Insurance Law

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SOUTH AFRICA

Plugging the hole in the cell captive fence before the wheels come off

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Plugging the hole in the cell captive fence before the wheels come off

The Financial Sector Conduct Authority (FSCA) and the Prudential Authority's (PA) (collectively, the Authorities) failure to provide further guidance regarding the requirements and ambit of the specific form of contractual ring-fencing required in terms of the Insurance Act 18 of 2017 (Insurance Act) in the context of cell captive arrangements, if not rectified, could lead to scenarios that defeat the objectives of cell captive arrangements by undermining the various benefits offered by cell structures, namely, improving the financial sustainability of the cell captive insurance sector.

In terms of the Insurance Act, a cell captive arrangement is established (i) via the conclusion of an arrangement between registered insurer and a cell owner seeking to place its insurance business and (ii) the cell owner subscribing for a separate and distinct class of shares created by the registered insurer which is managed by the registered insurer (i.e. cell captive) on a separate and distinct basis (similar to conducting separate and distinct business units).

In Joint Communication 2 of 2018, the Authorities expressly rejected considering protected cell company (PCC) legislation out of a concern for limited liability. According to the Authorities, the pooling of risk is core to the insurance business, thus the ring-fencing of a third-party insurance business would run "*contrary to the very nature of insurance*" by preventing the pooling of all of a cell captive insurer's risk.

However, the legislative prescripts render this notion a moot point as the Insurance Act itself not only contemplates but mandates such limited liability via the definitional requirement imposed upon cell captive insurers to ensure that each cell owner's business is "*contractually ring-fenced from the other insurance business of that insurer for as long as the insurer is not in winding-up*" (contractual ring-fencing requirement). This aim of this requirement is to:

- guard against cross-subsidisation between cells; and
- ensure that each cell within a cell captive structure is financially sound and solvent.

In this manner, if one cell within a cell structure becomes insolvent, creditors will be precluded from claiming assets belonging to the other cells within that cell structure for as long as the cell captive insurer is not in winding-up.

The Insurance Act juxtaposed against overseas PCC legislation

The contractual ring-fencing requirement contemplated by the Insurance Act is not too dissimilar from the formalised, and enhanced, legislative protections provided for in PCC legislation found in other jurisdictions (such as Mauritius and Guernsey). A PCC constitutes a legal entity comprised of segregated cells with each enjoying legislatively protected and prescribed limited liability from all other cells within that PCC. Therefore, similar to the contractual ring-fencing requirement envisaged by the Insurance Act, PCC legislation explicitly and directly prescribes and protects each cell's limited liability.

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Given the similarities between these models, this begs the question of why the Authorities are so reticent to embrace legislative ring-fencing by providing guidance on permissible ring-fencing models to be adopted by cell captive insurers in South Africa?

Without adequate regulatory guidance from the Authorities regarding the contractual ring-fencing requirement, the courts are being called upon to bridge the gap and provide the necessary guidance to cell captive insurers and cell owners, as in the case of *BMW Financial Services v Harding* [2007] JDR 0947 (C).

In the FSCA's Conduct Standard 2 of 2022 and the PA's Annual Report 2022/23, the Authorities seemingly acknowledge the need for a stricter regulatory framework to be put in place which inter alia enhances the governance, operational and financial soundness of cell structures. The Authorities' reticence runs contrary to their obligations to promote and maintain financial sustainability in terms of the Twin Peaks model of financial regulation imposed by the Financial Sector Regulation Act 9 of 2017, by fostering several potential impacts, including:

- **Reduced investor confidence:** Investors may be hesitant to invest in cell captive structures if they are unsure of the regulatory framework.
- **Increased costs:** Cell captive insurers may incur additional costs in developing and implementing their own ring-fencing arrangements.
- **Market fragmentation:** The lack of uniformity in ring-fencing arrangements could lead to market fragmentation and reduce the efficiency of the cell captive insurance market.

Ultimately, the Authorities' silence may lead to unintended consequences such as (i) valid cell structures not being established where a cell captive insurer decides not to cater for the type of ring-fencing envisaged by the Insurance Act or the adopted model falling short of stated requirements; (ii) an undesirable ring-fencing model being adopted by more than one cell captive insurer, which may have an adverse systemic impact on the cell captive insurance industry; and (iii) cell captive insurers and cell owners facing expensive restructures to unwind and reform their adopted ring-fencing models if same are found to be non-compliant by the Authorities or a court of law. Therefore, it is prudent for the Authorities to acknowledge the deficit in their guidance to the market and to provide same before the proverbial wheels come off.

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