shareholders' agreement

In South Africa the contractual relationship that underpins the simplified, practical operation set out above usually takes the form of a shareholders' agreement through which a special class of preference share is issued to the cell owner. The contents of these agreements vary amongst cell providers and are quite

complex, but, according to the cell captives consulted, essentially govern operational issues, the sharing of profits and the sharing of risks.

#### 2.4.2 Sharing of profits

The preference share agreement provides for the cell owner to benefit from any profits made in its cell captive through preferential dividend payments (i.e. profit rights preferential to the ordinary shareholders of the cell provider, but only relating to the profits made in the relevant cell captive).

#### 2.4.3 Sharing of risks

##### 2.4.3.1 *1st party cells*

As set out in section 2.2 above the claims in a 1<sup>st</sup> party cell are limited to the funds available in the cell captive. As such the risks in the cell are ring-fenced and cannot adversely affect other cells or the cell provider.

##### 2.4.3.2 *3<sup>rd</sup> party cells*

Unlike the case in some other jurisdictions, cell captives in South Africa are not set up as separate legal entities. The result is that 3<sup>rd</sup> party cells only afford a partial ring-fencing of risks, with the cell provider that remains ultimately liable for the risks underwritten in the cell. The cell structure allows for the following sharing of risks between the cell provider and the cell owner:

1. If losses are made in the cell captive, it is firstly funded by the capital which the cell owner provided and which is held within the cell captive;
2. If the capital within the cell captive is insufficient the cell owner will be liable to cover the residual liability;
3. If the cell owner cannot do so the cell provider has to carry the risk, with corresponding impact on its own capital. If the cell provider's capital is not sufficient to cover the liability it may become insolvent itself, bringing down with it all the other cells as well.

## 2.5 **Structure variations**

Two relevant variations of the cell captive structure include the “rent-a-captive” and “mutual cell” structures:

- A “**rent-a-captive**” is a cell captive where the cell owner does not capitalise the cell (or only provides part of the required capital). Instead, the cell provider capitalises the cell (or the balance thereof) and in return for this receives a fee and/or a portion of the underwriting profits.
- A “**mutual cell**” (also referred to as a “**group captive**” in international literature) is a cell captive that is set up jointly by a number of participants who wish to insure similar risks, e.g. a group of funeral

parlours (who might otherwise be completely independent from each other) wishing to provide funeral insurance. As such this variation would intuitively appeal to participants who may individually be too small to set up their own independent cells<sup>2</sup>. Research shows that the term is neither widely used nor a standard term in the cell captive industry.<sup>3</sup> As set out in *ANNEX C – Definition and role of mutual cell captives* – a mutual cell provides participants with the benefits of risk sharing and the pooling of risk management resources and expertise. This should theoretically minimise the cost of insurance over the longer term, but its establishment would depend on the following requirements to be met in order to ensure a successful long-term partnership:

- Participants must have a common need for guaranteed and flexible coverage with attractive terms and pricing over the longer term; and,
- Participants must have the desire and the ability to control the insurance programme.

Internationally mutual cells are most commonly found in the oil, petroleum, energy, cell phone, mining, medical care provision and telecommunications industries. In South Africa, mutual cells are mainly used by tertiary education institutions and municipalities.

- In the international literature there is also mention of the following additional structure variations:
  - An “**agency captive**“ is a cell captive owned by an insurance agency or brokerage firm so they may reinsure a portion of their clients risks through that company (this is not allowed in South Africa, see section 4.1 below);
  - An “**association captive**” is a cell captive owned by a trade, industry or service group for the benefit of its members (i.e. a specific example of a mutual captive); and,
  - A “**single parent captive**” is a cell captive formed primarily to insure the risks of the cell owner’s non-insurance parent or affiliates.

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<sup>2</sup> <http://www.insurancegateway.co.za/10.8.45.Irn=1928> – article published by Green Grapes Communications, expressing the view of Centriq Insurance Company.

<sup>3</sup> The term is not used in the Cell Captive Hand Book 2009.

## 2.6 Why cell captives?

In essence cell captives allow easier and cheaper access to the insurance industry than what would be the case if a cell owner applied for an insurance license outright. The main areas where cell captives enable easier and cheaper access are the following:

- Expertise (executive and non-executive) and resources:
  - In terms of the guidelines for registration as a long-term or short-term insurer under the Long-Term Insurance Act or the Short-Term Insurance Act<sup>4</sup>, the FSB shall not grant an application if the applicant does not have the financial resources, organisation or management that is necessary and adequate for the carrying on of insurance business;
  - Specifically the FSB requires an insurer to be headed up by an executive team and governed by a Board of Directors with relevant insurance, legal, accounting and management experience and the necessary resources;
  - *In the case of a cell captive all these requirements are met by the cell provider.*
- Minimum capital requirements:
  - The FSB has set minimum levels for the capital of an insurer (R5m in the case of a short-term insurer and R10m in the case of a long-term insurer);
  - Even if an applicant for an insurance license envisages a very small operation, it would need to provide the above minimum levels of capital;
  - *A cell provider will typically only require the cell owner to provide the level of capital required in its view to establish the solvency of the operation (i.e. without reference to the FSB's minimum levels that apply to an insurance license).*
- Regulatory compliance:
  - *The cell provider will be responsible to the FSB for all regulatory compliance aspects (e.g. quarterly and annual reporting) and will also do so in respect of business written in the cell captive. The cell owner therefore does not need to have the required compliance and reporting functions in-house.*

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<sup>4</sup> The two acts, both passed in 1998, that govern the provision of insurance in South Africa.

### 3 Current use of cell captives in South Africa

#### 3.1 Size of the cell captive market<sup>5</sup>

As at 31/03/2009 there were seven local long-term insurers that offered cell captives and eleven short-term insurers doing same. Information on the total number of individual active cells is more dated. As at end 2007 the number of active short-term cells was 182. The number of active long-term cells is unknown, as the information is not explicitly requested in the statutory returns.

#### 3.2 Current drivers for the use of cell captives

From the interviews conducted, it seems that cells are currently being used for the following main purposes (in alphabetical order):

- Group schemes:<sup>6</sup> In both the long term and short term insurance industries cell captives are used to provide financial benefits that the cell owners [sometimes incorrectly] perceive not to be available under normal group scheme arrangements between a client and the underwriter; i.e. branding, profit sharing and funeral insurance schemes;
- Niche product needs: Cell captives are frequently used to provide niche 1<sup>st</sup> or 3<sup>rd</sup> party insurance products that would not be readily available in the insurance market;
- Pooling of experience and sharing of costs: Mutual captives are used by tertiary institutions and municipalities in a united approach to risk management, pooling their experience and sharing of costs associated with the cell captive mechanism; and,
- Profit sharing: Cell captives are seen as an alternative mechanism to participate in the underwriting profits of insured risks. By establishing a cell captive, either the 1<sup>st</sup> or 3<sup>rd</sup> party participants or cell shareholders can share in the underwriting profits generated by the insurance policy (this point being a subset of the “Group Schemes” point above).

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<sup>5</sup> Source: Cell Company Handbook 09.

<sup>6</sup> Group schemes are arrangements whereby a defined group secures insurance cover with a registered insurer for its members, e.g. a church group for its members or a retailer for its customers; underwriting is on a group basis and premiums are typically collected in bulk by the insurer (i.e. from the church or the retailer in our example).

### **3.3 A current example<sup>7</sup>**

A current example of a cell captive that is focussed on a particular need is “BMW Insurance”, the product that has been specifically developed for BMW Financial Services (South Africa) to offer insurance to BMW owners through a cell captive provided by Guardrisk.

The offering was tailored to meet the particular needs of BMW and its customers and through the cell captive structure, BMW has more say/can make more direct inputs into product design than under a pure underwriting arrangement. In addition, BMW enjoys the branding benefits and if BMW owners have a better claims experience than the average South African motorist they (the BMW owners) would benefit from lower insurance premiums.

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<sup>7</sup> BMW Financial Services (South Africa) Pty Ltd v Harding and another [2007] 4 All SA 716 (C).

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## 4 Regulatory environment

### 4.1 Internationally

Cell captives are available in many jurisdictions, both onshore and offshore (for example, segregated account companies in Bermuda<sup>8</sup> and protected cell companies in Guernsey<sup>9</sup>).

Although legislation differs in the different jurisdictions, the basic premise is the same across domiciles: assets and liabilities of one cell are legally separated from assets and liabilities of any other cell, i.e. if one cell should go insolvent then creditors would not be able to lay claim to assets belonging to other cells. Often, these principles are embedded in company legislation rather than in insurance legislation directly.

Two types of cell captives are found in company legislation internationally:

- Protected Cell Companies (PCCs) (refer Annex E) which are found in a number of countries; and,
- Incorporated Cell Companies (ICCs), a new form of cell captive currently only found in Gibraltar and Jersey. It differs from a PCC in that in an ICC each cell is a separate legal entity (as opposed to asset & liability demarcation only).

### 4.2 In South Africa

#### 4.2.1 Reliance on shareholder agreements

There is no special regulatory dispensation for cell captives in South Africa<sup>10</sup>. Rather, cell captives are being regulated by the FSB only through specific license conditions for those insurers who wish to be cell providers. In the absence of any specific legislative or regulatory provision, various organisations have attempted to achieve through ‘shareholder agreements’ what specific cell captive regulation would be doing. It needs to be noted though that, as set out in *ANNEX D – An article on the role of cell captives in South Africa*, there is no uniform agreement as to the effectiveness of these shareholder agreements in achieving the desired effect. The following specific challenges are worth noting<sup>11</sup>:

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<sup>8</sup> **Total number of cell companies:** 271  
**Total number of individual active cells:** Not disclosed  
Source: Cell Company Handbook 09.

<sup>9</sup> **Total number of cell companies:** 72 PCCs & ICCs  
**Total number of individual active cells:** 344 PCC & ICC Cells  
Source: Cell Company Handbook 09.

<sup>10</sup> The Future of Micro-insurance Regulation in South Africa; National Treasury Discussion Paper; April 2008.

<sup>11</sup> Drawing directly on an article by Bowman Gilfillian attorneys (Jooste & Tucker, 2006), set out in Annex D.

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- The legal, financial and operational relationships between cell owners and cell providers are often complex and *should* vary greatly from cell to cell, but do not, as providers try to standardize their provision of cell captives. The end result is that these agreements are not always sufficiently adapted to suit the specific needs of the situation and are thus often either void for vagueness or for uncertainty.
  - The cell owner often assumes a high level involvement in the day-to-day business of the cell. This is problematic if the functions that the cell owner performs falls within definition of an “intermediary” (or even in some cases, that of a short-term or long-term insurer) for the purposes of South African insurance legislation. As will be explained in Section 4.2.2 below, an independent intermediary is not allowed to be a cell owner under South African insurance regulation.
  - Despite industry claims that cells are “distinct, watertight and ring fenced legal and accounting entities”, cells could technically be viewed as internal administrative and accounting concepts only and, as such, do not have separate legal personality. An example of a consequence hereof is that the creditor of a cell captive might be able to look to the assets of any of the other cells offered by the same cell provider or the assets of the cell provider itself (given the technical lack of legal separation).

#### 4.2.2 Insurance regulation

Some of the specific requirements by the FSB include the following<sup>12</sup> (in alphabetical order):

- Dividends from a long-term insurance cell: The total amount of dividends paid to all shareholders may not be contrary to section 29 of the Long-term insurance Act, 1998 (i.e. payment of dividends may not compromise the solvency of the insurer and must be approved by the Statutory Actuary);
- Financial soundness and ring-fencing issues:
  - Each individual cell should be financially sound, with no cross-subsidisation allowed between cells or back to the cell provider. This means that excess capital in a cell may not be included in the total assets of the cell provider and neither may it be used to offset claims in another cell (except when [a] the relevant cell owners provide written consent for such inter-cell transfer or when [b] catastrophic claims in a specific 3<sup>rd</sup> party cell causes the cell provider to go insolvent as set out in 2.4.3 above, thus leading to insolvency for the other cells also offered by the same cell provider);
  - The benefits provided by a 3<sup>rd</sup> party cell cannot be limited to the capital available within the cell or the financial position of the cell owner, i.e. if adverse claims lead to a situation where the cell

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<sup>12</sup> The requirements apply equally to long-term and short-term insurance conducted via a cell captive.

owner is required to contribute additional capital in order to meet claims, but cannot do so, the cell provider is liable to meet such claims; and,

- The way in which risks are shared between the cell provider and the cell owner must be explicitly covered in the shareholder agreement between them.
- Limitation in respect of independent intermediaries: No shares may be issued, whether directly or indirectly, to any independent intermediary (as defined in the regulations under the Long-term Insurance Act, 1998) or its associates through cells, except for the purpose of providing cover for such intermediary's own risk (corporate self-insurance) in that cell;
- No mixing of cell types: 1<sup>st</sup> party and 3<sup>rd</sup> party business may not be conducted in the same cell;
- Restrictions relating to the capital of a cell captive: The capital of a cell captive may not be invested in the business of the cell owner (including its subsidiaries and associates), unless the cell owner is a company quoted on the JSE and then only within prescribed limits, and neither may it be used to make a loan to the cell owner (including its subsidiaries and associates);
- Termination of a 3<sup>rd</sup> party cell's shareholder agreement: If the shareholder agreement between a cell provider and the owner of a 3<sup>rd</sup> party cell is terminated, the contractual obligations under the existing policies in the cell have to be met by the cell provider (including terms, conditions and price); and
- Valuation issues: The same actuarial assumptions must be used to value each cell's business, provided that the statutory actuary may take account of the experience of each cell when determining the basis for each cell.

#### 4.2.3 Case law

In a recent court case<sup>13</sup> the Registrar of Short-Term Insurance reiterated some of the requirements covered in section 4.2.2 above, indicating that when insurance is conducted by means of a cell captive arrangement:

- It must be made clear to the insured that the insurance is underwritten by the cell provider; and,
- The Registrar considers the cell provider to be ultimately responsible for the payment of claims (i.e. claims must be paid, irrespective of default by a cell owner or non-performance of a re-insurer with whom the risk might be reinsured).

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<sup>13</sup> BMW Financial Services (South Africa) Pty Ltd v Harding and another [2007] 4 All SA 716 (C).

#### 4.2.4 Financial Advisory and Intermediary Services Act (FAIS)

The Financial Advisory and Intermediary Services Act 2002 (Act No. 37 of 2002) was enacted on 15 November 2002. Its objective is to ensure that any person (natural or juristic) rendering financial services does so professionally, and to ensure that the consumer is protected against mis-selling of financial products and inappropriate advice.

Under the provisions of FAIS:

- The cell owner will need to be registered as a financial service provider; and,
- Sales staff must comply with the fit and proper requirements as set out in the FAIS framework.

We note the conflicting position between FAIS (requiring all cell owners to register as financial service providers as they are deemed to provide intermediary services) and the Long-Term Insurance Act (whereby an independent intermediary may not be a cell owner).

### 4.3 **Future solvency regime**

#### 4.3.1 Background

The FSB is in the process of developing a new solvency regime for the South African long-term and short-term insurance industries to be in line with international standards. The basis of the new Solvency Assessment and Management (“**SAM**”) Regime will be the principles of the Solvency II directive as adopted by the European Parliament for implementation by 2012. South African implementation is envisaged shortly thereafter.

Like Solvency II, SAM will introduce a comprehensive risk management framework for defining the required level of capital of an insurer, and will require the implementation of procedures to identify, measure, and manage risk levels.

#### 4.3.2 Application to cell captives

The European Captive Insurance and Reinsurance Owner’s Association (“**ECIROA**”) recently entered into talks with the members of the Captive Insurance Companies Association (“**CICA**”) about a joint lobbying effort on behalf of captives<sup>14</sup> over concerns that the regulatory and compliance burdens on cell captives may be disproportionately large under Solvency II. The primary outcome might be that captives have to increase their capital considerably, even though most underwrite relatively straightforward risks.

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<sup>14</sup> <http://www.captivereview.com/news/572812/eciroa-in-talks-with-cica-on-solvency-ii.shtml>.

Similar concerns may arise locally as details around the proposed SAM Regime unfold over the coming months (see section 6.2.3 below).

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## 5 The use of cell captives in the microinsurance sector

In this section we reflect on the main experience and perception items that came to light during the interviews which we conducted with cell providers (section 5.1) and cell owners (section 5.2 below).

### 5.1 Cell provider experience and perceptions

#### 5.1.1 The lack of specific regulation is a problem<sup>15</sup>

- “The lack of regulation creates a grey space and some players are certainly pushing the limits on the compliance front”;
- “I know some would disagree, but in our view compliance with FAIS and FICA<sup>16</sup> rests with the cell owner, not with us”;
- “On the one hand we don’t have specific current legislation governing cell captives and on the other the regulator has not yet indicated when a draft on cell captive legislation would become available, if at all. This creates uncertainty in the market”;
- “We just hope that if and when regulation comes, it doesn’t add to the cost of compliance”.

#### 5.1.2 Cell captives are not currently used extensively to conduct microinsurance

- “While we have had numerous enquiries from funeral parlours about the use of cell captives, only a few have come to fruition”;
- “We have no cell owners in the lower end of the market yet”;
- “We have only one cell owner left in the lower end of the market and that cell is in the process of winding up because it was not financially viable”...“we see business opportunity on the short term insurance side of the business”;

#### 5.1.3 Where there is current microinsurance activity, it tends to be funeral cover and credit protection

- “We mostly see interest from micro-lenders who want to participate in underwriting profits by becoming cell owners of credit life cells, or funeral parlours wanting access to more sophisticated risk management techniques”;
- “We mainly provide cell captives to burial societies and undertakers”... “The size of our cells varies between three thousand and fifty thousand members”.

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<sup>15</sup> Comments relating to cell captives generally and not limited to those that conduct microinsurance only.

<sup>16</sup> South African money laundering legislation.

#### 5.1.4 A number of potential microinsurance initiatives are too small to be viable

- “Many microinsurance groups are too small to reach the scale necessary”;
- “The cost of regulatory compliance is such that a small cell is simply not financially viable”;
- “We only enter into discussions if expected business exceeds R20m over the first five years of the business plan<sup>17</sup> ... smaller than that and it’s not financially viable for any of the stakeholders ... they should rather go the route of a group scheme”.

#### 5.1.5 It is challenging to get new microinsurance cells active

##### 5.1.5.1 *Entrants are not always aware of the regulatory rigour*

- “To ensure compliance, we set onerous requirements for the cell owners. In some cases that puts them off”;

##### 5.1.5.2 *Entrants require business case assistance*

- “More often than not we have to provide substantial assistance to the prospective cell owner to formulate and formalise their business case”.

##### 5.1.5.3 *The lead time to getting a cell active is about a year*

- “It takes up to 12 months to get a cell operational”.

#### 5.1.6 Active microinsurance cells often face a number of challenges

##### 5.1.6.1 *Unavailability of data*

- “A lack of correct administration data is a common problem”;
- “Restricted availability of data [relating to the insured lives] poses huge challenges to successfully run a cell captive in this market segment”.

##### 5.1.6.2 *Inadequate administration systems & personnel*

- “Often the cell owners simply do not have sufficiently robust administration systems and procedures”;
- “We see many cases where there is a dire lack of suitably trained administrative people”;

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<sup>17</sup> A minimum requirement of R20m premium income per annum to be attained within 5 years was mentioned in more than one interview.

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- “Although this is a growth sector, it is not attracting skilled people at an adequate rate”.

#### 5.1.6.3 *Poor administration resulting in poor pricing*

- “Poor admin results in poor claims history impacting on our ability to price correctly”.

#### 5.1.6.4 *Collection of premiums*

- “Collecting premiums from burial societies and undertakers is a challenge”;
- “We are faced with non-payment of premiums, lack of proper record keeping and inadequate systems to determine the correct premium due”;
- “If premiums are collected without formal receipts it is of great concern from an underwriting point of view as it means that we have no guarantee of who paid premiums”
- “Sometimes the premium collector see the premiums as his income”;
- “The challenges of premium collection in the burial society and funeral parlour market certainly discourage cell providers from this segment”.

#### 5.1.6.5 *Compliance management poses challenges*

- “In this segment it is often more difficult to ensure compliance and exercise control of policyholder protection because you are, by definition, removed from the ultimate policyholder and you often have – insurance wise - an inexperienced party in between”.

## 5.2 **Cell provider experience and perceptions**

It is not only cell providers that perceive the cell captive mechanism as less than optimal for the low-income end of the insurance market. As the following sub-sections illustrate, current and potential microinsurance cell owners also emphasise a number challenges:

### 5.2.1 It is complex to decide between cell providers

- “The different cell providers have vastly different pricing structures, making it difficult to understand which offers the best price proposition”.

### 5.2.2 Time consuming negotiations are required to set up a cell

- “This initiative has taken 3 years to develop due to the negotiations between key stakeholders”<sup>18</sup>.

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<sup>18</sup> Comment made by a large church group that provides insurance to its members through a cell captive.

5.2.3 Availability of capital is a challenge

- “It is a challenge to raise capital, if you don’t want to use their [the cell provider’s] capital”.

5.2.4 Life assurance companies should be incentivised to enter this segment

- “The life insurers should be incentivised to support and grow cell captives in the emerging sector”;
- “They spend a lot on training us and our support staff and should be able to claim some of that under their skills levy”.

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## 6 The future of cell captives in the provision of microinsurance

### 6.1 Introduction

In National Treasury's discussion paper on the provision and regulation of microinsurance in SA, cell captives are highlighted as one of the avenues to explore when it comes to the provision of quality low-cost insurance products to low-income consumers in the country. The goal of the discussion paper is set out as:

*“To develop a coherent and clear regulatory framework that will encourage and facilitate the provision and distribution of good value, low-cost products that are appropriate to the needs of low-income consumers by a variety of market players, who must treat their policyholders fairly and manage the risks of providing insurance.”*<sup>19</sup>

Cell captives are put forth as one of the potential vehicles for achieving this goal. As set out in the earlier sections it seems, though, there are a number of challenges to unlocking the cell captive mechanism in the low-income market. As set out below, there are a number of factors to consider in order to realize the potential that cell captives may have for the mass facilitation of microinsurance in future.

### 6.2 Regulatory issues

#### 6.2.1 Statutory recognition and regulation<sup>20</sup>

Given the growing number and popularity of cell captives in South Africa, statutory recognition and regulation of the cell captive concept is required. Legislation should provide for legal separation between the cells of each cell captive and should recognise each cell as having a separate legal personality. By reference to the international examples, changes to the Companies Act would likely be required to achieve this.

#### 6.2.2 Grey compliance areas

There seems to be differences of interpretation between market participants with regards to FAIS and FICA in the context of cell captives. The Regulator could consider clarifying these.

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<sup>19</sup> The Future of Micro-insurance Regulation in South Africa; National Treasury Discussion Paper; April 2008 Treasury document page vi.

<sup>20</sup> Relating to cell captives generally and not limited to the provision of microinsurance only.

### 6.2.3 Future solvency regime must consider the impact on cell captives

The currently envisaged European implementation of Solvency II has led to concerns that cell captives might be faced with disproportionately large regulatory and compliance burdens. Locally, the FSB's SAM project would need to carefully consider how to deal with cell captives.

## **6.3 Cell owner issues**

### 6.3.1 Roles and responsibilities

There is a perception among industry participants that prospective cell owners often have little or no understanding that cell captive insurance is a sophisticated insurance tool that needs a wide variety of skills to manage properly. Newcomers need to know that insurance experience, management expertise, data and administrative systems are vitally important for the successful management of a cell captive.

### 6.3.2 Use of mutual cells

It seems that a number of prospective cell opportunities are just not of suitable size to be financially viable. There might be need for a market mechanism where similar ventures are grouped together so they can jointly form a mutual cell. The regulatory and practical implications of doing so should be investigated further.

## 7 ANNEX A – Interviews Conducted

	<u>Interviewee</u>	<u>Company</u>	<u>Interview date</u>
1.	Jeremy Leach	Divisional Director Group Business Development, Hollard Group	23 November 2009
	Frans Prinsloo	Head of New Business Group Business Development, Hollard Group	23 November 2009
2.	Michael Blain	Chief Executive Centriq Insurance Company Limited	23 November 2009, 16 January 2010
	Trust Mdiya	Centriq Insurance Company Limited	1 February 2010
3.	John Solomon	Head of Compliance Sanlam Sky Solutions Sanlam Ltd	23 November 2009
4.	Herman Schoeman	Managing Director Guardrisk Insurance Company Ltd	24 November 2009
	Neil Pather	Executive Volume & Facilities, Guardrisk Insurance Company Ltd	24 November 2009, 28 January 2010
	Kobus Jordaan	Manager Volume & Facilities, Guardrisk Insurance Company Ltd	24 November 2009
	Portia Mogototoane	Guardrisk Insurance Company Ltd	8 February 2010
5.	Melonie van Zyl	Insurance Specialist	25 November 2009

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<u>Interviewee</u>	<u>Company</u>	<u>Interview date</u>
	Financial Services Board	
Jackie Huma	Head Insurance Compliance Financial Services Board	25 November 2009
Billy Clark	Senior Insurance Specialist Financial Services Board	25 November 2009
6. Katherine Gibson	Director Financial Services National Treasury of South Africa	25 November 2009
7. Rob Duggan	Executive General Manager Retail Metropolitan Life	30 November 2009
Peet Venter	Metropolitan Life	30 November 2009
Gabrie Cilliers	Metropolitan Life	30 November 2009
Donavan Daniels	Metropolitan Life	30 November 2009
8. Chris McCallum	Director ZestLife	7 December 2009
Ralph Richardson	Managing Director ZestLife	7 December 2009
9. Paul Zondagh	True South Actuaries and Consultants	4 December 2009
10. Marius Botha	Consulting Actuary Old Mutual Alternative Risk Transfer	23 February 2010
11. Rose De la Harpe	Prometheus Consulting	3 February 2010



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## 9 ANNEX C – Definition and role of mutual cell captives

In an article dated 2004, Guardrisk on their website<sup>21</sup> comment as follows;

Mutual captive insurance companies are captives or cell captives formed by a group of companies, normally within the same industry. But, while this form of insurance makes good business sense, it also requires companies to be able to set aside petty competitive issues and focus on their common risk profile and the benefits to be gained by sharing risk and pooling their risk management resources and expertise.

The main difference between a mutual captive and a conventional insurer is that the former provides long-term benefits to its members by means of premium subsidisation, expanded coverage and eventual dividend declarations as a result of risk sharing; while the latter simply focuses on increasing shareholder wealth over the short to medium term.

Quite simply, mutuals are cost effective and flexible insurance vehicles for companies that operate within the same business environment, which is often perceived as more risky than it really is by the insurance market. The players within a specific industry understand the risks and exposures within that industry - whether insured or uninsured - far better than any conventional cell captive or traditional insurer ever can.

Some good reasons to join a mutual are: common purpose or need; guaranteed and flexible coverage; attractive terms and pricing - it is not always the cheapest, but the mutual is in the business to provide long-term stable solutions to its members; control of the insurance programme; and, long-term partnership – insurance is not treated as a commodity, but rather focuses on building capacity and expertise.

Despite the highly competitive nature of today's business world, like it or not, companies operating within a specific industry share the same primary and systemic risks in the course of their normal operations. It is a perfect fit to also share these risks within the insurance and risk financing environment, pooling the risk and insuring within a mutual. Thus they share resources and expertise without giving away intellectual capital or their competitive edge.

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<sup>21</sup> <http://www.guardrisk.co.za/pages/109>.

Mutuals are not suitable for all industries and some industries are more suited to this concept than others. This includes the oil, petroleum, energy, cell phone, mining, medical care provision and telecommunications industries.

Instead of five separate industry players maintaining five separate insurance and risk financing programmes, and being subject to the management costs a number of separate insurance vehicles, mutuals pool their resources and harness bulk buying power for reinsurance.

In South Africa this concept has worked well for tertiary institutions and municipalities and many other industry sectors would be well advised to look in this direction too.

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## 10 ANNEX D – An article on the role of cell captives in South Africa

By Hamish Jooste and Claire Tucker

Bowman Gilfillian

10 July 2006

This is a fairly recent trend in South Africa, and while the legal framework in South Africa does not specifically cater for these structures, it is capable of supporting most of them.

The legal, financial and operational relationships between cell owners and cell captives are usually set out in a “shareholders agreement” (although, legally speaking, this agreement cannot be classified as, nor treated as, a shareholders agreement at all). These relationships are often complex and *should* vary greatly from cell to cell in accordance with the risk profile of the cell owners. However, a closer examination of the manner in which the cell captive concept is often implemented shows that choice is often not the outcome of this relationship.

Captive companies often create templates of shareholder agreements with a broad scope, attempting to cater, in this way, for the choice the insured party requires, rather than tailoring each agreement to the specific needs of the insured party. Ironically, the end result is that these agreements are not sufficiently adapted to suit the specific needs of the insured party. We have found that, from a legal perspective, large portions of these shareholders agreements are often either void for vagueness or for uncertainty.

Cell captives have a multitude of cell owners, and their articles of association apply to all owners. The articles of association often attempt to standardize the cells by stipulating standard terms and conditions which govern each cell. This prevents cell owners whose circumstances are different from the mold contemplated by the drafter from tailoring their cell to maximize returns.

The cell owner often assumes a high level involvement in the day-to-day business of the cell. This role can bring the cell owner within the definition of an “intermediary” (or even in some cases, that of a short-term or long-term insurer) for the purposes of South Africa insurance legislation. Many cell owners are not aware of this, nor of the restrictions (such as limitations on remuneration) which

the law imposes on intermediaries. Furthermore all intermediaries are required to be registered with the Financial Services Board.

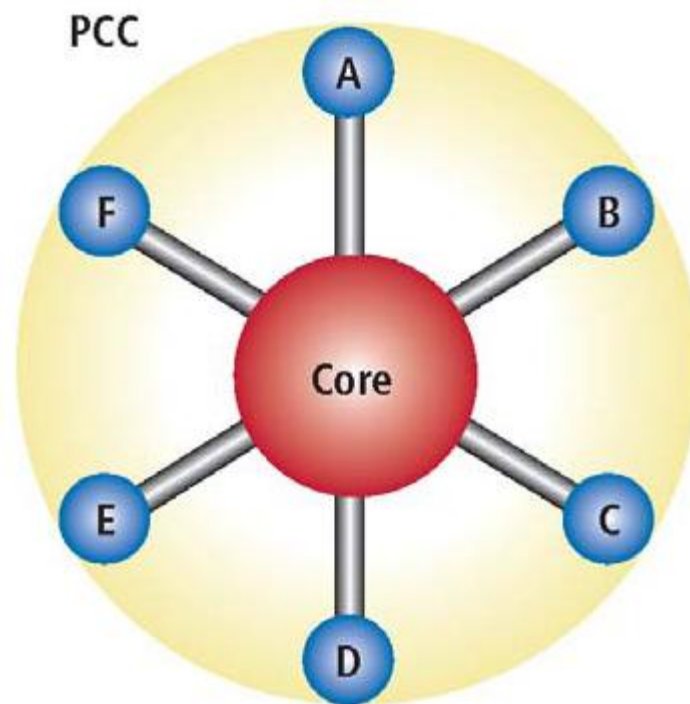
Despite industry claims that cells are “distinct, watertight and ring fenced legal and accounting entities”, cells are internal administrative and accounting concepts only and, as such, cells do not have separate legal personality. A creditor of a cell captive company can look to the assets of all of the cells within the company, because there is no legal separation between the company and the cells. The cell and the funds contained within may be lost if that the cell captive is wound up by a non-cell creditor of the cell captive.

Given the growing number and popularity of cell captives in South Africa, statutory recognition and regulation of the cell captive concept is urgently required. Legislation should provide for a firewall between the cells of each cell captive and should recognise each cell as having a separate legal personality. It should also cater for the income tax relief which should flow from this separation.

## 11 ANNEX E – Overview of Protected Cell Companies (PCC)

A Protected Cell Company (PCC) can be defined as<sup>22</sup>:

*A corporation whose patrimony is composed of assets contained in structurally separate parts named "cells" [cellular assets], which are legally and functionally separate, distinct and independent among each other, and of assets not constituting "cells" [non-cellular assets], also structurally and legally independent, that has as main legal characteristic the fact that the portion of capital designated to a specific cell is neither liable for the general obligations, commitments or liabilities of the corporation nor for the specific liabilities of the other cells.*



<sup>22</sup> This discussion draws directly on: <http://www.business-podium.com/boards/firmengruendung-offshore/80-protected-cell-companies-grundlagen-aufbau-nutzen-vorteile.html>.

The main characteristics of a protected cell company are as follows:

- Legal entity: The protected cell company has its own juridical personality, thus is capable of owning rights and assuming obligations on its. The "cells", although being a separate individual patrimonies, do not constitute separate entities themselves;
- "Cellular" patrimony: the patrimony of the entity is divided into different "protected cells", which allows segregation of risks, thus enabling ring-fencing among the distinct cells and the core patrimony;
- "Core" patrimony: a portion of the protected cell company's patrimony is composed of general assets ("non-cellular" assets), which are separate and distinct from each of the assets composing the protected cells, creating what is commonly known as the "core cell ";
- Segregation of assets and liabilities: the specific assets allocated to each cell may only be liable for liabilities incurred by such cell and should not be attached by creditors of the company's other cells. The liabilities unrelated to a specific cell are covered by the non-cellular assets or the core cell.