

# Can Language Prevent Flexible SCR Calculations? New Duties for Auditors in *The Prudential Authority v Constantia Insurance Company Limited*, Gauteng Local Division, Johannesburg, Case Number 2022-19765

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## Abstract

This article analyses the importance of the solvency capital requirement (hereafter SCR) and the minimum capital requirement (hereafter MCR) formulae and why an insurer's external auditor should audit these and disclose its contents in the insurer's financial statements. When calculating the SCR, the reason for requiring such a disclosure is to allow the Prudential Authority an opportunity to understand whether the assumptions, parameters and techniques (also referred to as economic considerations) applied by actuaries comply with section 36 of the *Insurance Act* 18 of 2017. Administrative costs and written premiums are considered when calculating the MCR, although written premiums could be subjected to different interpretations, which might affect this formula. Accordingly, had Constantia Insurance Company Limited's auditor audited these formulae in 2018 and disclosed their contents in the financial statements, the Prudential Authority would have commenced liquidation procedures in 2019, not choosing instead to wait and monitor the company's solvency requirements on a weekly basis for four years. As a result, owing to the lack of transparency in the financial statements and non-compliance with the SCR and MCR, Constantia spent nearly R733 000 000 over the three-year period to fund its business activities.

## Keywords

Solvency capital requirement; minimum capital requirement; audit minimum capital requirement; auditor duties in insurance law; liquidation of an insurer; just and equitable; public purpose.

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## 1 Introduction

The Prudential Authority lodged an *ex parte* application (during July 2022) to place Constantia Insurance Company Limited (hereafter Constantia) under provisional curatorship.<sup>1</sup> Generally, an *ex parte* application is an opportunity to appoint a provisional curator to manage the affairs of the financial institution or insurer involved until such time as the insurer is profitable.<sup>2</sup> The duration of such an appointment varies, but the court order will be terminated the moment the insurer complies with the solvency capital requirement (hereafter SCR) and the minimum capital requirement (hereafter MCR) formulae are satisfied.<sup>3</sup> Therefore, a curator could manage an insurer for a number of years if there is a positive prospect of its becoming solvent in the future.<sup>4</sup>

The *ex parte* application for provisional curatorship is not complex and is based on an affidavit stating why curatorship is important. However, there is no clear guidance on what constitutes a successful *ex parte* application with regard to insurers. In this regard it would appear that there must be an educated opinion that the insurer will become solvent in future.<sup>5</sup> In the case of Constantia, the *ex parte* affidavit was not without errors or mistakes – it made no reference to the SCR or section 36(1) of the *Insurance Act* 18 of 2017 (hereafter the *Insurance Act*). The fact that Constantia had submitted incorrect SCR (and MCR) figures since 2019 transpired only during an application for liquidation

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<sup>1</sup> *Ex parte the Prudential Authority* (Gauteng Local Division, Johannesburg) (unreported) case number 717/2022 of 18 August 2022 (hereafter *Ex parte Prudential Authority*). Contact the author for a copy of the affidavit or see SARB 2023 <https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2022/Order-granted-for-the-liquidation-of-Constantia-Insurance-Company-Limited>; Xuba *Role of the Prudential Authority* 15.

<sup>2</sup> Godwin and Schmulow 2015 *SALJ* 756-768; Bechard 2022 <https://www.moonstone.co.za/health-squared-placed-under-provisional-curatorship>. KeyHealth was placed under provisional curatorship in September 2020, which was subsequently terminated at the end of April 2022.

<sup>3</sup> See Poufina and Tsitsika 2018 *Theoretical Economics Journal* 2365 for an explanation of the history of solvency requirements and an explanation of the SCR formula.

<sup>4</sup> Bechard 2022 <https://www.moonstone.co.za/health-squared-placed-under-provisional-curatorship>. In 2022 Health Squared was placed under provisional curatorship and is liquidated in the present. The amount paid to the provisional curator is estimated at R280 000 per month.

<sup>5</sup> *Ex parte Prudential Authority* paras 6-10 of the affidavit of Johan Heyneke. Contact the author for a copy of the affidavit.

(in October 2022).<sup>6</sup> At the time the *ex parte* affidavit was drafted, the Prudential Authority was unaware of the fact that Constantia had used its own SCR/MCR formula without notifying the Prudential Authority or the Financial Services Conduct Authority (hereafter the FSCA).<sup>7</sup> In fact, Constantia should have instructed an auditor to audit these formulae to explain their contents in the financial statements in layman's language.<sup>8</sup> It would appear that Constantia's auditor was not aware of this duty since there were no disclosures of the formulae in its financial statements.<sup>9</sup> Section 36(3) of the *Insurance Act* states the following:<sup>10</sup>

If the Prudential Authority believes that any value calculated by an insurer ... in respect of its financial soundness does not reflect a reasonable value for the purposes of this Act, the Prudential Authority may direct the insurer or controlling company –

To appoint, at the cost of the insurer ... a suitably qualified person to be approved by the Prudential Authority to determine a reasonable value ... .

To calculate a value in a manner determined by the Prudential Authority, which value so calculated will be deemed to be the value.

Section 36(3)(b) of the *Insurance Act* provides for a possibility to argue that the Prudential Authority could recommend "improvements" to any SCR formula. For example, when the method of calculation, assumptions and

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<sup>6</sup> *The Prudential Authority v Constantia Insurance Company Limited* (Gauteng Local Division, Johannesburg) (unreported) case number 2022-19765 of 14 September 2022 (hereafter *Prudential Authority v Constantia Insurance*) para 17.1 of the affidavit of Kerwin Martin states that Constantia is in "a worse financial position than what was reported to" the Prudential Authority. Contact the author for a copy of the affidavit or see SARB 2023 <https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2022/Order-granted-for-the-liquidation-of-Constantia-Insurance-Company-Limited>.

<sup>7</sup> See generally, Steffen 2008 *International Study on Insurance Economics* 62 that SCR could be calculated on a full or partial internal model.

<sup>8</sup> FSB 2015 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20(v%204)%20FINAL.pdf). The formula should not be expressed in difficult terms in order to allow for an audit thereof. It should be easily explicable to a Court as well. The EU directive for MCR in FSB 2016 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Errata%20\(v%204\)%20to%20Position%20Paper%2074%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Errata%20(v%204)%20to%20Position%20Paper%2074%20(v%204)%20FINAL.pdf) states that calculations should be audited – audit implies the disclosure in financial statements. Also see solvency requirements for cell captives that uses a SCR formula simpler than that used by the insurers in the FSB Solvency Assessment and Management Steering Committee: Norton Rose Fullbright date unknown <https://www.bila.org.uk/wp-content/uploads/old/509ce6da277006.77306714.pdf>.

<sup>9</sup> See generally, Frostmoser 1983 *J Comp Bus & Cap Mkt L* 305-316.

<sup>10</sup> *Insurance Act* 18 of 2017 (hereafter the *Insurance Act*); Tarr and Mack 2013 *Accounting, Auditing and Accountability Journal* 1009-1026. An audit is to verify information.

techniques used, adjustments made, calibration effected or parameters used by any insurer are inappropriate for calculating an effective SCR.<sup>11</sup> Section 36(3)(b) of the *Insurance Act* states that what the Prudential Authority decides upon as necessary economic considerations (e.g. the use of more appropriate assumptions, techniques, etc.) to calculate an effective SCR is to be considered the correct SCR formula. This is possible, however, only when the Prudential Authority is aware of a defective SCR calculation. If Constantia had disclosed its SCR formula (via its financial statements), the Prudential Authority would have rectified the incorrect SCR calculation in terms of section 36 of the *Insurance Act*, and the Prudential Authority would have been made aware of how severely Constantia's SCR deviated from its financial statements (financial statements also disclose the solvency of a company).<sup>12</sup> Once the Prudential Authority had decided on a correct SCR formula, it could also have required a capital add-on to improve Constantia's cash flow.<sup>13</sup> However, this never happened in practice because the Prudential Authority was unaware of any deviations in the SCR calculations. Section 36 of the *Insurance Act* is very clear that any insurer that realises that it is unable to comply with the provisions of this section must immediately notify the Prudential Authority.<sup>14</sup> The reason as to why Constantia never notified the Prudential Authority remains unclear. This is because the Prudential Authority was unaware of Constantia's intentionally erroneous SCR. It is assumed that the Constantia's board of directors misled the Prudential Authority intentionally.<sup>15</sup> As a result, the Prudential Authority helped Constantia for approximately three years – prior to the *ex parte* application – allowing the company sufficient time to improve its solvency requirements. In reality this was not possible owing to the extent of the incorrect SCR calculation.<sup>16</sup> During June 2022 Constantia even made a number of YouTube videos of its significant financial turnaround.<sup>17</sup> Although

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<sup>11</sup> Section 36(5) of the *Insurance Act* or Minimum Capital Requirements (MCR); Pfeifer and Strassburger 2008 *Scandinavian Actuarial Journal* 62. The square root formula or standard formula can severely underestimate the true SCR required by regulators.

<sup>12</sup> Tarantino 2001 *The Physician Executive* 72-76; Li "Research on Financial Statements" 508-512 for an explanation of some defective aspects of financial statements.

<sup>13</sup> Section 37(1) of the *Insurance Act*.

<sup>14</sup> Section 39(2)(a) of the *Insurance Act*.

<sup>15</sup> Hock and Chung 2008 *S Ac LJ* 194. The duty of an auditor to "check on management" remains paramount. Equally, directors should exercise due supervision and oversight over the company's business affairs; Gaa 2010 *Journal of Business Ethics* 179-197, explaining why other stakeholders have a legitimate interest in transparent management or board of directors' decisions.

<sup>16</sup> *Prudential Authority v Constantia Insurance* para 27 of the affidavit of Kerwin Martin.

<sup>17</sup> Todd 2022 <https://m.youtube.com/watch?v=wUuFgSFkAjk>. To confirm this, the Prudential Authority asked the Court that the provisional affidavit should not be made

the Prudential Authority had since June 2019 requested weekly solvency calculations from Constantia, this monitoring process was in fact a fruitless exercise.<sup>18</sup> Since 2019 the Prudential Authority had also sought to analyse any proposed business plans (and their effectiveness) to help meet Constantia's solvency requirements. However, none of the proposed business plans ever materialised.

Subsequently, the Court granted the *ex parte* application and a provisional curator was appointed.<sup>19</sup> It should be pointed out here that the Prudential Authority had been led to believe that the SCR could be achieved in future if only Constantia could find a suitable investor.<sup>20</sup> Following the granting of the *ex parte* application, the provisional curator immediately realised that no investor would be able to assist Constantia in meeting the solvency requirements.<sup>21</sup>

This article explains the term "cumulative excesses" to enable an understanding of how flexible SCR can be.<sup>22</sup> While an excess calculation is not as complex as a SCR, it does illustrate the importance of relevant economic considerations relating to how excesses could be calculated in practice. In addition, this article also briefly explains the relevant economic considerations that should be kept in mind when calculating loss ratios as flexible calculations, since loss ratios may vary even if the written premium income remains fixed.<sup>23</sup> It is not known which SCR formula Constantia used. It is assumed that Constantia used the basic SCR formula, which did not take into account all economic considerations, as explained earlier (method, assumptions, techniques, adjustments, calibration and parameters).<sup>24</sup> Irrespective of how simple the formula might be, the importance of language cannot be overstated in preventing flexible calculations. The latter is possible

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public. If it were to be made public, policyholders would terminate their insurance making it extremely difficult for the curator to regain Constantia's financial soundness.

<sup>18</sup> *Prudential Authority v Constantia Insurance* para 27 of the affidavit of Kerwin Martin.

<sup>19</sup> Sections 39 and 54 of the *Insurance Act* requires the insurer to notify the Prudential Authority without delay in the event of a deteriorating financial position and makes provision for curatorship instead of business rescue, among other things.

<sup>20</sup> See generally, for example, s 4 of the *Companies Act* 71 of 2008, which explains liquidity and solvency with reference to the ability to pay creditors in a 12-month period.

<sup>21</sup> *Prudential Authority v Constantia Insurance* para 21 of the affidavit.

<sup>22</sup> See part 2 of the article below.

<sup>23</sup> See sub-part 2.1 of the article below.

<sup>24</sup> *Prudential Authority v Constantia Insurance* para 21 of the affidavit states that SCR or PCR should have been R903 342 000 instead of R304 158 000. See generally, Doff 2008 *GPRIP* 193-206; Pfeifer and Strassburger 2008 *Scandinavian Actuarial Journal* 62. The square root formula or standard formula can severely underestimate the true SCR required by regulators.

only if an auditor observes the language that requires the disclosure of SCR and MCR formulae in the financial statements of insurers.<sup>25</sup> The language that requires disclosure is contained in the Financial Services Board (hereafter the FSB) Steering Committee Position Paper (hereafter the Steering Committee).<sup>26</sup>

## **2 A simple explanation of the phrase "cumulative excess" and the way this explanation relates to more complex phrases or calculations**

Constantia has recently been liquidated by the Prudential Authority of the Reserve Bank in terms of section 32 of the *Financial Sector Regulation Act 9* of 2017 (the FSRA). The purpose of this Act is to establish *inter alia* the Prudential Authority and the FSCA to ensure that the South African economy remains stable, as well as to enhance financial stability by conferring powers on the Reserve Bank.<sup>27</sup> The reason why the Reserve Bank has sole oversight of the financial services industry in South Africa is to protect financial customers and policyholders in South Africa. More importantly, to make sure an insurer has the financial ability to pay all policyholder claims and to treat policyholders fairly.<sup>28</sup> It is not always easy to understand how financial stability in the South African economy can be achieved.<sup>29</sup> A practical example could be the excesses or cumulative excesses used by non-life insurers when calculating the settlement of a claim submitted by a policyholder. Generally, non-life insurers simply apply a single excess (simple calculation) to a claim. For example, a claim submitted for R10 000 less a R4 500 excess equals R5 500 to be paid by the insurer.

A cumulative excess serves a similar purpose, but its calculation is flexible and depends on the relevant circumstances of an accident. For example, whether the accident occurred after 1 a.m., the driver is under the age of 25, the driver obtained his or her driver's licence within the last two years, there are no witnesses or no third parties involved in the accident and lastly, the accident

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<sup>25</sup> Huneberg 2019 *Obiter* 170-190.

<sup>26</sup> The FSB is known as the FSCA (Financial Services Conduct Authority) at present. See, for example, FSB 2015 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20(v%204)%20FINAL.pdf) with specific reference to MCR; FSB 2016 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Errata%20\(v%204\)%20to%20Position%20Paper%2074%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Errata%20(v%204)%20to%20Position%20Paper%2074%20(v%204)%20FINAL.pdf) with reference to the EU position.

<sup>27</sup> Godwin and Schmulow 2015 *SALJ* 756-768.

<sup>28</sup> Hollander and Van Lill 2019 [https://www.ekon.sun.ac.za/wpapers/2019/wp112019\\_4](https://www.ekon.sun.ac.za/wpapers/2019/wp112019_4).

<sup>29</sup> Huneberg 2019 *Obiter* 170-190.

occurred within six months of the inception of the policy. Each of these circumstances could be assigned a separate excess of 10%.<sup>30</sup> Focussing on these excesses, it would appear that only one excess is applicable to a specific scenario or circumstance. If a driver causes an accident after 1 a.m., is under the age of 25, obtained his or her driver's licence within the past two years, there are no witnesses and the accident happened within six months of the date of inception of the policy, the excess payable by the policyholder before the insurer would settle the claim would be R350 000 on a R700 000 claim submitted.<sup>31</sup> This is known as a cumulative excess and such excesses formed part of policies that were sold in the past.<sup>32</sup>

Most financial customers or policyholders would agree to an excess or even a cumulative excess, but very few of them would understand the financial implications of a cumulative excess unless the cumulative effect were explained in detail. The purpose of a non-life broker (commonly known as a registered financial services provider) is to explain the above non-life products to a prospective policyholder to allow him or her to make an informed decision as to whether the non-life insurance product is suitable or not. Even if the policyholder agrees to a cumulative excess – without any form of explanation – it is assumed that the policyholder has been misled in concluding a policy of insurance.<sup>33</sup> The latter produces financial instability since very few policyholders would be able to pay an excess of R350 000 on a R700 000 claim. This is also possible with more complex formulae such as the SCR formula, which Constantia used without explaining its parameters or techniques to the Prudential Authority.<sup>34</sup>

## **2.1 More complex calculation than cumulative excesses – the loss ratio**

Section 1 of the *Insurance Act* does not define a written premium. For this reason, it is possible to calculate the loss ratio for a particular binder holder with different end results based on the same written premium.<sup>35</sup> Generally, a

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<sup>30</sup> This example is underwriting at the claim stage, which is generally prohibited. See, for example, Deonandan *Insurance Warranties* 8.

<sup>31</sup> R70 000 excess for each circumstance or economic consideration totals R350 000.

<sup>32</sup> See, generally, *Anderson Insurance Underwriting Managers Pty (Ltd) v Constantia Insurance Company Limited* [2017] ZAGPJHC 195 (30 June 2017) (hereafter *Anderson Insurance Underwriting Managers v Constantia Insurance*).

<sup>33</sup> See, generally, Huneberg 2019 *Obiter* 170-190.

<sup>34</sup> Or MCR, without explaining Constantia's interpretation of administrative costs, for example.

<sup>35</sup> See, generally, Haight 1967 *Dick L Rev* 605. This article explains the importance of consensus between an insurer and an insured. In addition, an agent of an insurer should issue a binder to an insured to keep an insurer liable. This is also possible in South Africa where an agent sells a policy without an insurance company and acts as a

binder holder is an underwriting manager who will participate in the profits of an insurer. That is, if the binder holder is profitable as evidenced by a low loss ratio. The loss ratio calculation is based on various economic considerations which are relevant to the business of an insurer. Legislation is not too clear on how these considerations should be identified in practice to calculate a loss ratio. For example, considerations that affect the loss ratio calculation could include reinsurance commission, unearned premium reserve (UPR) and/or claims incurred but not reported (IBNR), to mention a few.<sup>36</sup>

Example 1 – simple calculation:<sup>37</sup>

Earned premium	1 000 000
Less broker commission (12.5%)	(125 000)
Less binder fee (5%)	(50 000)
Less insurer fee (3%)	(30 000)
Less IBNR	(100 000)
Less claims	(450 000)
Total profits/(loss) for binder holder	245 000
Loss ratio (755 000/1 000 000)	75.5%

Example 2:

Earned premium	1 000 000
*Plus reinsurance commission	100 000
Less broker commission (12.5%)	(125 000)
Less binder fee (5%)	(50 000)
Less insurer fee (3%)	(30 000)
*Less UPR (unearned premium reserve)	(20 000)

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"binder" for a limited period only, such as 48 hours; see GN R1493 in GG 19495 of 27 November 1998 as amended by GN R1076 in GG 34877 of 23 December 2011 (Regulations under the Short-Term Insurance Act, 1998).

<sup>36</sup> See Regulations under the Short-Term Insurance Act, 1998. See, generally, the calculation for loss ratios in Hardy 1888 *JIA* 256, the author explaining administrative costs; Nelson 1877 *Journal of Statistical Society of London* 42-89.

<sup>37</sup> Example 1 does not include all relevant economic considerations.



*Less IBNR (claims incurred but not reported)	(100 000)
Less claims	(450 000)
Total profits (or loss) for binder holder	325 000
Loss ratio (675 000/1 000 000)	67.5%

Generally, the binder holder agreement between the insurer and the binder holder could either agree with example 1 (to exclude reinsurance commission etc.) or example 2 (to include reinsurance commission etc.). The consequence of this is clearly evident in example 2 above – a lower loss ratio. Therefore, the binder holder is more profitable and could share in a larger amount of profits.

Whether the binder holder is more profitable in example 1 or example 2 depends on the relevant economic considerations (e.g., reinsurance commission etc.) included in the binder holder agreement relevant to a loss ratio calculation. Nevertheless, if the excesses or loss ratios are designed to fit the risk profile of a specific policyholder or binder holder, then although such a policyholder enjoys insurance coverage or the binder holder is able to make profits, the financial implications could be severe for both parties owing to the flexibility of these calculations.<sup>38</sup> Although a cumulative excess could be subjected to the *Conventional Penalties Act* 15 of 1962 (hereafter the *Penalties Act*) to reduce the cumulative effect of the excess calculation, the actual profitability of a binder holder is based on economic considerations that cannot be seen as a penalty in terms of the *Penalties Act*, for example the reinsurance commission in example 2 above. Since a binder holder agreement could limit the economic considerations to calculate a favourable loss ratio, section 36 of the *Insurance Act* provides for no similar flexibility between an insurer and the Prudential Authority. The insurer must inform the Prudential Authority of not meeting the SCR requirements or inform the Prudential Authority what additional assumptions, parameters and the like should be considered when calculating the SCR. The Prudential Authority can take all the economic considerations (assumptions and parameters, as explained earlier) into account when calculating the SCR and consequently, reject an insurer's

<sup>38</sup> *Anderson Insurance Underwriting Managers v Constantia Insurance* paras 15-19, where the Court explained the difficulty finding new insurer for a binder holder in an instance when the previous insurer is liquidated. A new insurer will consider the binder application as a financial risk. This unfortunate outcome occurs without recourse to factual evidence. As a result, Constantia acquired 16 000 policyholders for free at the expense of Anderson.

calculation if it does not include all such considerations.<sup>39</sup> An example of a simple or basic SCR formula is:<sup>40</sup>

$$\text{Basic SCR} = \sqrt{\sum_{i,j} \text{Corr}_{i,j} \times \text{SCR}_i \times \text{SCR}_j}$$

Where:

SCR<sub>i</sub> denotes the sub-module i and SCR<sub>j</sub> denotes the sub-module j, and where Corr 'i,j' means that the sum of the different terms should cover all possible combinations of i and j. In the calculation, SCR<sub>i</sub> and SCR<sub>j</sub> are replaced by the following: SCR nl premium and reserve denotes the non-life premium and reserve risk sub-module and SCR nl catastrophe denotes the non-life catastrophe risk sub-module.<sup>41</sup>

In terms of the FSRA the Reserve Bank, the Prudential Authority and the Financial Services Conduct Authority (hereafter the FSCA, which was previously known as the FSB) could consult one another to consider what should be included in the SCR formula to support the financial stability of South African policyholders or insurers; in other words, what assumptions, techniques or parameters should be taken into account when calculating a more complex SCR.<sup>42</sup> For this reason the Steering Committee recommends that an auditor should audit the formula and (it is assumed) at least disclose its contents in the financial statements of an insurer after auditing it. This action

<sup>39</sup> Pfeifer and Strassburger 2008 *Scandinavian Actuarial Journal* 62. The square root formula or standard formula can severely underestimate the true SCR required by regulators.

<sup>40</sup> *Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the Taking-up and Pursuit of the Business of Insurance and Reinsurance (Solvency II)* [2009] OJ L 335, 1-155 Annex IV para 1; EIOPA 2021 [https://www.eiopa.europa.eu/rulebook/solvency-ii/article-6543\\_en](https://www.eiopa.europa.eu/rulebook/solvency-ii/article-6543_en).

<sup>41</sup> The factor Corr <sub>i,j</sub> denotes the items set out in row i and in column j of the following correlation matrix:

j refers to right i refers to below	Market	Default	Life	Health	Non-life
Market	1	0,25	0,25	0,25	0,25
Default	0,25	1	0,25	0,25	0,5
Life	0,25	0,25	1	0,25	0
Health	0,25	0,25	0,25	1	0
Non-life	0,25	0,5	0	0	1

<sup>42</sup> Preamble of the *Financial Sector Regulation Act* 9 of 2017; Pfeifer and Strassburger 2008 *Scandinavian Actuarial Journal* 62. The square root formula or standard formula can severely underestimate the true SCR required by regulators.

would prevent any form of misrepresentation in the SCR or MCR calculation when financial statements are submitted to the FSCA.<sup>43</sup>

The following paragraphs focus on the powers of the Reserve Bank, the Prudential Authority and the FSCA in this regard.

### **3 The Reserve Bank – the SCR as a more complex calculation than loss ratios**

Cumulative excesses, as explained above, were implemented by an underwriting firm in South Africa, Anderson Insurance Underwriting Managers. An underwriting manager is a type of binder holder that can act on behalf of an insurer as if it were an insurance company; for example, to complete binder functions (to settle or reject claims, calculate premiums etc.) on behalf of an insurer. In the case of *Anderson Insurance Underwriting Managers v Constantia Insurance Company Ltd*<sup>44</sup> Anderson negotiated a "binder" agreement with Constantia to continue with the latter's cumulative excess practices. Later, instead of being an underwriting manager Anderson tried to become a division of Constantia. In this regard Anderson completed "binder" functions similar to those of an insurer without being a binder holder.<sup>45</sup> A binder holder is a company with a separate legal personality, while a division forms part of an insurer without a separate legal personality. In this case Anderson negotiated a division agreement with Constantia and immediately afterwards deregistered Anderson as a private company. Subsequently Constantia appointed a new chief executive officer (CEO) who rejected all the negotiated agreements between Constantia and Anderson.<sup>46</sup> Consequently, Constantia gained approximately 16 000 policyholders at the expense of Anderson, which was now not a separate legal entity owing to its deregistered status. Since Anderson was no longer a true binder holder Constantia refused to pay it any fees. Anderson Insurance closed its doors for business and six years later Constantia was liquidated by the Prudential Authority (during September 2022) for disclosing incorrect SCR calculations since 2019. It is interesting to note that the rejection of the negotiated division agreements and cumulative excesses was not of interest to the Reserve Bank prior to the inception of the FSRA. Today, the Prudential Authority and the Reserve Bank can formally reject any insurance product (cumulative excess product) that is contrary to

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<sup>43</sup> See, for example, FSB 2015 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20(v%204)%20FINAL.pdf) with reference to the EU position.

<sup>44</sup> *Anderson Insurance Underwriting Managers v Constantia Insurance*.

<sup>45</sup> *Anderson Insurance Underwriting Managers v Constantia Insurance* paras 15-19.

<sup>46</sup> *Anderson Insurance Underwriting Managers v Constantia Insurance* paras 25-32.

the purpose or scope of the FSRA.<sup>47</sup> Arguably, a cumulative excess policy is contrary to the principles of financial stability and the same applies to an insurer that rejects negotiated agreements, leaving underwriting managers and their employees without any income.

The powers of the Reserve Bank are regulated in Part 1 to 6 of the FSRA. Section 11 of the FSRA stipulates that the Reserve Bank may make use of any power to protect the financial stability of consumers and policyholders. Any power is regulated to some extent in the FSRA; for example, section 12(a)(ii) of the FSRA, which allows a financial sector regulator (e.g. the Prudential Authority or the FSCA) to dictate to the Reserve Bank how it (the Reserve Bank) should exercise its powers.<sup>48</sup> The preceding sentence makes it clear that the Reserve Bank plays a very important role in the South African insurance sector. For example, the Governor of the Reserve Bank may make any determination based on the information received from the Prudential Authority. This is intended to prevent or eliminate weak (cumulative excesses, loss ratios) or fraudulent or disruptive business practices (undisclosed basic SCR calculations or CEOs of insurance companies that reject valid contracts concluded with binder holders) as regulated in section 182(b)(iii) of FSRA. In addition, the Governor may also at any time revoke any issued determination, or the Prudential Authority can notify the Reserve Bank of its intentions to liquidate an insurer, especially when the insurer does not comply with the required SCR calculations in terms of section 30(3) of FSRA to prevent any form of financial instability.<sup>49</sup> It is possible, depending on the discretion of a regulator (the Prudential Authority or FSCA), to replace the regulator's SCR formula with the insurer's own SCR formula, but this should be clearly communicated to the regulator to clarify the basis for the SCR calculation (the assumptions, parameters, etc. used by the insurer) as being true and correct. Generally, the MCR should not be less than 25% of the SCR.<sup>50</sup> Breaching the MCR would not necessarily lead to a regulatory intervention, as the insurer could quickly rectify the MCR; that is, could receive a capital injection from existing shareholders. However, breach of the SCR would require the

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<sup>47</sup> Godwin and Schmulow 2015 *SALJ* 756-768.

<sup>48</sup> See Godwin and Schmulow 2015 *SALJ* 756-768.

<sup>49</sup> See, generally, Pellicchia and Perciaccante 2019 *Munich Personal RePEc Archive* 1-8. The SCR formula could be changed depending on its underlying theory or assumption(s).

<sup>50</sup> See as an example FSB 2015 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20(v%204)%20FINAL.pdf)

intervention of the regulator to rectify the insurer's solvency – *ex parte* an application to appoint a provisional curator.<sup>51</sup>

In South Africa the SCR is known as the prescribed capital requirement (hereafter PCR), while the MCR is the absolute minimum capital required to protect the policyholders when conducting the business of an insurer; that is, the minimum capital required to settle policyholders' claims successfully in the future.<sup>52</sup> The Steering Committee requires simple formulae to allow an auditor the opportunity to audit a specific formula in detail.<sup>53</sup> The Steering Committee could be criticised, however, for not explaining all the relevant economic considerations that constitute administrative expenses, written premiums, technical provisions, capital-at-risk, deferred taxes and administrative expenses. If the latter is not properly explained, the insurer can decide what constitutes administrative costs or written premiums, making the latter very flexible to the latter formulae.

#### 4 The Prudential Authority

The Prudential Authority is a juristic or legal person operating side by side with the Reserve Bank, as indicated by section 32(2) of the FSRA. The objective of the Prudential Authority is to promote the financial soundness of insurers and to protect policyholders should an insurer fail to meet its PCR.<sup>54</sup> The Prudential Authority assists and cooperates with the FSCA (in terms of section 34(1)(b) of FSRA) to understand the PCR calculation used by an insurer, thereby calculating a more correct PCR if necessary. Based on these calculations the Prudential Authority has the power to place the insurer under provisional curatorship, but this can be done only if there is a clear indication that the insurer will become solvent in the future. If the insurer is unable to become solvent under the management of a curator, the Prudential Authority will liquidate the insurer. The Prudential Authority had focussed on Constantia's solvency requirements since 2019, but Constantia never explained that it had used approximately R700 000 000 (of its equity portfolio) to fund its business operations (from 2019 to 2022).<sup>55</sup> The selling of shares (equity) to raise capital to fund Constantia's business activities (e.g. to settle claims) could be contrary

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<sup>51</sup> Norton Rose Fullbright 2015 <https://www.nortonrosefullbright.com/en/knowledge/publications/f12a4a4a/ten-things-you-need-to-know-about-insolvency-ii>.

<sup>52</sup> FSB 2015 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20(v%204)%20FINAL.pdf).

<sup>53</sup> See FSB 2015 [https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20\(v%204\)%20FINAL.pdf](https://www.fsca.co.za/Regulated%20Entities/SAM%20DOCUMENTS/Position%20Paper%2068%20(v%204)%20FINAL.pdf).

<sup>54</sup> Godwin and Schmulow 2015 *SALJ* 756-768.

<sup>55</sup> *Ex parte Prudential Authority* para 36 of the affidavit of Johan Heyneke.

to the well-known insolvency law principle – *concursum creditorum* (e.g. policyholders who submitted claims and are awaiting payment of these claims are considered creditors – continuously decreasing the R700 000 000 has a direct impact on the *pro rata* settlement of claims).

#### **4.1 A comparison of Constantia's MCR and PCR**

The Prudential Authority submitted an affidavit attesting to why Constantia should be liquidated (in October 2022) and why the provisional appointment of a curator should be terminated immediately. Section 48(2)(a) of the FSRA allows an individual working for the Prudential Authority to bring such an application on behalf of the CEO of the Prudential Authority and the Governor of the Reserve Bank. It is clear that the Prudential Authority and the FSCA had been working together on Constantia's financial position from 2019 to 2022, since Constantia had been required to send weekly insolvency calculations. It is also clear that after the appointment of the provisional curator, the provisional curator had recalculated the PCR based on the true financial information pertaining to Constantia.

The curator focussed on the calculated MCR and PCR as presented by the board of directors of Constantia in the past, which showed the PCR as R304 158 000 and the MCR as R272 178 000. However, the curator realised that Constantia required R909 342 000 to cover its PCR requirements (a deficit of R600 000 000).<sup>56</sup> The MCR was also calculated incorrectly, and it should have reflected R227 335 000 in 2022.<sup>57</sup> Consequently, the Prudential Authority had relied on Constantia's incorrect calculations when they applied for a provisional curator court order. If one focusses on the recommendations of the Steering Committee, the question that arises here is, when an auditor was allowed to audit the formulae, why was it impossible for the auditor to do so successfully and to express an audited opinion in the financial statements?<sup>58</sup> If the auditor had followed this simple process suggested by the Steering Committee, the Prudential Authority and FSCA would have realised that an *ex parte* application for provisional curatorship was the wrong legal step to take in 2022.<sup>59</sup> Another question could also be asked – are auditors aware of their duty to audit these formulae? The difference identified between R908 342 000 and R304 158 000 is clearly an attempt to bring the PCR within reach of the

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<sup>56</sup> *Prudential Authority v Constantia Insurance* paras 45 and 46 of the affidavit; Godwin and Schmulow 2015 SALJ 756-768.

<sup>57</sup> *Ex parte Prudential Authority* para 36 of the affidavit.

<sup>58</sup> See, generally, Penman 2016 <https://academiccommons.columbia.edu/doi/10.7916/D82N5DNK> 1-58 on how to design financial statements to promote transparency.

<sup>59</sup> *Ex parte Prudential Authority* para 36 of the affidavit.

MCR. However, R908 342 000 exceeds the MCR by far more than the required 25%. The questions relating to the auditor above were not answered or explained in the affidavit for liquidation submitted by the Prudential Authority. After realising that the weekly calculations submitted had been incorrect since 2019, the Prudential Authority used its own actuaries to calculate the PCR.<sup>60</sup> This is probably the real reason why Constantia was unable to renew its reinsurance treaty relevant to the PCR in 2022. The reinsurer probably calculated a PCR similar to that calculated by the Prudential Authority.<sup>61</sup> Even if reinsurance had been obtained on the R304 158 000, it would not have been sufficient to ensure financial stability for Constantia or to allow it to continue to conduct business as an insurer, especially when one considers the true PCR. It would appear that the board of directors of Constantia (the CEO, the financial controller, the chief financial officer) knew the true PCR and MCR, but nevertheless had remained uninformative and non-transparent in their email correspondence with the Prudential Authority and the FSCA since 2019.<sup>62</sup> In fact, the financial management have not disputed the Prudential Authority's calculation of PCR and MCR in 2022 or 2023 nor have they blamed the auditor for an incorrect audit.<sup>63</sup>

## 5 The relationship between the annual financial statements and PCR

Constantia's financial statements complied with section 44 of the *Insurance Act* and section 29 of the *Companies Act 71 of 2008* as well as with the International Financial Reporting Standards (hereafter IFRS).<sup>64</sup> The IFRS is an international framework for the drafting of financial statements, which complies with the International Accounting Standards Board (hereafter IASB) requirements.<sup>65</sup> What is very strange in terms of Constantia's financial statements is that Constantia was both liquid and solvent in 2022. It should be mentioned that an auditor's calculation of solvency and/or liquidity disclosed in the financial statements is not the same as the actuarial calculation for the

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<sup>60</sup> *Prudential Authority v Constantia Insurance* para 47 of the affidavit.

<sup>61</sup> See, generally, *Ex parte Prudential Authority* para 36 of the affidavit.

<sup>62</sup> For an explanation of the financial position as communicated to the Prudential Authority before liquidation, see *Ex parte Prudential Authority* para 36 of the affidavit.

<sup>63</sup> *Prudential Authority v Constantia Insurance* para 47.5 of the affidavit. See, generally, *The Commissioner of the South African Revenue Services v Zikhulise Cleaning Maintenance and Transport Services* (High Court of South Africa, Gauteng Division, Pretoria) (unreported) case number 14886/16 of 14 October 2020 para 9 pertaining to a *bona fide* argument.

<sup>64</sup> Section 29(2) of the *Companies Act 71 of 2008* that financial statements should not be incomplete in any material matter; IFRS date unknown <https://www.ifrs.org>.

<sup>65</sup> Deloitte date unknown <https://www.iasplus.com/en/resources/ifrsf/iasb-ifrs-ic/iasb>.

PCR and MCR.<sup>66</sup> The latter calculations were not part of the auditor's calculations as required by the IFRS. However, as required by the Steering Committee, the auditor should have at least disclosed the relevant actuarial techniques used by Constantia to calculate the PCR and MCR; that is, should have given an overview of the economic considerations (assumptions, parameters etc.) used by Constantia's actuary when calculating the PCR and MCR.<sup>67</sup> Nevertheless, as stated earlier, the auditor did not comply with this requirement. An auditor should therefore take note of the Steering Committee's requirements that, to promote transparency, auditors must audit the relevant formulae and disclose this in the financial statements.<sup>68</sup>

Whatever the case, the reason why Constantia's financial statements showed the company to be solvent is because the balance sheet had a positive equity amount in line with accounting principles, which are not the same as actuarial calculations. In terms of accounting principles, liabilities plus equity equal assets, and if there is no equity owing to an increase in liabilities, such a company is considered insolvent. In the 2021 balance sheet the equity disclosed was R84 000 000. The cash flow position had also improved significantly, from R75 000 000 to R191 000 000.<sup>69</sup> The cashflow statement is a more accurate method for understanding the "equity" of a company or insurer. That is, the ability to generate cash would lead to net profits and profits equal equity in the balance sheet.

In addition, a balance sheet is merely a snapshot of the business affairs of a company on a specific day, while the cash flow statement indicates all incoming and outgoing cash during the financial year.<sup>70</sup> In this regard Constantia's cash inflow was more than its outflow from an accounting perspective. Thus, in terms of accounting principles Constantia was both liquid and solvent in 2021 (and was assumed to be so also in 2022), but in terms of actuarial calculations (PCR and MCR) Constantia did not meet the Steering Committee's required solvency requirements.

Constantia had also invested in equity portfolios which amounted to nearly R733 000 000 in 2019 but decreased to R133 000 000 in March 2022.<sup>71</sup> These investments were made in three companies, namely Finbond, Trustco and

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<sup>66</sup> See, generally, *Ex parte Prudential Authority* para 36 of the affidavit; *Prudential Authority v Constantia Insurance* para 48 of the affidavit.

<sup>67</sup> Norton Rose Fullbright 2015 <https://www.nortonrosefullbright.com/en/knowledge/publications/f12a4a4a/ten-things-you-need-to-know-about-insolvency-ii>.

<sup>68</sup> *Ex parte Prudential Authority* para 36.1.4 of the affidavit.

<sup>69</sup> *Ex parte Prudential Authority* para 36.3 of the affidavit.

<sup>70</sup> *Ex parte Prudential Authority* para 36 of the affidavit.

<sup>71</sup> *Ex parte Prudential Authority* para 36 of the affidavit.



Conduit Capital. These investments together with reinsurance in 2019 had allowed for PCR compliance and it would probably have been much easier to achieve the required PCR in 2019 than in 2022, when the equity portfolios decreased to approximately R133 000 000.<sup>72</sup> The reason for the decrease in these equity portfolios is unclear. They could have been used to finance Constantia's business activities (to sell shares, for example in Trustco, to generate cash in hand to settle claims).<sup>73</sup>

Accordingly, it would appear that Constantia used the basic PCR formula, the auditor neglected to audit the formulae and Constantia never disclosed the basic PCR formula to either the Prudential Authority or the FSCA. The Prudential Authority realised the material differences only when a provisional curator was appointed, who indicated that the actual PCR was closer to R900 000 000. The audited financial statements indicated liquidity and solvency for Constantia, which is contrary to the actual PCR and MCR calculations. In this regard, one wonders what the value of the financial statements relevant to the business of an insurer is if an auditor did not audit these formulae and did not give a relevant explanation of them in the financial statements.<sup>74</sup>

## **6 The relationship between actual equity investments and dividends**

In the above paragraph it is said that Constantia's equity portfolio was divided between Finbond, Trustco and Conduit Capital. The exact percentage of shares or investments in each of these companies is uncertain. Whatever the case, Trustco also tried to purchase shares in Constantia in 2019 (i.e., 32.2% in total). The Prudential Authority granted it permission to continue with this transaction, the sole purpose being to invest in or inject capital into Constantia as a way of improving its solvency requirements. The reason why Constantia did not continue with the Trustco transaction remains unclear and is not disclosed in the *ex parte* affidavit for provisional curatorship.<sup>75</sup> It seems that Constantia would have been used as a finance vehicle for building a new city outside the city of Windhoek (Namibia), as the developer of this city is Trustco. However, with hindsight, in view of the PCR requirement, it would have been

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<sup>72</sup> *Ex parte Prudential Authority* para 38 of the affidavit.

<sup>73</sup> *Ex parte Prudential Authority* para 38.20 of the affidavit. It is assumed that it was used to supplement Constantia's cashflow. See, generally, *Commissioner of Taxes v Booyens Estates Ltd* 1918 AD 576 579. Selling the equity portfolio might have been intended to assist in conducting the business of the company.

<sup>74</sup> See, generally, Hanion 2003 *Nat'l Tax J* 831-863. In specific circumstances the value of financial statements is "not much".

<sup>75</sup> *Ex parte Prudential Authority* para 38.5 of the affidavit.

very difficult to use Constantia as a finance vehicle in this case.<sup>76</sup> The way in which Constantia would have been used for this would probably have been in the form of dividends (contributions) to be paid to Trustco. Knowing what the PCR requirement was in 2019, Constantia would never have been sufficiently solvent to pay any dividends to finance a new city development. In addition, in terms of section 36 of the *Insurance Act* an insurer is not allowed to pay any dividends in the event of a poor PCR. This is probably the real reason why Constantia did not continue with Trustco's new development city scheme.<sup>77</sup>

Additionally, Constantia (through Conduit Capital) approached Mmuso Consortium (a broad-based black economic empowerment company) to invest R500 000 000 in Constantia. In return Mmuso would have become a significant owner or shareholder of Constantia by subscribing to new Constantia shares subject to certain conditions.<sup>78</sup> In this regard section 7(2) of the *Insurance Act* (which also regulates the Fitness and Propriety of Key Persons and Significant Owners of Insurers) requires significant owners to have access to capital in future. Further, a significant owner must be able to meet the debts of the insurer as they fall due and/or a significant owner should not be subjected to any civil judgments due to unpaid debt.<sup>79</sup> Constantia was later informed that Mmuso could not produce financial statements demonstrating its financial ability to comply with section 7(2) of the *Insurance Act*. These financial statements were required by the Prudential Authority to ensure such compliance.<sup>80</sup> For this reason Mmuso did not continue with its investment in Constantia.

## **7 When being placed under curatorship, is there a possibility of finding future investors?**

It is clear that the Prudential Authority had not recognised the severity of the PCR and MCR in 2019, 2020, 2021, since it believed that if a provisional curator was appointed in 2022 there was a possibility of finding a suitable investor to rectify Constantia's solvency requirements.<sup>81</sup> The belief in the possibility of concluding an investment contract more successfully during the provisional curator's management of Constantia was based on the fact that the Prudential Authority was required to act in Constantia's best interests. Therefore, the Prudential Authority would try through the appointment of a

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<sup>76</sup> *Ex parte Prudential Authority* para 38.4.2 of the affidavit.

<sup>77</sup> *Ex parte Prudential Authority* para 38.7 of the affidavit.

<sup>78</sup> *Ex parte Prudential Authority* para 38.17 of the affidavit.

<sup>79</sup> *Ex parte Prudential Authority* para 38.19 of the affidavit.

<sup>80</sup> *Ex parte Prudential Authority* para 38.21 of the affidavit.

<sup>81</sup> *Ex parte Prudential Authority* para 44.2 of the affidavit.

provisional curator to encourage any investor to invest in Constantia on fair contractual terms to secure its economic or financial stability.<sup>82</sup>

## 8 Balance sheet on the day of application for liquidation

When the application for liquidation was lodged in October 2022, the Prudential Authority stated that the equity in Constantia's balance sheet was a negative R85 000 000. This position implied that Constantia's liabilities exceeded its assets. A balance sheet is not a true reflection of solvency since, as discussed earlier, it is merely a snapshot of a company's business affairs on a specific day. In this regard more emphasis should be placed on the cash flow statement, as was discussed earlier.<sup>83</sup> Nevertheless, the Prudential Authority's affidavit indicated that the actual cash in hand was R154 000 000, which was not enough to sustain Constantia's business activities up to the end of 2022.<sup>84</sup>

Based on the MCR, the application for liquidation clearly stated that Constantia was not sufficiently solvent to continue with its business activities, since the MCR does not deviate more than 25% of the PCR.<sup>85</sup> The affidavit further indicated that the real reason why liquidation should be granted was for a public purpose.<sup>86</sup> The "public purpose" could, for example, be that owing to the incorrect calculation of the MCR and PCR in 2019, 2020, 2021 and 2022 the policyholders, prospective policyholders and Constantia investors should be protected from Constantia's dishonest business activities<sup>87</sup> because Constantia had misled the Prudential Authority.<sup>88</sup> It appears that if investors had been approached such investors would not have understood the true insolvency or liquidity problems at Constantia before signing investment agreements. Any investor would, with hindsight, have realised that the investment made would require far more capital to meet the PCR in the future. Accordingly, investing in Constantia would have been impossible for any investor to comply with section 7(2) of the *Insurance Act*. This would be in the light of the fact that Constantia needed approximately R900 000 000 in

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<sup>82</sup> *Ex parte Prudential Authority* para 44.4 of the affidavit.

<sup>83</sup> *Ex parte Prudential Authority* para 48.1 of the affidavit.

<sup>84</sup> *Ex parte Prudential Authority* para 48.2 of the affidavit.

<sup>85</sup> *Ex parte Prudential Authority* para 48.4 of the affidavit.

<sup>86</sup> See, generally, Marles 2007 *J Transnat'l L & Pol'y* 308. The term "public purpose" could be explained as that which is beneficial to society. It could also imply a public interest because it requires some genuine interest of the public. If a mere reference to public interest can magically be put forward or argued, then such an interest is meaningless.

<sup>87</sup> *Ex parte Prudential Authority* para 36 of the affidavit.

<sup>88</sup> *Prudential Authority v Constantia Insurance* para 50 of the affidavit; Lee, Ali and Gloeck 2008 *Southern African Journal of Accountability and Auditing Research* 27-34.

capital.<sup>89</sup> In this instance, not one but a few investors would have had to be willing to invest a minimum of R900 000 000 to ensure economic stability, not just for Constantia, but also for Constantia's policyholders and prospective policyholders.

## 9 Just and equitable to liquidate?

In the above discussion we have noticed public purpose being stated as a ground for liquidating Constantia. In terms of section 344(H) of the *Companies Act* 61 of 1973, when a company is liquidated the liquidation must also be just and equitable.<sup>90</sup> To understand this phrase, the affidavit for liquidation indicated that if the order for liquidation were not granted the holding of R154 000 000 in cash would be insufficient for Constantia to be able to carry on with the business of an insurer. It would be to the detriment of those policyholders who had submitted claims and were expecting payment of their claims before the end of 2022.<sup>91</sup> It was therefore just and equitable to liquidate Constantia before there was no cash left to settle the claims of policyholders.<sup>92</sup> For the reasons stated above (i.e. the incorrect PCR and MCR calculations submitted to the Prudential Authority), it was just and equitable to liquidate Constantia on an urgent basis (via a final order) without granting a provisional liquidation order first (time was of the essence).<sup>93</sup> The reason for putting Constantia into final liquidation immediately was to preserve the R154 000 000 in cash. R154 000 000 was a reasonable amount to protect the interests of policyholders who had already submitted their claims and were awaiting settlement.<sup>94</sup> A provisional liquidation order would have resulted in more claims being

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<sup>89</sup> *Prudential Authority v Constantia Insurance* para 51 of the affidavit. It should be pointed out that there is no realistic expectation of finding a few investors who not only are able to invest R900 000 000, but also have the additional capital to comply with s 7(2) of the *Insurance Act* pertaining to the significant owners of an insurer.

<sup>90</sup> The *Companies Act* 61 of 1973 is still valid under exceptional circumstances such as the liquidation of a company. In this regard, see for example *Wynand Cornelius van Zyl v Boat Lodge Investments CC* (High Court of Kwa-Zulu Natal) unreported case number 9417/2019P of 31 May 2021. In this case there was a deadlock in the management of the close corporation. The Court had to decide whether it was just and equitable to wind up the close corporation due to a deadlock in management decisions. See, further, Chesterman 1973 *MLR* 129-152.

<sup>91</sup> *Prudential Authority v Constantia Insurance* para 52 of the affidavit; Maloka and Muthugulu-Ugoda 2016 *PELJ* 1-23.

<sup>92</sup> See, for example, *Ex parte Prudential Authority* para 36 of the affidavit.

<sup>93</sup> *Prudential Authority v Constantia Insurance* paras 57-58 of the affidavit.

<sup>94</sup> *Ex parte Prudential Authority* paras 59.3 and 59.7 of the affidavit; in *Paarwater v South Sahara Investments Pty (Ltd)* 2005 4 All SA 185 (SCA) just and equitableness is proven on a balance of probabilities.

submitted, thus making it impossible to settle the full amount of the claims.<sup>95</sup> It is interesting to note that the Prudential Authority and/or provisional curator did not need to provide any security when applying for the liquidation order.<sup>96</sup>

## 10 Conclusion

It is clear that the Reserve Bank and the Prudential Authority now have a greater responsibility to protect the South African economy than prior to the promulgation of the FSRA.<sup>97</sup> There is a duty on these organs to protect and preserve the economic stability of South Africa's insurers. However, the different methods used to calculate the PCR are to the detriment of the public (i.e. policyholders and or prospective policyholders), unless an auditor complies with its duties to audit the relevant formulae and to disclose their contents in financial statements.<sup>98</sup> If Constantia's auditor had complied with this requirement to promote transparency, the Prudential Authority would have liquidated Constantia earlier and not applied for a provisional curator court order in 2022. This is because there was no possibility of complying with the PCR in practice. From 2019 Constantia had not been transparent in its dealings with the Prudential Authority as it continued to decrease the value of its equity portfolio (from R733 000 000 to R133 000 000). Thus, the financial statements submitted to the Prudential Authority indicating solvency were not a true reflection of Constantia's solvency position. The language used by auditors and actuaries with regard to solvency criteria is not similar, but similarity may be increased to promote transparency if the PCR and MCR formulae are audited. In addition, the requirements for solvency and liquidity in the 2008 *Companies Act* and the requirements for solvency in the *Insurance Act* are not the same.<sup>99</sup> The 2008 *Companies Act* focusses on the ability to pay creditors, whereas section 36 of the *Insurance Act* clearly requires the company's own funds to be equal to the PCR. For this reason, in 2019 the Prudential Authority requested the submission of ongoing weekly solvency calculations from Constantia, which in return submitted incorrect calculations. Although an insurer is a company and the *Companies Act* is relevant, the

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<sup>95</sup> *Ex parte Prudential Authority* para 59 of the affidavit.

<sup>96</sup> *Ex parte Prudential Authority* para 61 of the affidavit. S 57(2)(e) of the *Insurance Act* makes provision for no security.

<sup>97</sup> FSCA, previously known as the FSB, had to liquidate insurers; See SaXum Insurance date unknown <http://saxuminsurance.com>; Kruger 2016 <https://www.moonstone.co.za/liquidation-of-saxum-insurance>.

<sup>98</sup> See, generally, *Ex parte Prudential Authority* para 36 of the affidavit. To hold an auditor liable for failing to audit the contents of an agreement, see, generally *KPMG Chartered Accountants v Securefin* 2009 2 All SA 523 (SCA). See, further, Maroun and Gowar 2013 *International Journal of Auditing* 177-189.

<sup>99</sup> See generally, *Ex parte Prudential Authority* paras 36-37 of the affidavit.

nature of an insurer's business is insurance, and more focus should be placed on section 36 of the *Insurance Act* to promote a stable South African economy. Financial statements that contain no auditing of the PCR and MCR should not be relied on.<sup>100</sup> Taking this position would eliminate the vague language requirements for solvency (for example, administrative tasks, written premiums, parameters, and/or assumptions) and allow the Prudential Authority an opportunity to ascertain the parameters that have been used in the insurer's calculations and if necessary to redo the calculations immediately.

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## List of Abbreviations

CEO	chief executive officer
Dick L Rev	Dickinson Law Review
EIOPA	European Insurance and Occupational Pensions Authority
EU	European Union
FSB	Financial Services Board
FSCA	Financial Services Conduct Authority
FSRA	Financial Sector Regulation Act 9 of 2017

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GPRIIP	Geneva Papers on Risk and Insurance - Issues and Practice
IASB	International Accounting Standards Board
IBNR	incurred but not reported
IFRS	International Financial Reporting Standards
J Comp Bus & Cap Mkt L	Journal of Comparative Business and Market Law
J Transnat'l L & Pol'y	Journal of Transnational Law and Policy
JIA	Journal of the Institute of Actuaries
MCR	minimum capital requirement
MLR	Modern Law Review
Nat'l Tax J	National Tax Journal
PCR	prescribed capital requirement
PELJ	Potchefstroom Electronic Law Journal
S Ac LJ	Singapore Academy of Law Journal
SALJ	South African Law Journal
SARB	South African Reserve Bank
SCR	solvency capital requirement
UPR	unearned premium reserve