Third-party cell captives as an enabler for transformation in the insurance sector

Stakeholder workshop

23 May 2018, Johannesburg

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@cenfri_org #cellcaptives

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About us

- Independent think tank
- Inclusive insurance work in SA and globally
- Catalyse dialogue through research
  - Focus on the issues and trends, rather than legal technical details
  - Balanced view

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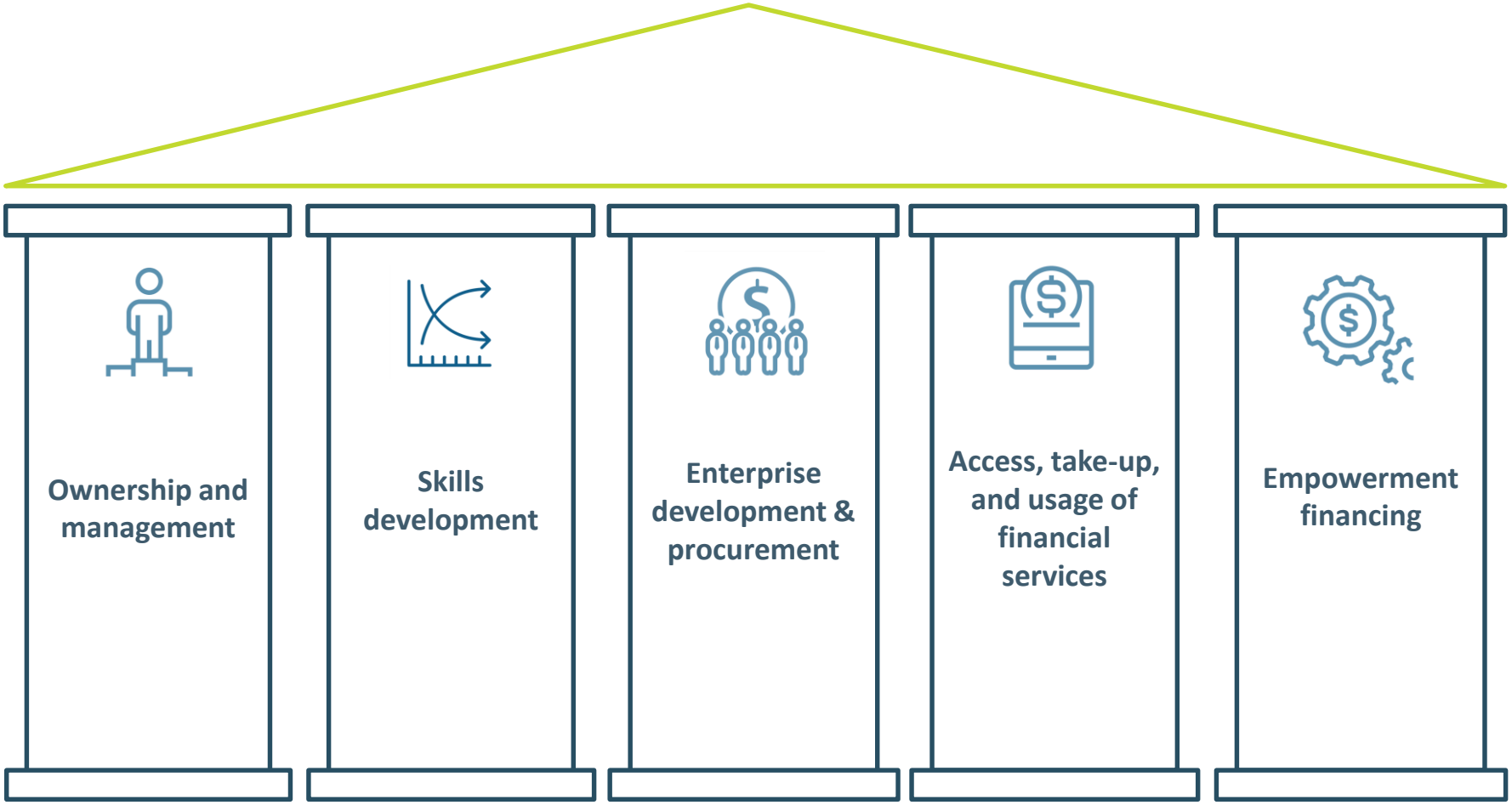
Why this study?

Transformation is about more than just ownership



Who is involved? Who do they serve? How do they operate?

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 Source: National Treasury (2017), Insurance Act 18 (2017)

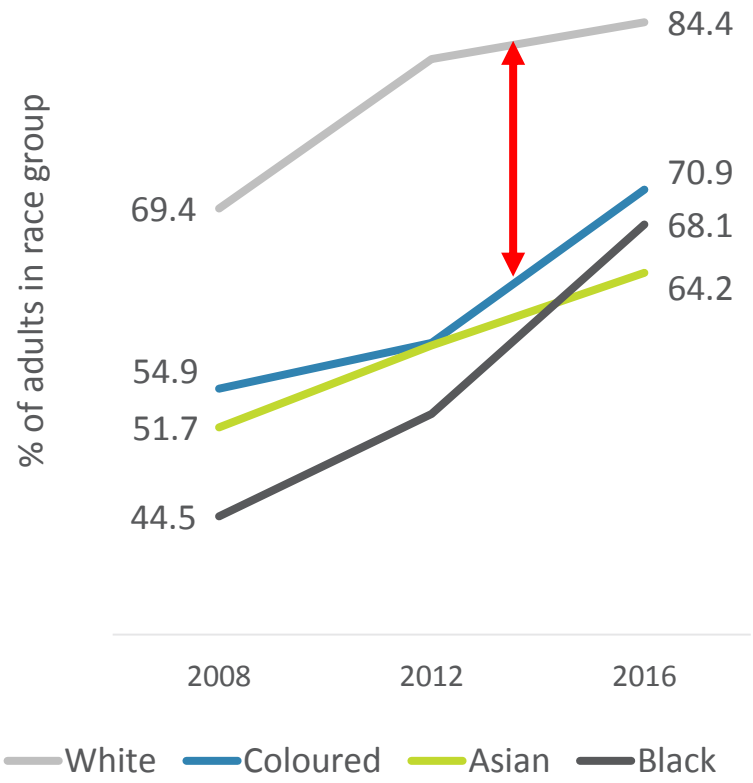
Why this study?

Insurance transformation progress

FSC Actual relative to target

	Life offices	Short-term insurers
Black ownership	↑	↓
Management control	↓	↓
Access to financial services	↓	↓
Skills development	↑	↑
Procurement	↑	↑

Insurance uptake across population groups



 Source: ASISA (2017), SAIA (2017), Finscope South Africa (2008, 2012, 2016)

Towards a new compact

Progress… but more needs to be done

- Insurance Act ups the ante
- 2018 Financial Sector Summit
- ***Role for 3rd party cell captives?***
  - As part of bigger picture
  - Benefits?
  - Issues?

What are the issues?

Regulatory changes introduced further to 2013 Discussion Paper proposals

Licensing:

- Dedicated licence, 1st and 3rd party split
- No more similar arrangements

Governance and operational requirements:

- Licensing conditions to be amended
- Prescribing provisions in SPAs

Market conduct :

- Enhanced disclosure
- Restrictions on “white labelling”
- Insurer accountable for market conduct

Reporting at cell level:

- Info request 5/2016

Prudential:

- Insurer accountable for soundness
- MCR R1m per cell, no “rent-a-cell”

What are the issues?

Remaining regulatory questions

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Who may be a cell owner?

What products may affinity cells provide?

Is R1m feasible *upfront* for all cells and how may a cell be capitalised?

About the study

Study objectives:

- Framework
- Transformation role
- Dialogue

Method

- Desktop research and regulatory review
- >30 interviews

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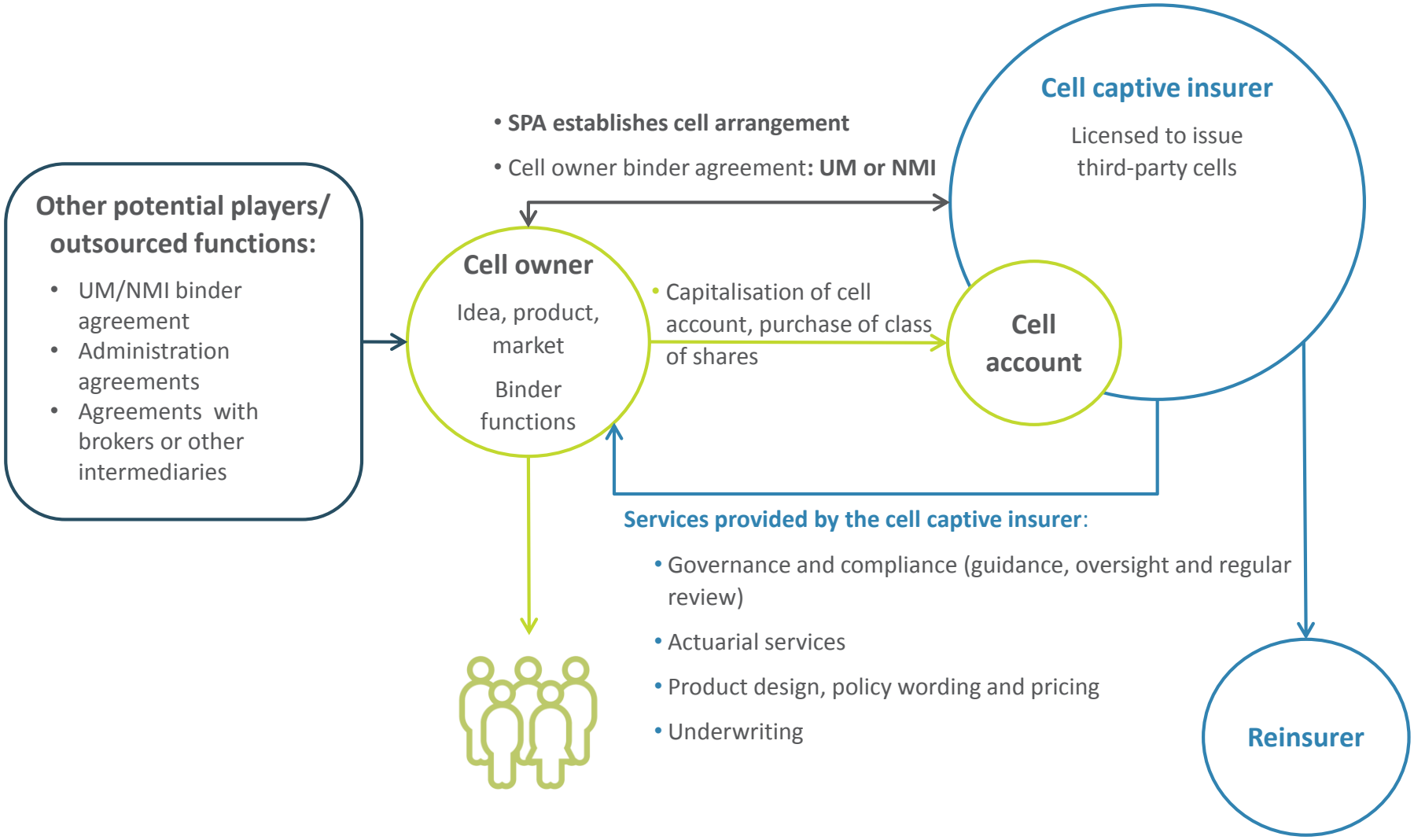
Presentation outline

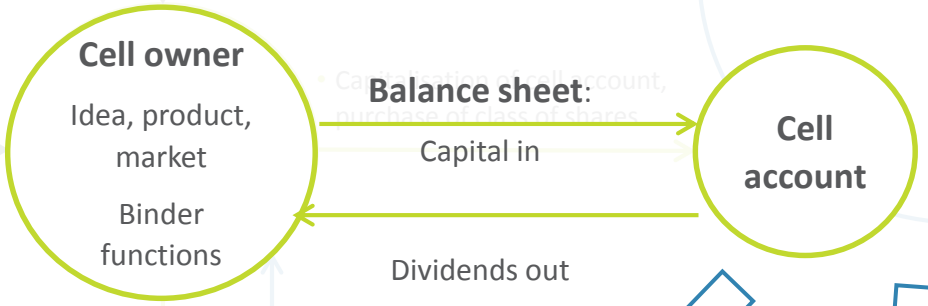
- The cell captive structure
- The cell captive landscape
- Why go the cell route?
- Are cell captives a vehicle for transformation?
- How to unlock the true transformation potential?

The cell captive structure

What is a cell captive and how does it operate?



What is a cell captive and how does it operate?



Income statement: possible outflows

- Administration fees payable to TPA
- Binder fees payable to binder holders
- Reinsurance premiums paid to reinsurer
- Claims paid to customers
- Management fees paid to cell captive insurer
- Where binder holder is UM – can be paid profit share in terms of binder agreement

Income statement: possible inflows

- Premiums from policyholders received via administrator/binder holder/intermediaries
- Reinsurance payments received from reinsurer
- Investment income earned on capital investment

What is required to be a cell owner

Capital & other requirements

Cell Owner Capital Required	Cell Captive Insurer Requirements
Minimum Statutory Capital: R1m – must be own capital	**Due diligence**: Legal entity structure; financials; risk management – governance & compliance
Solvency Capital: Determined by insurer – only 15% of insurer's own solvency capital may be taken into account (draft prudential standards)	**Value proposition**: Idea/product/market; cost; expected claims ratio
Operational capital: For start-up add additional infrastructure/operational capital – from interviews conducted this could range from a minimum R5m – R6m	**Distribution method :** Insurtech/social media/call centre/intermediaries Operational requirements : IT infrastructure; automation; value chain service providers

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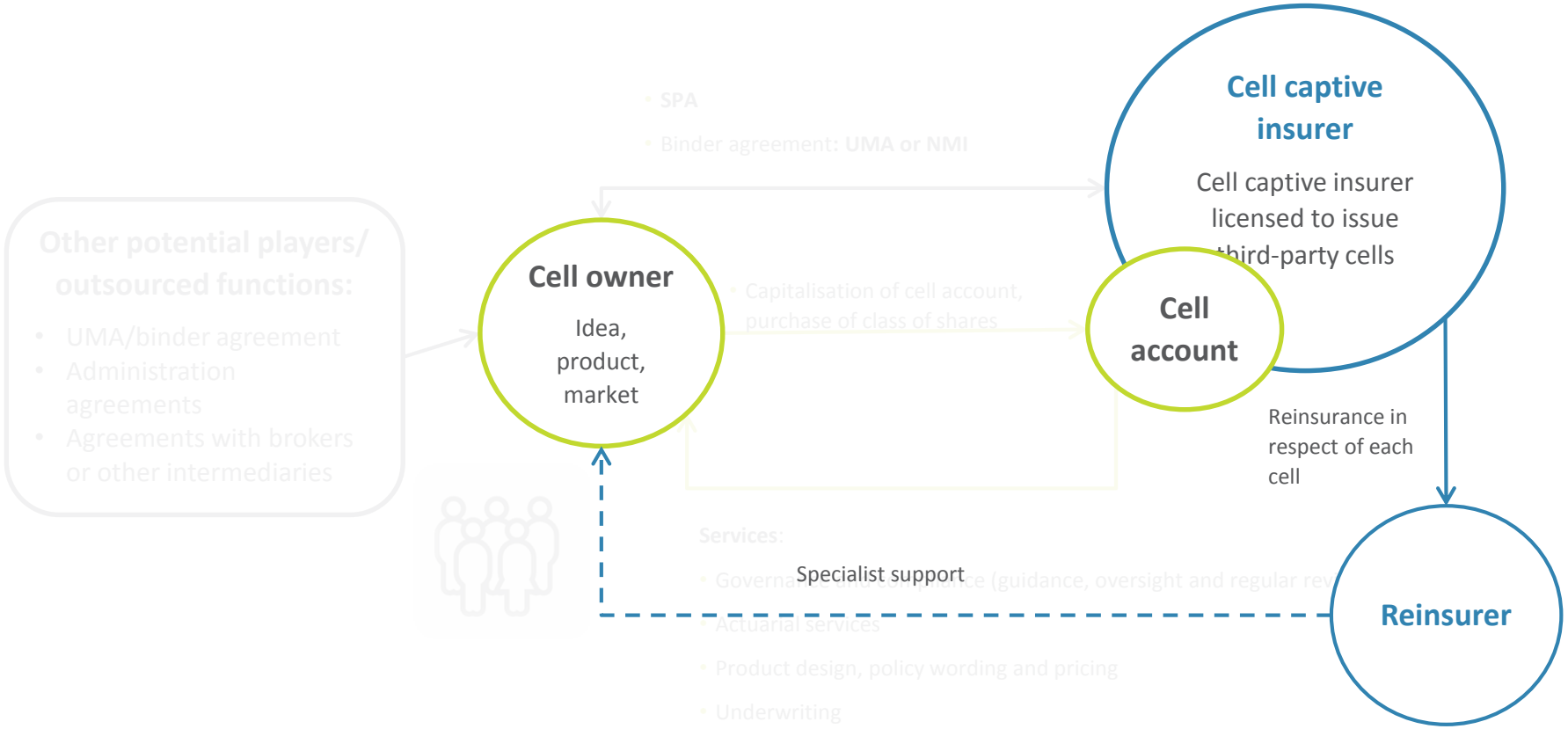
The role of reinsurers in the cell environment

Reinsurers a “market maker” and strategic player in the cell environment



The financing of the cell business venture

Sources of risk and operational capital

Risk capital

1. Cell owner's own capital ("skin in the game")
2. Allowance by cell insurers to build capital over time: "rent-a-cell"

Operational capital

1. Cell owner's own capital
2. Equity stake in cell owner provided to service provider partner or another
3. Obtain venture capital: Insurer and/or reinsurer investment company arms, also more general venture capital companies

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The cell captive landscape

The cell captive landscape

The cell provider landscape

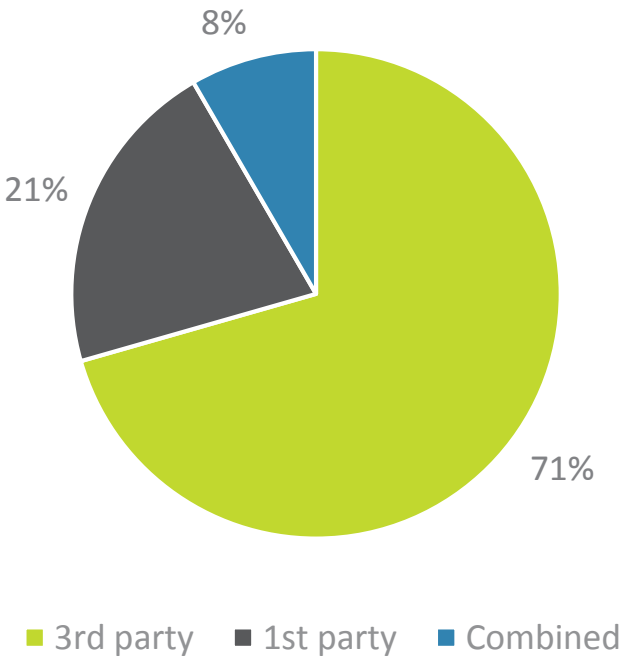
Long-term insurers	Short-term insurers
1. Absa Life Limited	1. Unitrans insurance Limited
2. AIG Life South Africa Limited	2. Centriq Insurance Company Limited
3. Bryte Life Company Limited (exiting)	3. Guardrisk Insurance Company Limited
4. Centriq Life Insurance Company Limited	4. Old Mutual Insure (previously Mutual & Federal Risk Financing Ltd)
5. Guardrisk Life Limited	5. Regent Insurance Company Limited
6. Momentum Ability Limited	
7. Old Mutual Alternative Risk Transfer Limited	
8. Regent Life Assurance Company Limited	

The cell captive landscape

Number and types of cells

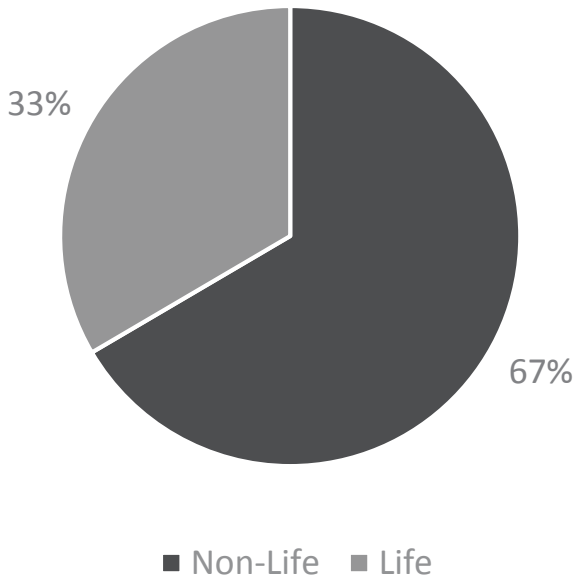
Largest cell captive insurers: 1st vs. 3rd party

n ≈ 300



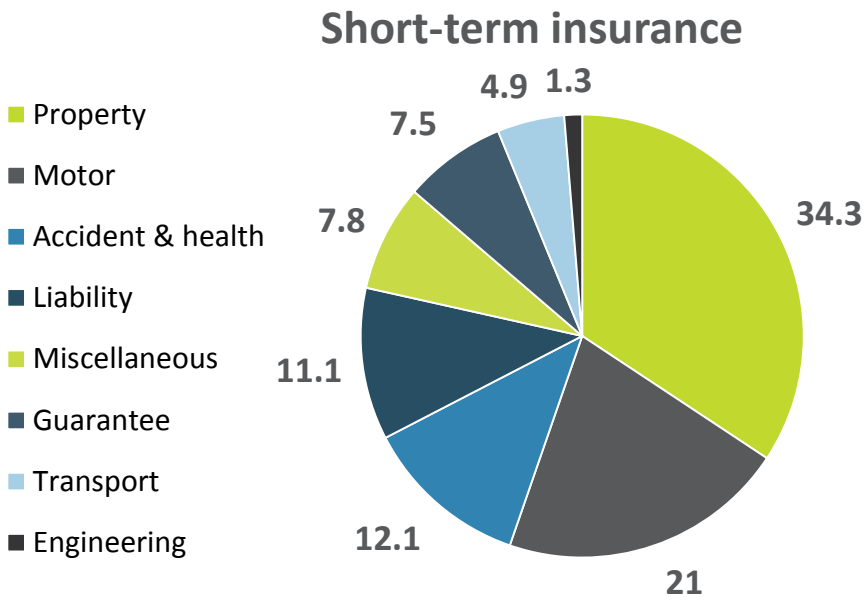
Largest cell captive insurers: LT vs. ST

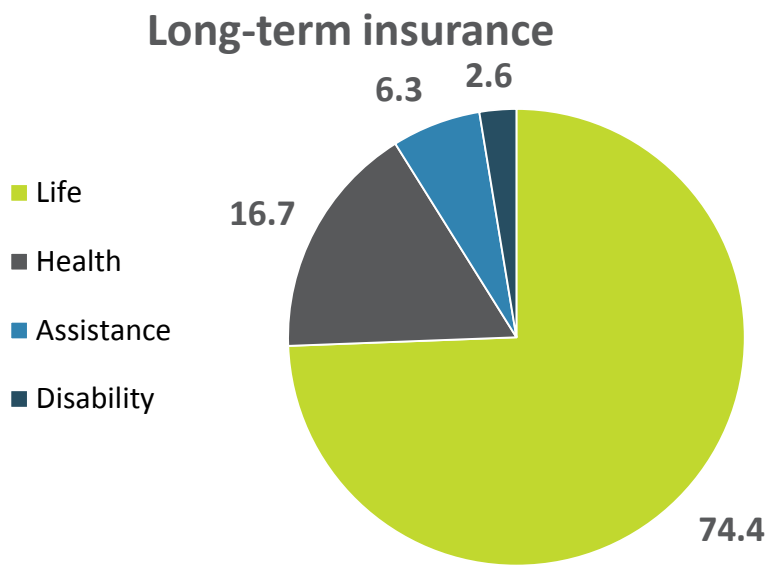
n ≈ 300



The cell captive landscape

Products provided



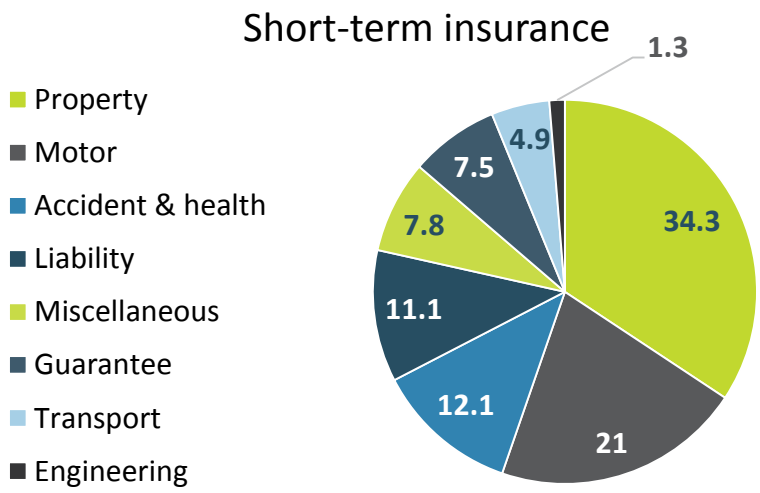


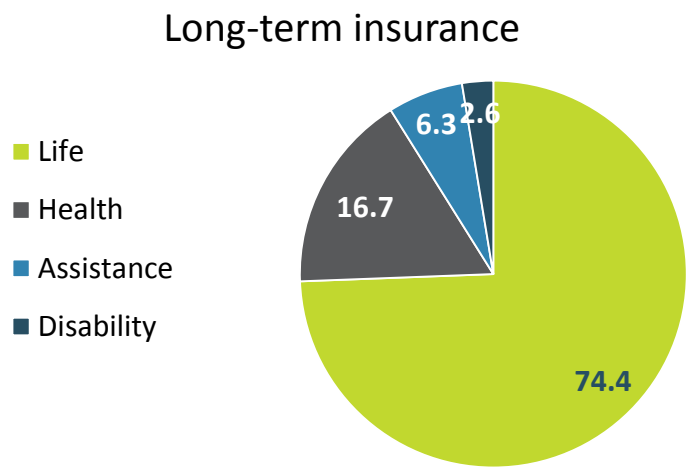
The cell captive landscape

Products provided

From interviews, following main product types identified:

- **Funeral** (individual, assistance business or life)
- **Credit life**
- Life cover packaged as **dread disease** only covering cancer
- **Funeral sold as group schemes** – sold to retailers, churches and undertakers (life policy)
- **Corporate asset/short-term insurance:** Engineering, aviation, renewable energy





The cell captive landscape: cell arrangement categories

Four main types

	Underwriting Manager cell (UM)	Affinity cell (NMI)	Non-Mandated Intermediary (NMI) cell	Silent Partner cell
Cell owner is binder holder	✓	✓	✓	x
Cell owner is underwriting manager	✓	x	x	x
Cell owner is non mandated intermediary (NMI)	x	✓	✓	x
Affinity relationship with clients	x	✓	x	x

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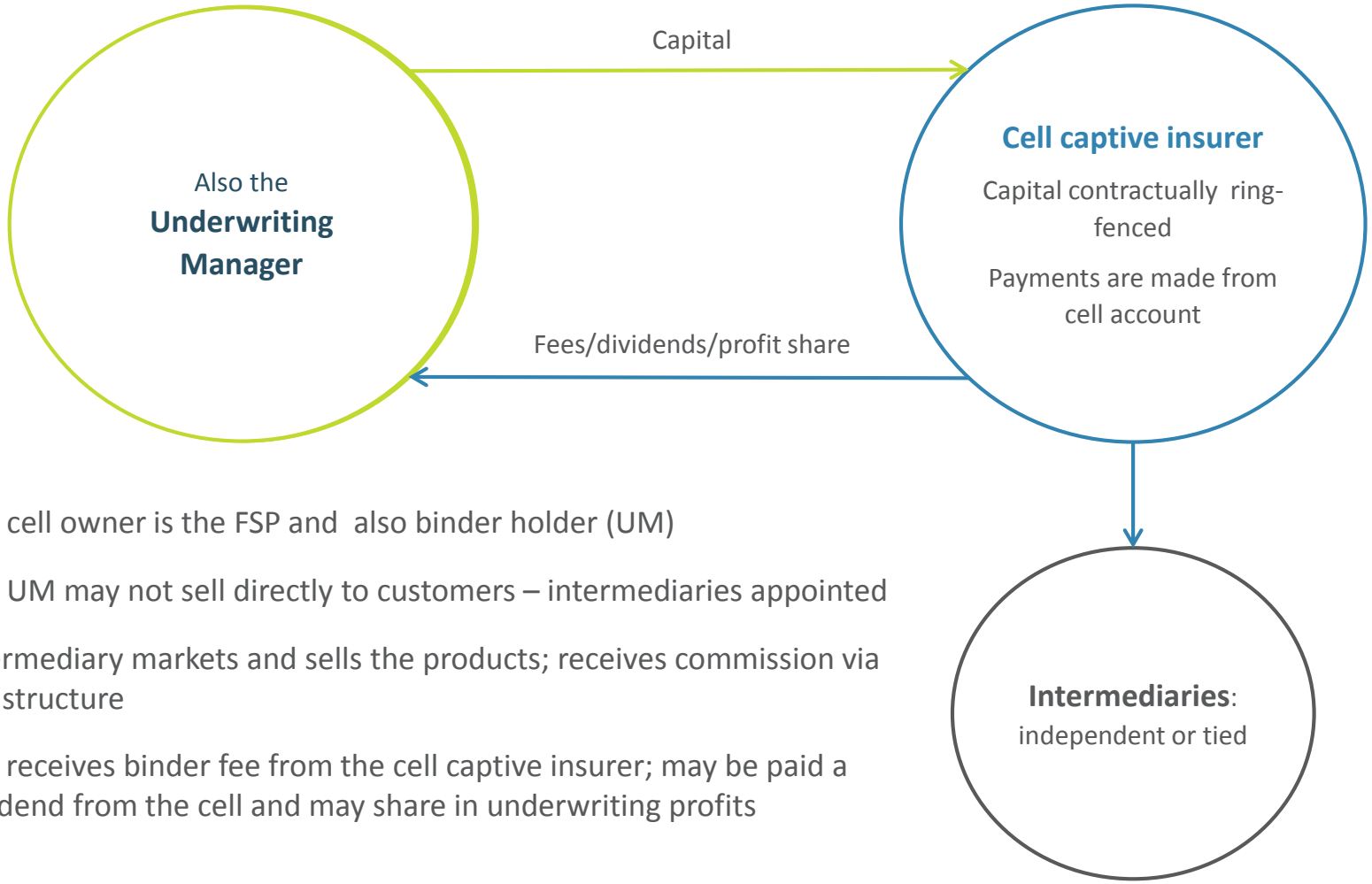
The cell captive landscape: types of cell structures

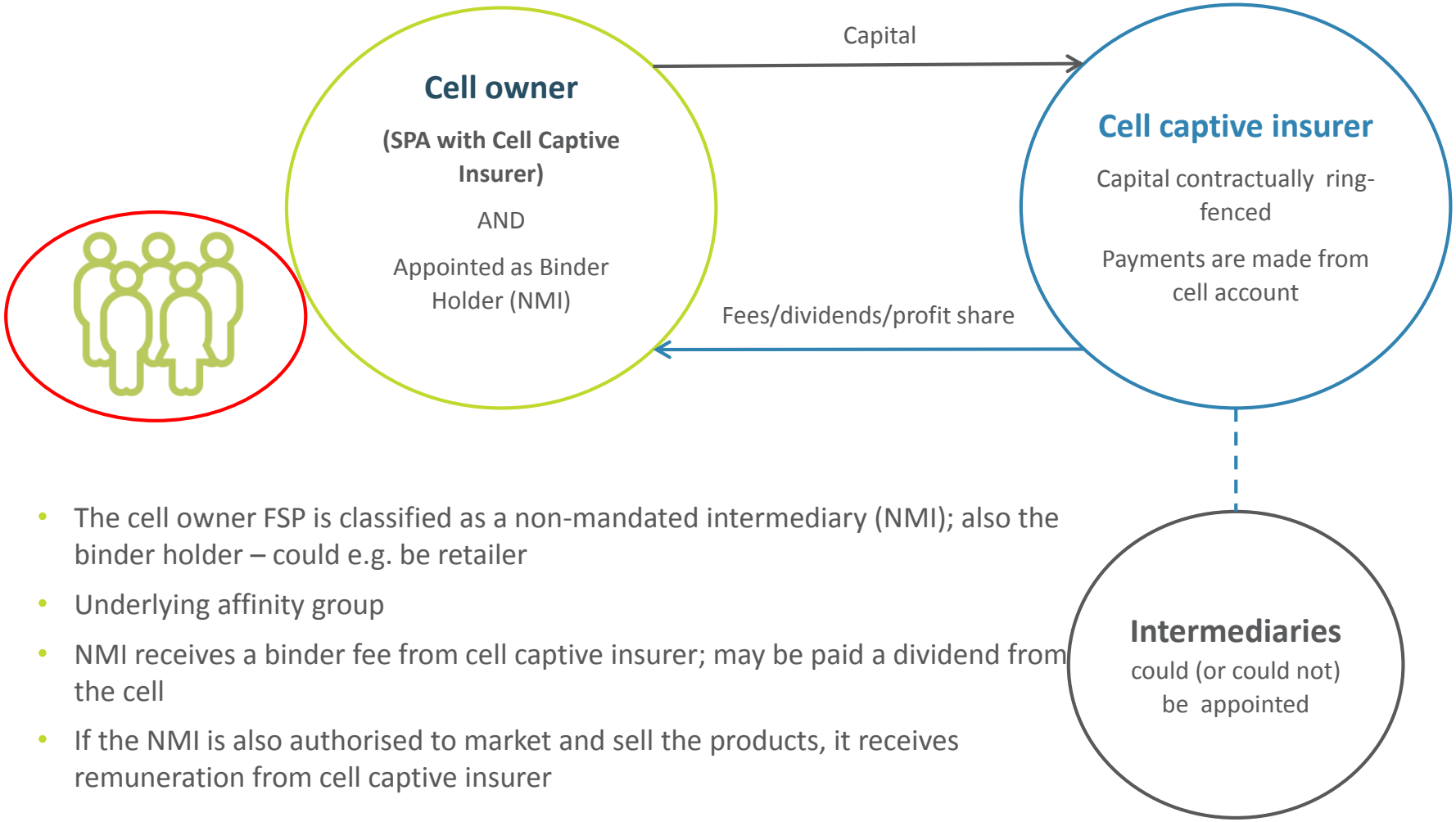
Type A: The cell owner as **underwriting manager (UM)**



- The cell owner is the FSP and also binder holder (UM)
- The UM may not sell directly to customers – intermediaries appointed
- Intermediary markets and sells the products; receives commission via cell structure
- UM receives binder fee from the cell captive insurer; may be paid a dividend from the cell and may share in underwriting profits

The cell captive landscape: types of cell structures

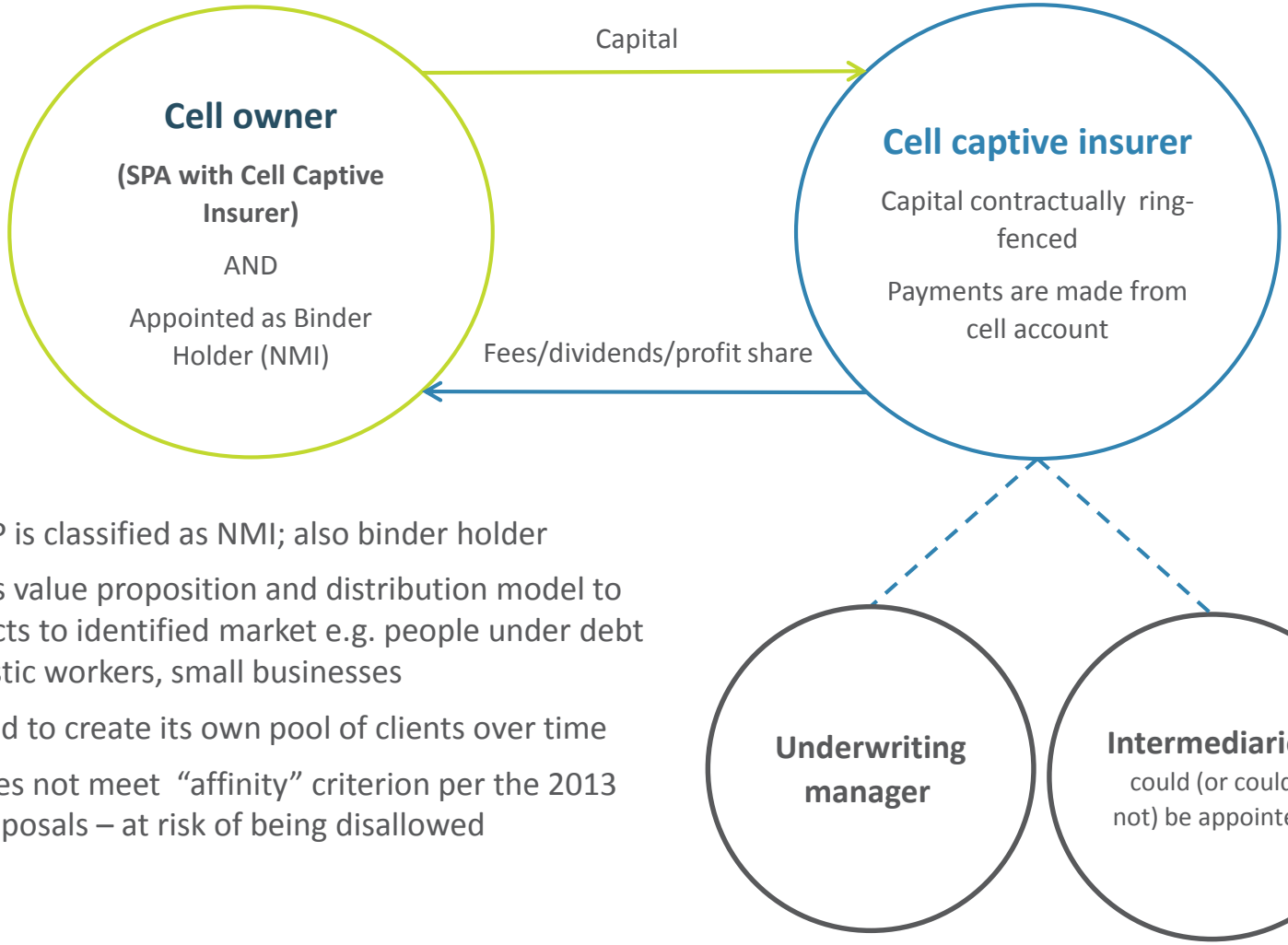
Type B: The affinity cell – cell owner as non-mandated intermediary **(NMI)**



- The cell owner FSP is classified as a non-mandated intermediary (NMI); also the binder holder – could e.g. be retailer
- Underlying affinity group
- NMI receives a binder fee from cell captive insurer; may be paid a dividend from the cell
- If the NMI is also authorised to market and sell the products, it receives remuneration from cell captive insurer

The cell captive landscape: types of cell structures

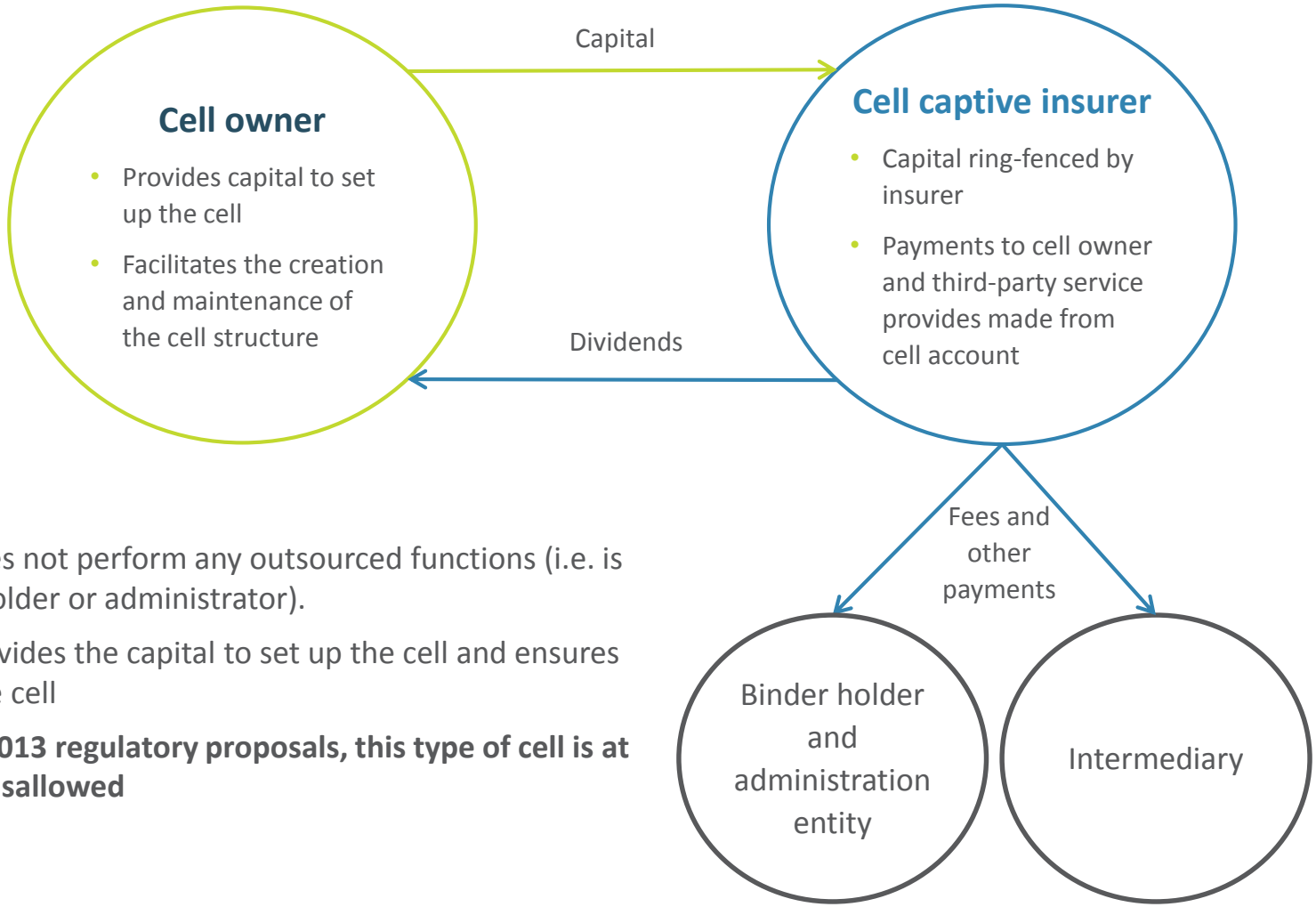
Type C: The cell owner as non-mandated intermediary **(NMI)**



- Cell owner FSP is classified as NMI; also binder holder
- Cell owner has value proposition and distribution model to market products to identified market e.g. people under debt review, domestic workers, small businesses
- Cell established to create its own pool of clients over time
- Cell owner does not meet "affinity" criterion per the 2013 regulatory proposals – at risk of being disallowed

The cell captive landscape: types of cell structures

Type D: The **silent partner** cell owner



- Cell owner does not perform any outsourced functions (i.e. is not a binder holder or administrator).
- Cell owner provides the capital to set up the cell and ensures solvency of the cell
- **According to 2013 regulatory proposals, this type of cell is at risk of being disallowed**

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Why go the cell route?

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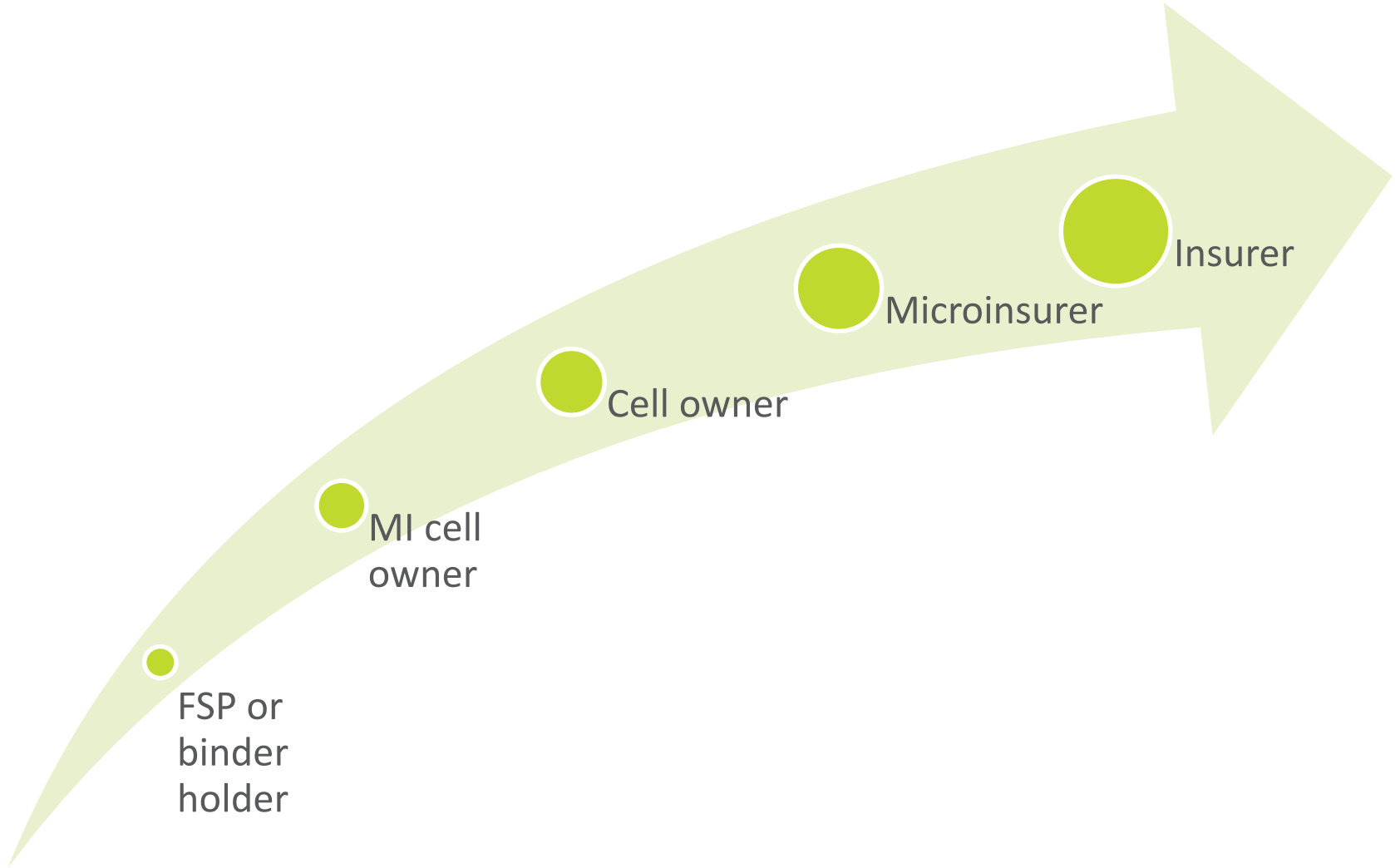
One of a number of options for insurance provision



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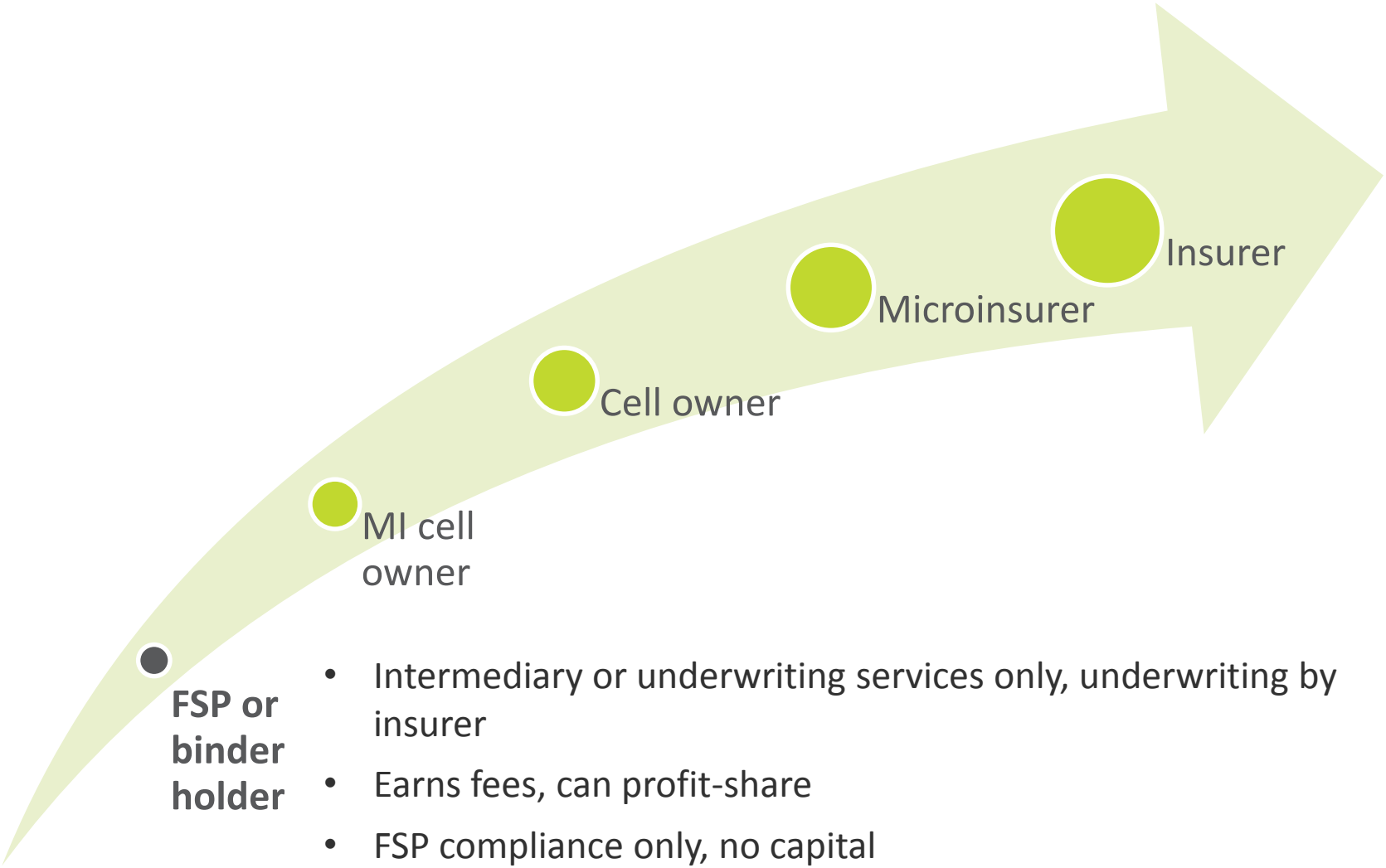
One of a number of options for insurance provision



- Intermediary or underwriting services only, underwriting by insurer
- Earns fees, can profit-share
- FSP compliance only, no capital
- BUT: limited scope to tailor offering to own client base

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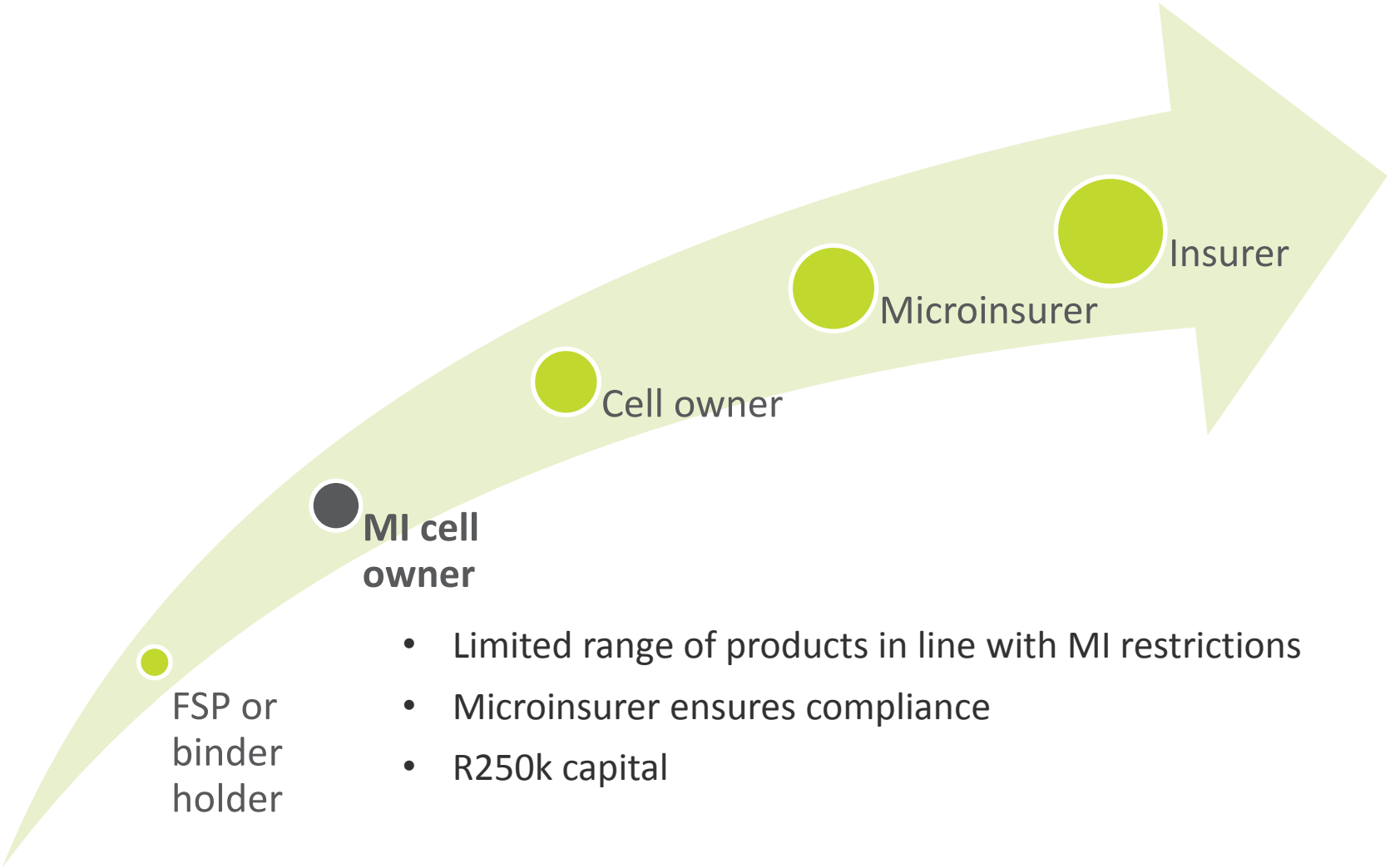
One of a number of options for insurance provision



- Limited range of products in line with MI restrictions
- Microinsurer ensures compliance
- R250k capital

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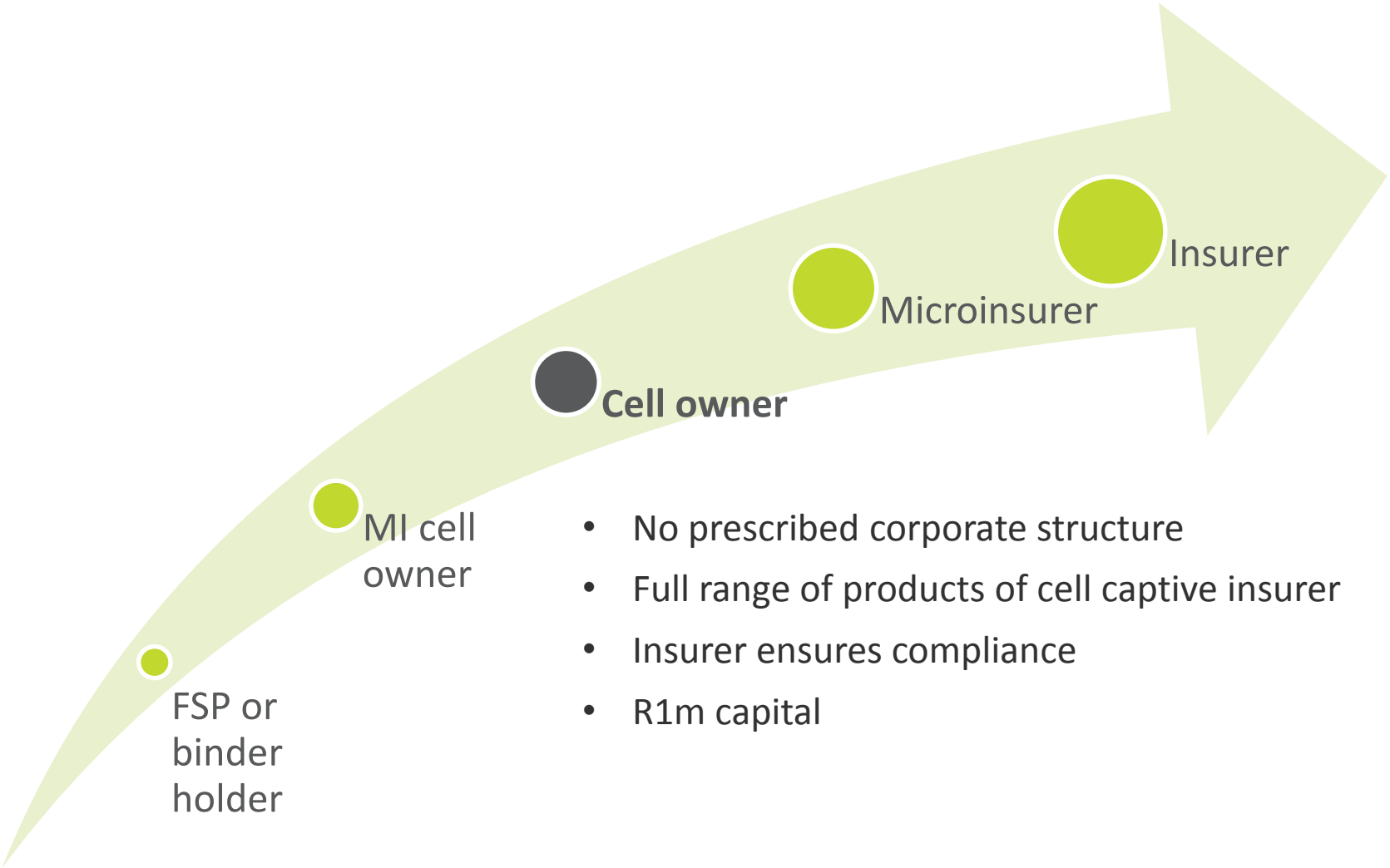
One of a number of options for insurance provision



- No prescribed corporate structure
- Full range of products of cell captive insurer
- Insurer ensures compliance
- R1m capital

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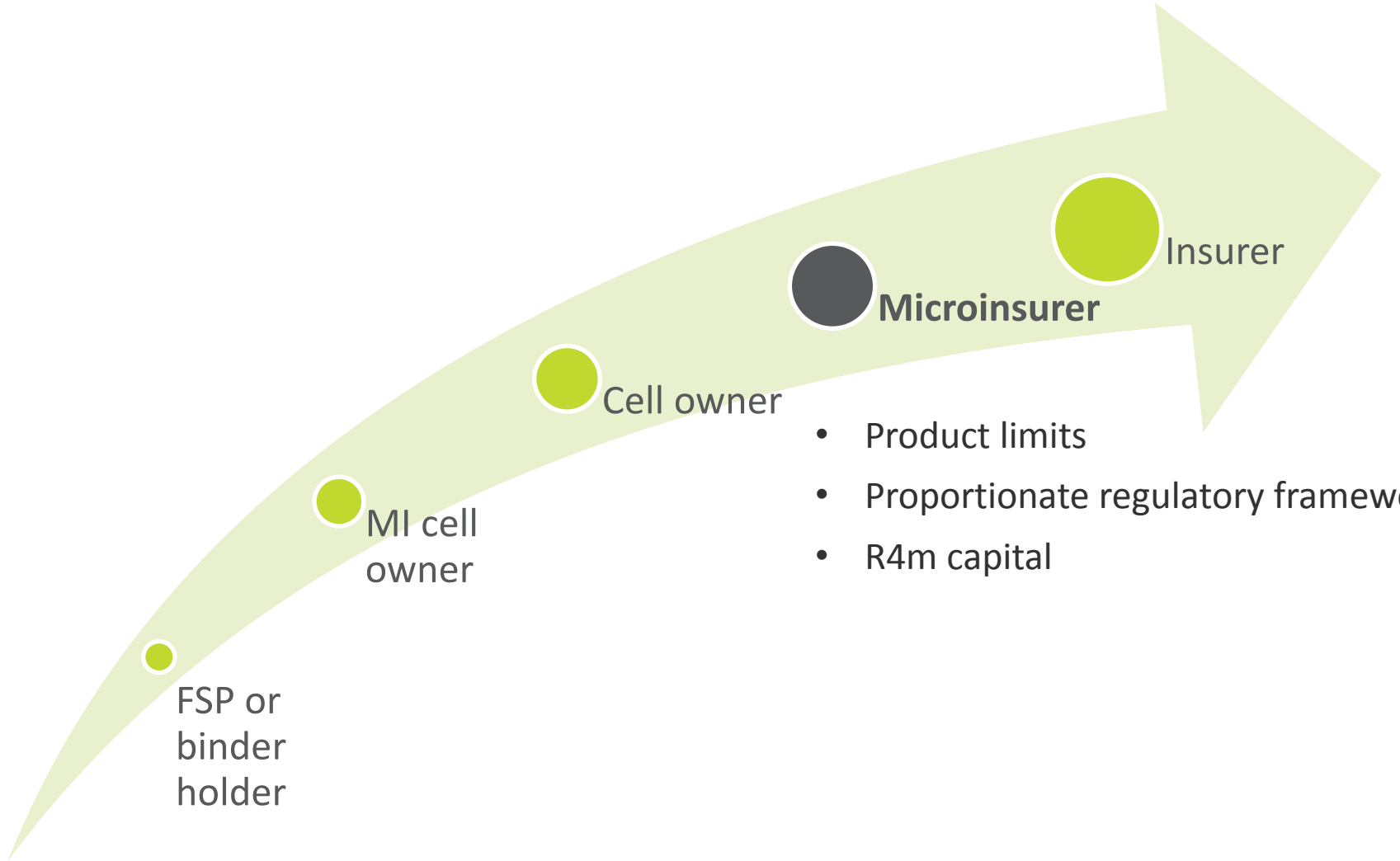
One of a number of options for insurance provision



- Product limits
- Proportionate regulatory framework
- R4m capital

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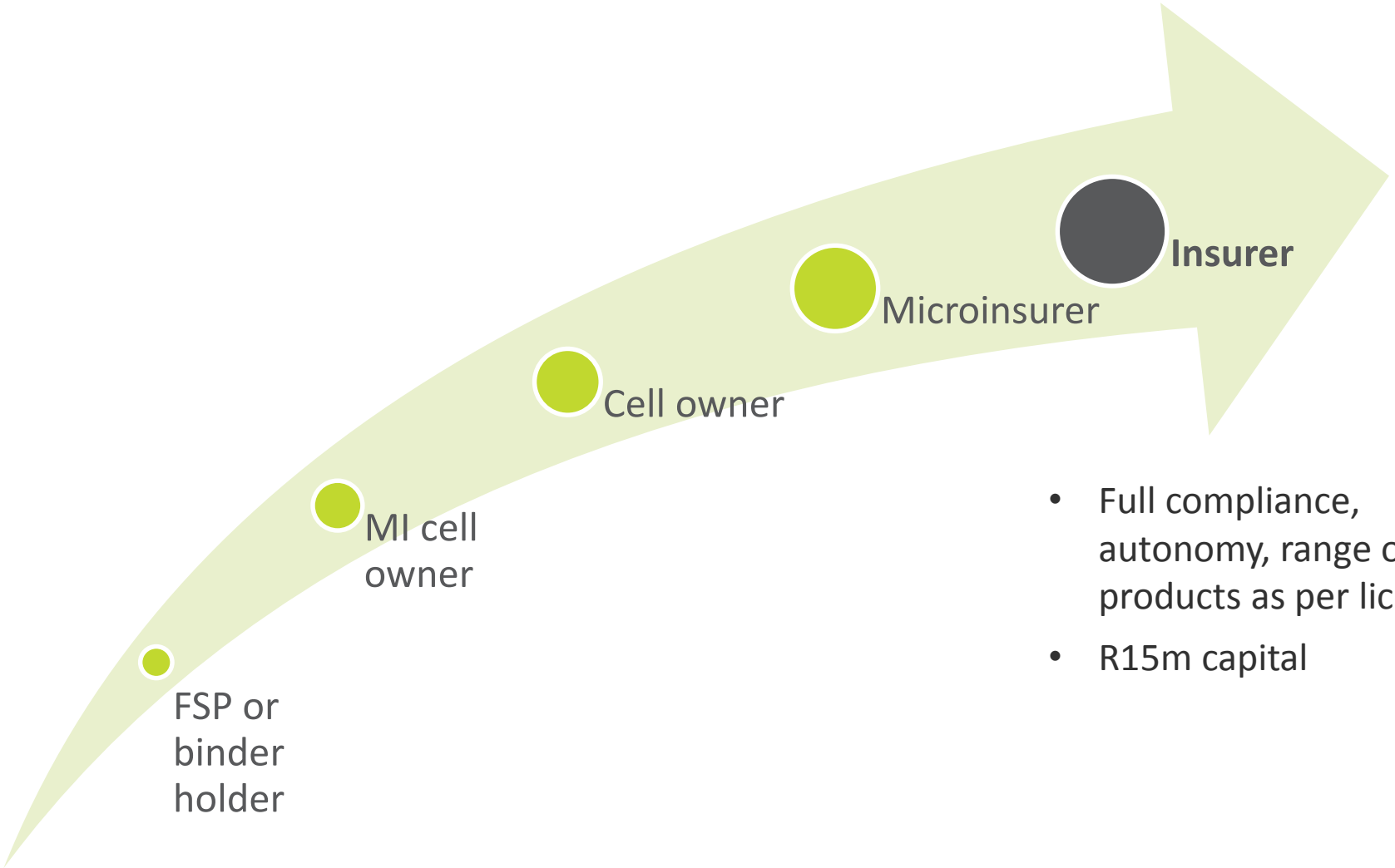
One of a number of options for insurance provision



- Full compliance, autonomy, range or products as per licence
- R15m capital

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Why establish a cell?

The cell owner perspective

Autonomy

- Design innovative products, relevant to target market
- Control of value chain
- Focus on aspects of insurance business they are good at (e.g. underwriting)

Nimbleness

- Own IT infrastructure
- Shorter value chain vs traditional insurer value chain
- Gets closer to customers
- Automated processes – easier decision-making than traditional corporate world

Share in economic benefits

- Cell owner may feel they "own" client group and/or brand
- Cost savings contributing to surplus build-up
- Ability to share profits with communities

Compliance and support

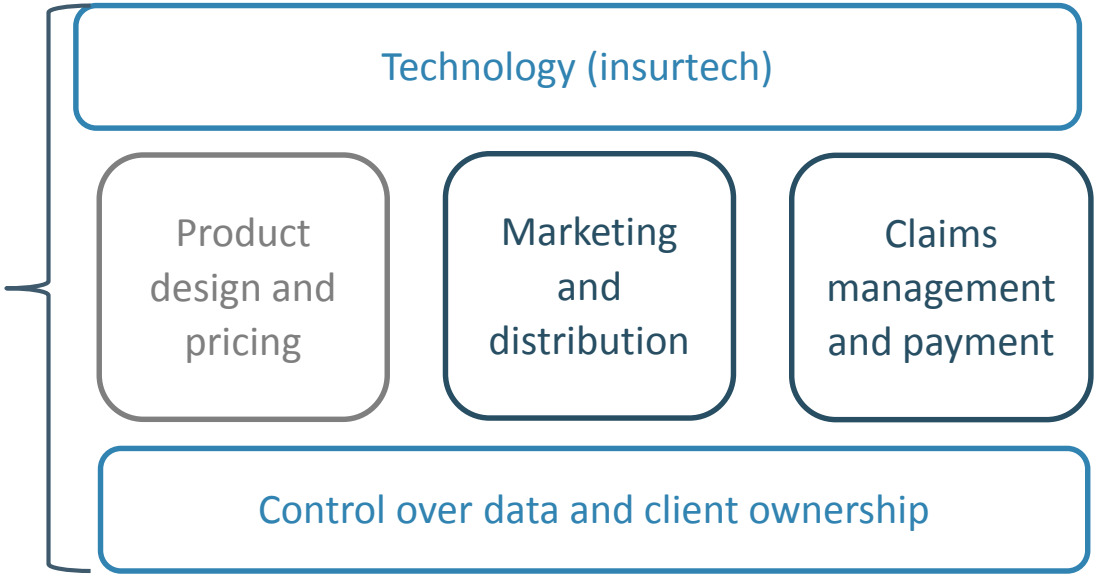
- Lower capital requirements
- Less onerous to set up cell
- Insurer oversees regulatory compliance, regular reviews
- Access to insurance expertise, e.g. actuarial and legal

Cell-owner-controlled value chain

Advantages for customers and the cell owner

Advantages of customers: niche offerings, accessible and tailored insurance, simplified policy wording

Advantages for cell owner: control over costs and quality, automated processes, data analysis. Essentially less legacy system constraints.



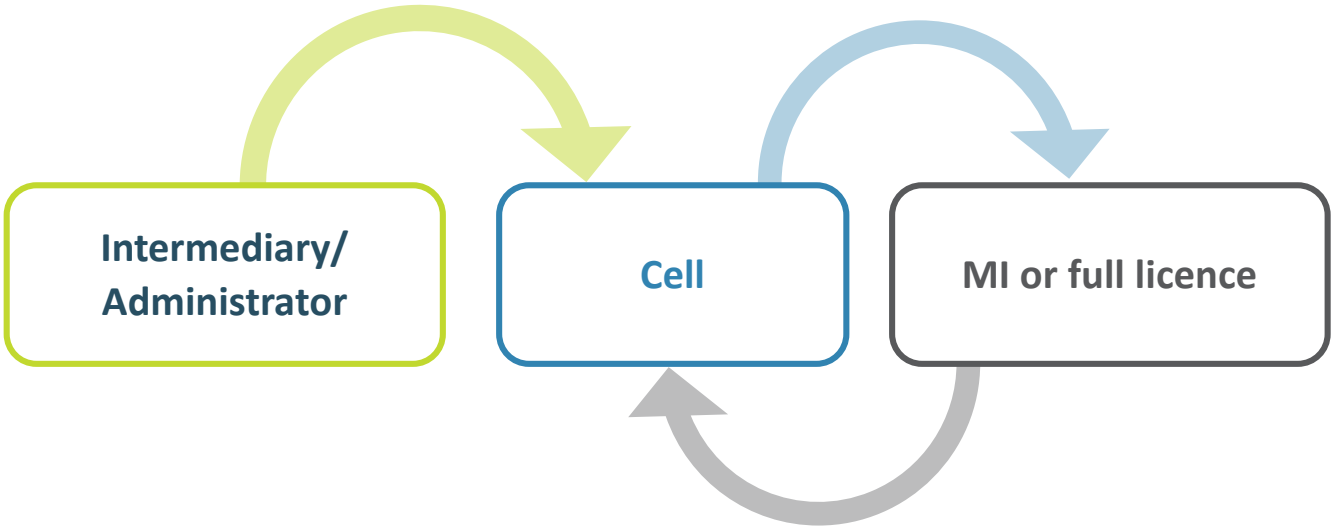
Insurtech, cost-effectiveness and competition

New technology developments attract new types of entrants to the insurance space

Direct effect: New ideas and innovative use of technology (e.g. chatbots, smartphone-based client interaction) lowers costs for client

Indirect effect: Over time, greater competition in market due to more entrants – lowers costs to client - possibly **the most important channel** through which costs are lowered

The potential cell graduation path



- In principle: stepping stone to a full insurance licence
- But cell may also be the destination

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Are cell captives a vehicle for transformation?

Are cells contributing to transformation?

An indicative classification

Company	Ownership	Management	Financial inclusion	Capacity development
Cell A	✓	✓	✓	-
Cell B	✓	✓	✓	✓
Cell C			✓	✓
Cell D	✓	1/2 ?	✓	✓
Cell E	-	-	✓	✓
Cell F	1/2	1/2	✓	✓
Cell G	-	-	✓	-
Cell H	-	-	✓	-
Cell I	-	-	✓	-
Cell J	-	-	✓	-
Cell K	-	-	-	-
Cell L	-	-	-	-

Black owned and managed

Transformative in its capacitation and FI role

Transformative largely via FI focus

No explicit transformation

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Ownership and economic participation

Transformation through ownership is a long game

	FSC Actual relative to target	
	Life offices	**Short-term insurers**
Black ownership	↑	↓

- Limited progress in transforming ownership in the insurance market
- Direct ownership in the traditional sector requires large capital investment
- **Cell captives provide an opportunity for black entrepreneurs and small black business to participate in the economic benefits of the insurance market**

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 Source: Adapted from SAIA (2017), ASISA (2017)

Management control and employment equity

Limited transformation at middle to upper management

	FSC Actual relative to target	
	Life offices	**Short-term insurers**
Management control	↓	↓

- Limited progress in transforming management in the insurance market
- Notably, senior and middle management far below FSC targets
- Black entrepreneurs oftentimes leave traditional insurers in pursuit of greater management control along the cell value chain
- **Cell captives provide an opportunity for management to be transformed outside of the prevailing corporate culture of the traditional insurance sector**

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 Source: Adapted from SAIA (2017), ASISA (2017)

Skills development

Promoting entry into insurance markets

	FSC Actual relative to target	
	Life offices	**Short-term insurers**
Skills development	↑	↑

- It is not an insubstantial process to become a cell
- Mentorship and support can aid *incubation into* cell structure, as well as *from cell to insurer*
- Coordinated initiatives between industry and organisations like SETA could support skills development.
- **Cell captives provide a unique opportunity for capacity development and skills transfer**

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Enterprise and supplier development

Strengthening the supply chain

	FSC Actual relative to target	
	Life offices	**Short-term insurers**
ESD and Procurement	↑	↑

- Industry has taken initiative in strengthening supply chains
- Small black businesses and other enterprise development beneficiaries receive financial and non-financial support from industry associations, ASISA and SAIA
- Cell owners and underwriting managers can advance the formalisation of MSMEs
- **Cells have potential to support procurement from local suppliers or providers of outsourced services in the value chain that are black-owned, and contribute to employment creation**

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Access to financial services

A business case for financial inclusion

	FSC Actual relative to target	
	Life offices	**Short-term insurers**
Financial Inclusion	↓	↓

- Broad-based target markets present untapped market opportunities
- Low-income target markets and less sophisticated consumers can access affordable, tailored products
- ***Technology and innovation*, driven by cell captives, play an important role in delivering affordable products, simplifying processes and encouraging competition**

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What can be done to unlock the full transformation potential?

Findings

Cells and transformation

- Cells are a vehicle to expand direct ownership and diversity of players with autonomy in terms of product design and ability to share in the economic benefits in the insurance market.
- BUT, the cell captive is not a panacea – it requires high levels of business acumen and capacity, and not ALL cells are transformed.

Cells, capacity-building and growth

- Owning and operating a cell is often the end-goal and not just a stepping stone to full licence.
- The transformation potential is not only about incubation to a full insurance licence; equally important is capacitation/incubation into cell ownership.

Findings

Cells and formalisation

- Cells play an important capacitation role vis-à-vis the community facing organisations/affinities that they deal with to get them to FSP status and bring them into the formal insurance space
  - E.g. assisting funeral parlours with FAIS compliance and providing legally underwritten policies
- Or may be a formalisation destination itself
- *(For those who want to come into the net)*

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Remaining questions:

Risk capital

- **R1m MCR**
  - Current market: cell owners often enter with very low minimum risk capital
  - The move to R1m minimum capital is not questioned – cell owners must have skin in the game
- **The initial capital investment of R1m minimum must be the cell owner's own**
  - Current market: the insurer often capitalises the cell initially for which the cell pays a fee and only starts to draw dividends when it has built up its own capital base.
  - What if an organisation cannot raise the full R1m upfront?
- **Suggestion for discussion:**
  - Allow the R1m to be met in instalments, as long as the actual capital needed to support the business does not exceed the instalments to date?
  - Or allow cell captive insurer to "frontload" the capitalisation?

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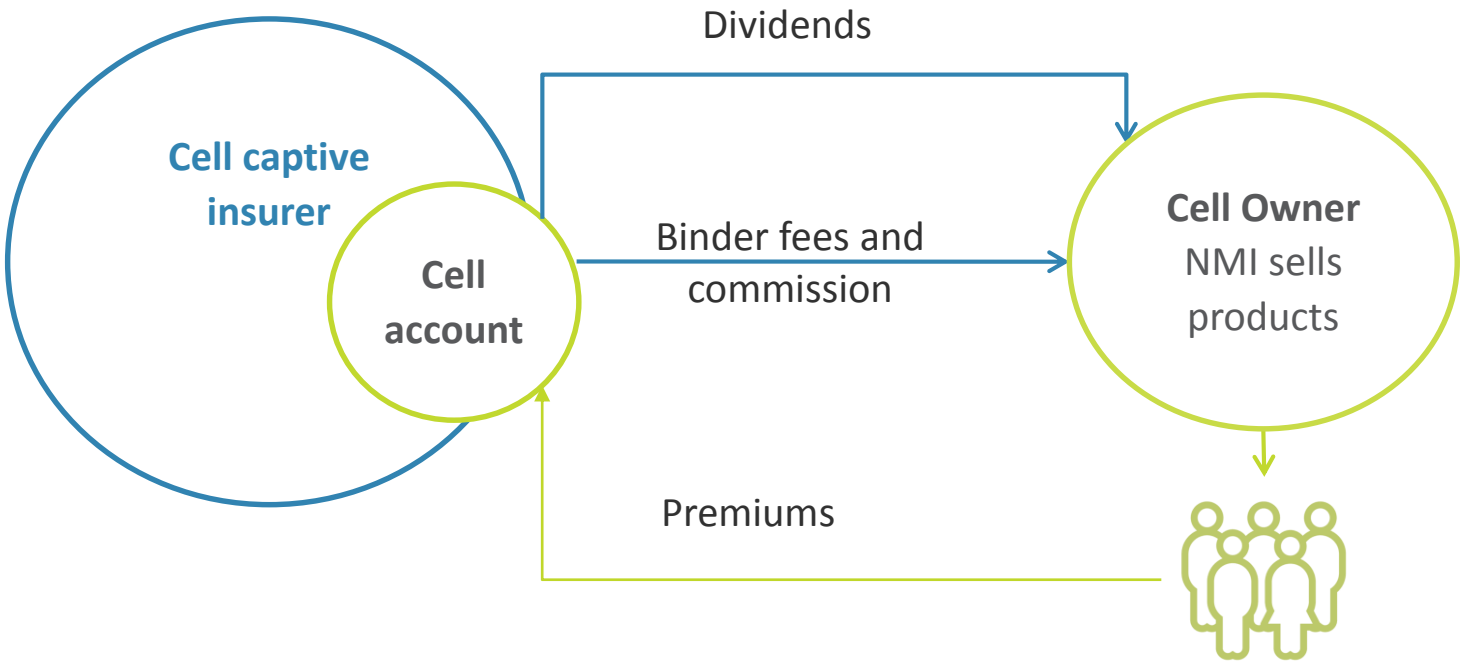
Remaining questions:

Who may be a cell owner? Conflicts of interest



Cell owner acts as agent of the insured and of the insurer → potential conflict

Remaining questions:

Who may be a cell owner? Conflicts of interest

What if business plan demonstrates:

- Cost savings, innovative, relevant and inclusive products
- Financial education

Mitigation of conflicts of interest:

- NMI does not purport to be independent and relationship with cell structure disclosed
- All remuneration (incl. dividend) disclosed
- *Full market conduct framework applies*

Suggestions for debate:

- Allow NMIs to offer insurance as cells even though they are non-affinities if certain requirements to mitigate conflicts or interest are met?
- Or entirely do away with the definition of affinity for cell ownership purposes?

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Remaining questions:

What products may be sold?

- Regulatory proposal: products related to underlying business of affinity
- Precedent of products not related to underlying affinity through the retailer distribution model
  - Does it make a material difference whether the retailer is a cell owner?
- The affinity does not state that it is providing competitive product offerings: it is simply a (white-labelled) channel for the products provided via the cell

Suggestion for debate:

- Don’t limit product offering; rather rely on protection of market conduct framework

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What can industry do?

- Ongoing mentoring/capacitation already provided by cell captive insurers as part of cell arrangements (though not all have the same hands-on role or appetite for capacity-building of cells)
- What can cell captive insurers and industry associations contribute as a proposal for institutionalising the potentially transformative role of cells into a substantive contribution towards industry-wide transformation commitments?
  - Can a central fund for cell captive financing be created?
  - Incubation plan?

Thank you

Please engage with us:

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About Cenfri

The Centre for Financial Regulation & Inclusion (Cenfri) is a global think tank and non-profit enterprise that bridges the gap between insights and impact in the financial sector. Cenfri's people are driven by a vision of a world where all people live their financial lives optimally to enhance welfare and grow the economy. Its core focus is on generating insights that can inform policymakers, market players and donors seeking to unlock development outcomes through inclusive financial services and the financial sector more broadly.

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