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An investigation of an overlap in penalty calculations: profit commission in reinsurance treaties versus profit commission in binder agreements for underwriting managers

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ABSTRACT
Reinsurance treaties and binder agreements regulate penalty calculations in the event the insurer and underwriting manager is unprofitable and/or profitable. The formulae and different premium terminologies are investigated to calculate loss ratios and whether there is an overlap in sliding scale penalty calculations/formulae relevant to loss ratios of treaties and binder agreements. Treaties and binder agreements generally use sliding scale penalties to calculate reinsurance commission or sharing in the insurer's profits by an underwriting manager and is in conflict with the Conventional Penalties Act 15 of 1962 of South Africa. The Conventional Penalties Act 15 of 1962 must guide reinsurers and insurers in their profit calculations formulae to prevent any form of sliding scale penalties relevant to loss ratios. It is therefore suggested that a standard template of profit calculations and terminologies should be used in binder agreements to prevent different calculations of loss ratios in the short term insurance landscape. This will guide the Financial Conduct Authority Services (previously the Financial Services Board) to understand loss ratios of affordable short term financial products when compared to loss ratios of other short term financial products in South Africa.

KEYWORDS
Reinsurance commission; loss ratio; risk premium; penalties; underwriting manager

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1. BACKGROUND AND OVERVIEW

1.1 Background

1.1.1 New business entities of underwriting managers and non-mandated intermediaries were introduced and entered into the Short Term Insurance Act 53 of 1998[1] on 23 December 2011 (Kilian & Vandeventer, 2017b).

1.1.2 The purpose of an underwriting manager[2] as either a private or public company is to act on behalf of an insurer as if it is an insurance company.[3] This company's binder functions are to change policies, determine policy premiums, cancel policies, and pay claims (Mushai & MacGregor, 2016). For these purposes, an insurance company may conclude a binder agreement with an underwriting manager for the sole purpose of allowing the latter to fulfil their binder functions of behalf of the insurer and in order to render the insurer profitable whereby the underwriting manager may receive profit. With the change of the Short Term Insurance Act in 2011, the legislator did not, however, regulate the different formulae relevant to profit calculations (Van Niekerk, 1998). In order to understand profits from an insurance perspective, it is first vital to understand what is considered to be 'profits' in terms of the Companies Act 71 of 2008[4] and then determine how it relates to profits in terms of the Short Term Insurance Act as changed in 2011. The relationship between an insurer and underwriting manager is regulated by a contract and is generally referred to as a profit-sharing or binder contract instead of using treaty terminology relevant to reinsurers (Van Niekerk, 2008).

1.1.3 The main problem driving this research is to analyse the different profit calculations as found in reinsurance treaties and underwriting managers' agreements or binders.[5] A treaty contract is entered into between a reinsurance company and an insurer, whereby the insurer may receive profit or commission if the claim's loss ratio is appropriate. On the other hand, a non-mandated intermediary as either a public or private company may not share in the profits of the insurer and is irrelevant to our discussion.

1.2 Overview

1.2.1 The article examines an underwriting manager's different profit or loss ratio calculations and attempts to prove a possible overlap in sliding scale profit calculations with

1 Amended by Short-Term Insurance Act, 1998: Amendment of Regulations Made under Section 70, *Government Gazette* 34877, Notice No. R. 1076, dated 23 December 2011

2 The Insurance Act 27 of 1943 defined the concept underwriting manager in full. This concept was only introduced in the current Short Term Insurance Act by *Government Gazette* No 34877 of 23 December 2011. The definition causes problems due to interchangeable terminology in reference to binder or binder-holder in the *Gazette* with specific reference to non-mandated intermediaries.

3 *Namibia Insurance Association* v *Governments of the Republic of Namibia* 2001 NR 1 (HC)

4 Companies Act 71 of 2008

5 *Standard General Insurance Co Ltd* v *Voest-Alpine Industrie anlangenbou GmbH* 1994 (3) SA 365(A)

those of reinsurance treaties. It is important to determine how and whether the Conventional Penalties Act 15 of 1962[6] is relevant to both types of sliding scale calculations.[7]

1.2.2 The main research problem in this study is to analyse and interpret different formulae which are applied to calculate profits, and to investigate a potential overlap in penalty calculations applicable between 1) an insurer and an underwriting manager, and 2) between a reinsurer and insurer (Delport, 2011). The article explores whether penalty calculations relevant to sliding scale loss ratios are subject to the Conventional Penalties Act 15 of 1962 (Havenga, 2001). The use of different terminologies relevant to profit calculations between an insurer and an underwriting manager is investigated (Havenga, 1987), and profits relevant to cell captive insurance are considered.

1.2.3 This article employs three approaches to the investigation. Firstly, this study relies on example treaty or binder contract clauses relevant to profit calculations (Kilian & Vandeventer, 2017b). These clauses are relevant to the discussion in order to understand the terminology of premium or risk premium and relevant expenses expressed in profits or losses. Secondly, sources are employed in the study to explain the different terminologies relevant to binder or treaty contractual parties in the South African short-term insurance system, i.e. a division of an insurance company.[8] Thirdly, the investigation relies on the comparison of different sliding scale calculations expressed by specific tables to provide answers to the research objectives mentioned above. Sliding scale profit calculations are compared to those of reinsurance profit calculations.

1.2.4 These calculations are compared to different loss ratio examples to understand whether any overlap in penalty calculation could exist between a reinsurer and insurer and between an insurer and underwriting manager (Reinecke et al., 2002). The relevant calculations are analysed to establish contraventions of the Conventional Penalties Act and how to alter them by the contractual parties as required by the said Act.[9]

2. PROFITS IN COMPANY LAW

2.1 Company law principles relevant to profits are regulated in Section 4 of the Companies Act 71 of 2008. In this Act, 'distributions' are used as terminology instead of the terms of 'payment of dividends' as employed in the previous Companies Act (Kilian & Vandeventer, 2017a). Instead of referring to the term 'distributions' in this article, we employ the term 'dividends' as a method to avoid confusion with the sliding scale profit payment distributions (Mushai & MacGregor, 2016).

2.2 For shareholders of a company to receive a dividend, it is a generally accepted principle that the company should be profitable, or at least must have been profitable in

6 Conventional Penalties Act 15 of 1962

7 *Innocent Sithembele Mthethwa* v *Orange Insurance Limited FSOS* 06362/08-09/GP3 15 September 2010

8 *Anderson Insurance Underwriting Managers* v *Constantia Insurance* 2017 JDR 1278 (GJ)

9 *Lake* v *Reinsurance Corporation Ltd* 1976 (3) SA 124 (W)

previous financial years. To participate in the profits of a company, a person should be a specific shareholder of that company in terms of the Memorandum of Incorporation (MOI), since not all classes of shareholders are entitled to specific dividends, e.g. founder shares. A founder shareholder, in addition, may receive capitalisation shares rather than dividends from the company by simply allotting additional shares to the shareholder (Davis et al., 2013). The requirements to effect dividend payments are regulated by Section 4 of the Companies Act 71 of 2008.

2.3 These requirements are simply the liquidity test, the solvency test and the ability of the company to pay its creditors within 12 months after payment of any dividends. Should a company not be able to comply with Section 4, the company is for all practical reasons not allowed to effect dividend payments (Barth, 2002). It should be kept in mind, however, that the profit-sharing agreements between a reinsurer and an insurance company, or profit sharing relevant to an underwriting manager and insurance company, are not subject to company law principles. An insurance company is not usually a shareholder of a reinsurance company; an underwriting manager is also generally not a shareholder of an insurance company which can participate in distributable profits.[10]

2.4 For practical purposes, Section 4 of the Companies Act is thus not relevant and the interpretation of profits is not subject to solvency or liquidity criteria (Kilian & Vandeventer, 2017a). Profit-sharing agreements are therefore regulated by insurance law principles. The question arises: when should insurance profits be subject to Section 4 of the Companies Act? For this, the establishment of certain definitions is vital.

3. THE UNDERWRITING MANAGER

3.1 In Section 6.1 of the *Government Gazette* 34877, an underwriting manager is defined as:

- a) A person that performs one or more of the binder functions referred to in Section 48A(1)(a–e), and
- b) If that person renders services as an intermediary—
    1) Does not perform any act, the result of which is that another person will or does or offers to enter into, vary or renew a policy on behalf of an insurer, potential policy holder or policy holders, and
    2) Renders those services (other than the services in 1 above) to or on behalf of an insurer only.

3.2 The above definition is complex, yet vague, on what precisely constitutes an ‘underwriting manager’. An underwriting manager may be either a private or public company performing binder functions on behalf of an insurer as if it is the insurer in terms of Section

10 *Namibia Insurance* supra

48(A)(1) of the Short Term Insurance Act.[11] Although this company is not registered as an insurer in terms of the Financial Advisory and Intermediary Services Act 37 of 2002,[12] the underwriting manager is acting as an insurer. To recognise a private or public company as an underwriting manager, the binder agreement between an insurer and such a company must refer to this company specifically as an 'underwriting manager'.

3.3 The agreement must also acknowledge or contain one or all of the following binder functions on behalf of the insurer. It must:
— enter into or vary a policy,
— determine the policy wording,
— determine premiums,
— determine the value of policy benefits, and/or
— settle claims.

3.4 Should the underwriting manager have the necessary skills to settle claims in terms of *Government Gazette* No 34877 of 23 December 2011, the underwriting manager may share in the profits of the insurer at the end of that particular financial year. The definition makes it clear that only an underwriting manager may enter, vary or renew policies without the assistance of an insurer.

3.5 The *Government Gazette* No 34877 of 23 December 2011 uses the term 'binder' or 'binder holder', but these terms cause confusion about the duties of an underwriting manager and in the case of non-mandated intermediaries, some compliance practitioners interpret the intermediary as being able to conclude binder functions on behalf of the insurer,[13] and therefore acting as a binder holder. We are of the opinion, however, that the definition of a non-mandated intermediary is manifestly clear in the *Government Gazette* and that only an underwriting manager is allowed to use Section 48(A)(1)(a–e) to share in the profits of the insurer and relevant to correct interpretation of Rule 6.3.1 of the *Government Gazette*. Nonetheless, in order to calculate profits, the insurer and underwriting manager may agree on any one of the following simple formulae without requiring any shares in the insurer (with exception of Table 6 which relates to cell captive insurance). On the other hand, a cell captive insurer is an insurer that only conducts business through cell structures, for example a binder holder or cell owner that holds shares in an insurer. The shares are 'ring-fenced' and dividend participation is administered and accounted for separately from other classes of shares. In this regard Section 4 of the Companies Act 71 of 2008 is relevant to the cell captive insurer.

11 *BKB Limited* v *Collins* 2014 JDR 2715 (ECG)
12 Financial Advisory and Intermediary Services Act 37 of 2002
13 Rule 6.3.1 of the *Government Gazette* No 34877 of 23 December 2011 states: 'A binder agreement must in addition to those matters provided for under section 48 A(2)…' A non-mandated intermediary also requires a binder agreement and this causes confusion in the insurance landscape as to relevant binder functions for non-mandated intermediaries.

TABLE 1.

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)
Less IBNR (claims incurred but not reported)	(100 000)
Less claims	(450 000)
Total profits (or loss) for insurer	325 000
Loss ratio (675 000/1000 000)	67.5%

TABLE 2.

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 insurer	245 000
Loss ratio (755 000/ 1000 000)	75.5%

TABLE 3.

Risk premium	600 000
Plus reinsurance commission	10 000
Less broker commission (12.5%)	(75 000)
Less binder fee (5%)	(30 000)
Less insurer fee (3%)	(18 000)
Less IBNR	(100 000)
Less claims	(450 000)
Total profits/(loss) for insurer	(63 000)
Loss ratio (663000/600 000)	110.5%

TABLE 4.

Risk premium	600 000
Less broker commission (12.5%)	(75 000)
Less binder fee (5%)	(30 000)
Less insurer fee (3%)	(18 000)
Less IBNR	(100 000)
Less claims	(450 000)
Total profits/(loss) for insurer	(73 000)
Loss ratio (673 000/600 000)	112%

TABLE 5. Additional 'profit' or 'loss' fee based on a sliding scale for underwriting manager

For loss ratio	Greater than	68%			50% share in the 'loss' i.e. R73 000 loss equals R36 500 to be paid to insurer (Table 4)
For loss ratio	Above	63%	Less than	68%	Additional 2% share in 'profits' i.e. R325 000 equals an extra payment of R6 500 to the underwriting manager (Table 1)
For loss ratio	Above	60%	Less than	63%	Additional 5% share in 'profits'

TABLE 6. Cell captive

Underwriting manager acquires shares in the insurer	Insurer sells shares to the underwriting manager
Number of issued shares	1000
Number of cell captive issued shares	100
Net profit available for dividends	R1 000
Total cell captive dividend (1000/100)	R10 per share

4. PROFIT AND 'PROFITS'

4.1 As stated in terms of *Government Gazette* No 34877 of 23 December 2011, an underwriting manager is the only entity allowed to share in the insurer's profits without having any shares in the insurer (Kilian & Vandeventer, 2017b). When Tables 1 and 2 are considered, it is clear that the loss ratio in Table 1 is 67.5%. In other words, the profits relevant to Table 1 comprise the surplus of 67.5% (or R325 000 in this case). The loss ratio in Table 2 is 75.5% or, in other words, the profits made in one financial year are R245 000. Sasria (South African Special Risks Insurance Association) as an expense has been excluded from the tables and is also an expense that must be kept in mind when calculating loss ratios (Mushai & Macgregor, 2016).

4.2 Based on the calculations relevant to the same earned premium in Tables 1 and 2, the calculation of individual loss ratios or profit calculations is remarkably different. Generally, the insurer and the underwriting manager are both free, and allowed, to conclude a binder agreement to regulate the calculation of profits based on agreeable terms relevant to profit calculations, as is illustrated in Table 1 and 2. From an insurance perspective, Table 1 indicates a very profitable underwriting manager as compared to the result shown in Table 2. Since the pertinent *Government Gazette* contains no prescribed template of formulae or terms to be used in the calculation of loss ratios, this may have negative consequences when the regulator of the insurance industry, the Financial Conduct Authority Services, (previously the Financial Services Board) generally comments on perceived low loss ratios without the recognition of different profit calculations. Generally, the regulator will conclude that loss ratios of 70% or less imply reckless insurance practices where profits are derived from the breach of certain financial rights of policy holders (Ndlovu, 2008).

4.3 To circumvent loss ratios of 70% or less, the regulator proposed a concept new to the insurance industry: treating customers fairly (Treating Customers Fairly, 2014). An inherent problem of TCF, however, is that a 70% loss ratio or less is not indicative of reckless selling of insurance policies (as indicated in Tables 1 and 2) (Van Niekerk, 1999).[14]

4.4 There are products currently available in the market which seem to be in direct contravention of TCF. These products are:

- Product A: vehicle loss cover that grows monthly in terms of a fixed formula to cover partial loss in the event of a write-off or;
- Product B: vehicle loss cover that uses the calculation of cumulative excesses relevant to an accident i.e. 10% excess or less for driving at or after 23:00 at night and/or 10% excess or less if no third parties were involved in the accident and/or 10% excess or less if the driver is younger than 25 years; and/or 10% excess or less if the driver has obtained his or her driver's licence within the previous two years.

4.5 In both these scenarios, premiums are sold as fixed monthly premiums that are up to 60% cheaper than other insurance products in the market (Van Niekerk, 2005). Therefore, a cumulative excess policy is similar to a product where cover increases every month until full cover is achieved by causing an accident that falls outside the scope of the cumulative excesses. In both scenarios an affordable premium is assigned to enter the insurance market (Long & Marquis, 2002). These products are not necessarily associated with a reduced loss ratio which would indicate a breach of TCF. The latter could be explained by means of the following examples.

4.5.1 EXAMPLE A

The value of an insurable vehicle is R200 000. The premium assigned to cover the risk is R150 per month. Other insurers will cover a R200 000 vehicle for approximately R700 per month (Long & Marquis, 2002). This premium covers only 5% of the motor vehicle's value in the first year of insurance while in the second, third or fourth years of insurance, the cover annually grows by 5%. Thus, should a write-off occur in year one, the underwriting manager will pay only R200 000 × 0.5 to settle the loan from the financier. However, TCF should compare how many policy holders per 1000 submit claims in comparison to other policy holders who enjoy full cover in order to view the loss ratios in perspective.

14 To understand reckless selling of products, the Financial Conduct Authority Services should rather focus on how many policy holders per 1000 are submitting claims. A product with cumulative excesses may have 500 policy holders per 1000 submitting claims instead of the average of i.e. 100 per 1000. When one compares general products with, for example, cumulative excess products, the 500 policy holders may contribute to a higher loss ratio even if additional deductions/expenses are used in the profit calculations due to the fact that they are higher risk policy holders.

4.5.2 Example B

The value of an insurable motor vehicle is R200 000. The premium assigned is R200 per month while other insurance companies will charge a premium of approximately R700 per month (Long & Marquis, 2002). The underwriting manager, in its product excess terms, specifies that should an accident occur after 23:00 at night, an excess of 10% will be deducted from the amount to be claimed, and may consequently apply other relevant 10% excesses. These excesses are generally cumulative and could result in receiving 60% of the value of a write-off claim because the total combined excesses are 40%. However, TCF should analyse how many other claims were paid with no relevant excesses applicable to a policy holder's cumulative excess claim i.e. accident occurred 19:00 at night, no third parties involved in the accident, etc. Therefore cumulative excesses are not necessarily an indication of favourable loss ratios since they are only one element relevant to other additional deductions in profit calculations as indicated in Table 2. As an example, in Anderson Insurance Underwriting Managers,[15] the underwriting manager sold cumulative excess policies; yet the company was severely unprofitable. It is our considered opinion that the regulator should set a fixed template for profit calculations to create an objective market measurement or standard to identify reckless selling of policies based on affordability, instead of focusing on loss ratios *per se*. In addition, cumulative excesses or growth cover per month may also be perceived as a penalty in the law, although no South African case law exists to support the latter.

4.6 Although both examples A and B seem profitable, Table 4 could result in no available profits at the end of the financial year due to additional deductions.[16] In Table 4, the terminology ‘risk premium’ is employed, while Tables 1 and 2 refer to ‘earned’ or ‘gross premium’. There is no specific guidance in any relevant legislation in South Africa to interpret ‘risk premium’ or ‘earned premium’. Nonetheless, the binder agreement between the parties may supply a definition of ‘risk premium’.

4.7 An earned premium could include value-added products, i.e. car hire options, excess buy-back options etc. The value-added products are simply those in which the true identity of the insurers is not disclosed to the policy holder, and the underwriting manager is not acting as a manager on behalf of those insurers of value-added products. The insurers for value-added products are specialists in their respective fields and may provide a more competitive premium relevant to car hire than the insurer of the underwriting manager. During a submitted claim, the policy holder has contact with the underwriting manager only and not with the insurer of the value-added product. The underwriting manager in turn settles the car hire rental claim by submitting the claim to the value-added insurer. For this reason, the value-added claim and premium are both excluded from the earned premium calculation and from the calculation of the loss ratio.

15 *Anderson Insurance* supra

16 *Commissioner for Inland Revenue* v *South African Fire and Accident Insurance Co Ltd* 1960 (3) SA 1 (A)

4.8 Tables 3 and 4 provide examples of risk premiums where the loss ratios are extremely high when compared to Tables 1 and 2 which include the premiums of value-added products. In this respect, the underwriting manager is unable to share in any profits of the insurer, since the insurer is suffering a loss. However, when the risk premium is ignored, the underwriting manager is allowed to share in the insurer's profits without being required to reduce the loss ratio. In addition to a risk premium, both the insurer and underwriting manager can agree on the contents of a sliding scale profit fee as stipulated in Table 5.

4.9 In understanding the principle of a sliding scale formula, Tables 2 and 4 are pertinent. The loss ratio in Table 2 is 75.5% compared to the loss ratio in Table 4: it simply prescribes a 50% contribution to the insurer when the loss ratio is above 68%. Although 75.5% equals profits of 24.5%, the sliding scale causes the underwriting manager to be unprofitable. The underwriting manager must in this case repay 75.5% less 68% which equals 7.5%, multiplied by 50%, which equates to nearly 4% of additional payments to the insurer. The underwriting manager has to pay the insurer 50% of 7.5%, even with a profit of 24.5%.

4.10 When one considers the principle of 112% in Table 4, it implies that the underwriting manager must pay the insurer 112% less 68% which equals 44% multiplied by 50%. Thus, examples A and B may suggest that the underwriting manager or insurer is profiting, but this 'profitability' might nevertheless be unprofitable due to the sliding scale formula and the interpretation of risk premium. On the other hand, if the loss ratio is less than 66%, the underwriting manager will receive a sliding scale profit of 2% in addition to a binder fee. A sliding scale profit formula may be perceived as a penalty in the law, although no South African case law with reference to sliding scale formulae is in existence.

5. CELL CAPTIVE AND INSURER DIVISION

5.1 It should be noted at the outset that insurance companies have tried to create cell captive insurance by creating an additional company that exists alongside the insurance company for the sole purpose of sharing in the profits of the insurer.[17] The additional company thus acts as a shareholder of the insurer; should the insurer pay dividends, the additional company will receive a dividend declared to its shareholders, one of which is an underwriting manager. The reason for the latter is simply that the issue of shares of an insurance company is regulated by legislation and is subject to the Registrar's approval. To circumvent this problem, the insurer creates an additional company in which the underwriting manager holds shares. Profits for dividends in this regard should be interpreted in terms of accountancy and company law principles, and not in terms of a formula discussed earlier. Profits or net profits are simply indicated in the financial statements of the insurer, and more specifically in the income statement to illustrate the ability to pay creditors within 12 months. Profits and/or the availability of profits also depend on company law principles where the

17 *Anderson Insurance* supra

board of directors decides how net profits will be issued as dividends to the shareholders. Should the board of directors decide not to recommend any dividends to the shareholders of the company, irrespective of the underwriting manager's loss ratio, the underwriting manager will not receive any dividends as a shareholder (Kilian & Vandeventer, 2017a). Should there be no profits for the present financial year, the binder agreement can nevertheless require that the underwriting manager must contribute a certain calculated amount to the other company.

5.2 The effect of the latter scenario could be similar to Table 4 and depends on the wording of the binder agreement between the insurer and the underwriting manager. Table 4 and the related example of contributing money, in the event of no declared dividends, could be regulated by the Penalties Act of South Africa. In terms of this Act, any penalties are subjected to review; the presiding officer of a South African court may decrease the penalty to an amount that is just and equitable. The same argument could be used in Table 5 for any penalty contributions, should the loss ratio of the underwriting manager exceeds 68%.

5.3 Rather than an underwriting manager having shares in another company, an insurer might be able to issue shares directly to an underwriting manager in the future and this relationship is referred to as a true cell captive relationship. The latter has been applicable to the South African insurance landscape as from 1 July 2018 and is regulated and fully explained in Section 1 of the Insurance Act 18 of 2017[18] (Kilian & Vandeventer, 2017b).

5.4 Instead of creating a cell captive relationship in the future, it is possible to create a division within the insurer where the name of the division is the same as that of an existing underwriting manager. In such an event the division has no legal personality and no private or public company registration is required. Therefore, the same relationship could be similar to a cell captive—the only difference being that the division is neither a private nor public company. Generally, the underwriting manager is deregistered as a company.[19] The division could make use of the calculations in either Tables 1 to 5 or issue certain shares as division shares held by a private individual in the insurer as shareholder; generally the private individual is the previous managing director of an underwriting manager who converted the underwriting manager into a division.

5.5 The private individual is a person who manages the division and based on the profitability of the division, the private person is entitled to receive dividends from the insurer. It should be noted that a division is not regulated by the Companies Act 2008 or any other insurance legislation, making this form of business very risky. To illustrate the high risk associated with a division, the following case is relevant to our discussion.

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18 Insurance Act 18 of 2017

19 *Anderson Insurance* supra

5.6 In Anderson Insurance Underwriting Managers*,* the High Court held that a division has no legal personality, and thus has no rights or duties as in the case of an underwriting manager.[20] An underwriting manager, for example, could own a book of policy holders and be part of the goodwill of the company. Should the book of policy holders be transferred to an insurer and later change the status of an underwriting manager to that of a division, the division still has no proprietary rights or ownership rights concerning the goodwill of the business. For practical purposes, the insurer is the sole owner of the book's goodwill. In the Anderson case, a number of policy holders were transferred to Constantia. After the transfer, Anderson was simply known as 'motor and commercial insurance, a division of Constantia Insurance'. Following the transfer, Constantia failed to sign appropriate contracts to regulate future 'binder fees' and/or to honour the business relationship as was agreed to prior to the transfer. In this respect, Constantia acquired a number of policy holders without paying any compensation due for the goodwill (existing policyholders) to Anderson. In fact, Constantia argued that Anderson had no standing in the law to approach the court and to ask for relief since a division cannot conclude a contract with Constantia; a division has no legal personality, which is a requirement in the law to conclude contracts lawfully.

6. THE REINSURER

6.1 An underwriting manager exercises binder functions on behalf of an insurer; based on the profitability of this insurer, the underwriting manager may share in the profits of the insurer as was discussed earlier in the tables. In this case, reinsurance commission is part of the formula to calculate the loss ratio of the underwriting manager. In terms of the law of insurance, the reinsurer and the insurer may conclude an agreement or as it is commonly known, a treaty, whereby the reinsurer will pay reinsurance commission to the insurer (Havenga, 2001). Following payment, the insurer may cede the reinsurance commission to the underwriting manager to increase the loss ratio of the underwriting manager in terms of its binder functions. However, whether the reinsurance commission is part of the binder agreement depends solely on the consensus reached between the underwriting manager and the insurer. Reinsurance commission is calculated by means of the following sliding scale table:

TABLE 7. Sliding scale table for reinsurance commission

Commission	For	Loss ratio
7%	For	85% and above
8%	For	84%
9%	For	83%
10%	For	82%
11%	For	81%
12%	For	80%
13%	For	79% and below

20 Ibid.

6.2 For purposes of reinsurance commission, it is vital to calculate the premium payable to the reinsurer who accepts the insurer's risk in the event of a catastrophe. If the agreed premium is R12 million per annum and the overall loss ratio of the insurer during a financial year without the occurrence of a catastrophe is 85%, the reinsurance commission at 7% is R840 000, payable to the insurer. It is possible to pay provisional reinsurance commission at the beginning of the financial year to an insurer at 13% and to adjust the commission at the end of the financial year. For example, the estimated premium paid on R12 million at 13% is R1 560 000. At the end of the financial year, the actual premium was R10 million at 9% commission, which equals R900 000. Thus, the insurer must repay R660 000 (R1 560 000 – R900 000) as adjusted commission to the reinsurer at the end of the financial year.

6.3 It is also possible to include the following sliding scale percentages in a treaty between the insurer and reinsurer in addition to the above:

TABLE 8. Sliding scale percentages in a treaty between the insurer and reinsurer

50% of reinsurance commission	Loss ratio between 85%–90%
100% of reinsurance commission	Loss ratio between 90%–110%

6.4 In terms of Table 8, reinsurance commission at 7% is R840 000, but the loss ratio falls within 85–90%; the actual reinsurance commission payable is therefore only R420 000. It can be argued that there is an overlap with Table 5 as previously discussed in terms of a sliding scale calculation of 'profits'. In both instances, a penalty is raised should the loss ratio of either the underwriting manager or insurer fall within a specific loss ratio category, i.e. a loss ratio greater than 66% for an underwriting manager or a loss ratio within 85–90% for an insurer. It should be noted that the Penalties Act may also be relevant to Table 8.

7. REINSURER WRITTEN PREMIUM

7.1 The relevance of the risk premium was illustrated earlier. It should be noted that value- added products will probably have their own reinsurance treaties to cover, for example, car hire in the event of a catastrophe and that the premium (excluding value-added products) or risk premium is the true written or earned premium. In addition the reinsurer could agree with the insurer that a 10% risk premium will cover only 90% of the risk associated with any catastrophe claims (Clemente et al., 2015). In this respect the insurer will bear the other 10% risk. This is also common practice where different reinsurance companies express their interest in the risk quota. For example:

TABLE 9. Total risk for different reinsurance companies

Reinsurer A accepts	50% of the catastrophe risk quota
Reinsurer B accepts	30% of the catastrophe risk quota
Reinsurer C accepts	10% of the catastrophe risk quota
Total risk	90%

TABLE 10. Total premium for different reinsurance companies

Risk premium	R100 million per annum
Reinsurance premium payable	R10 million per annum or 10% of risk premium
Reinsurer A receives a premium of	5/9 x R10m per annum
Reinsurer B receives a premium of	3/9 x R10m per annum
Reinsurer C receives a premium of	1/9 x R10m per annum

7.2 Additionally, the reinsurance treaty may also specify a condition as regards liability for catastrophe claims. The most common conditions contain a minimum amount of damages within 72 hours after the occurrence of a catastrophe. If the minimum amount of damages is not met within 72 hours, the insurer will bear all the risk. In these circumstances, the insurer will not be allowed to submit a reinsurance claim to any reinsurer who is a partaker in the risk quota.

8. THE PENALTIES ACT

The Conventional Penalties Act is relevant to this discussion. In the tables, reference is made to a sliding scale contribution in the event that the loss ratio exceeds a certain percentage. The sliding scale contribution is considered a penalty and the Conventional Penalties Act is then pertinent to our discussion. In terms of Section 1, a penalty can be enforced in any competent court in South Africa—but the aggrieved contractual party is not allowed to claim both a penalty and damages for breach of contract. In addition, Section 3 states that any competent court may reduce any penalty relevant to any form of contractual agreements even if there is no breach of contract between the contractual parties. A court of law is therefore able to reduce the sliding scale penalty (Delport, 2011). To reduce the sliding scale penalty, the court will for example consider whether the insurer and or reinsurer are profitable although no case law exists in South Africa relevant to treaty or binder sliding scale penalties.

9. CONCLUSION

9.1 Only an underwriting manager may act on behalf of an insurer (as if it is the insurer) in terms of the binder functions. A non-mandated intermediary should not be able to complete any binder functions since the underwriting manager is the only company allowed to share in the profits of the insurer. Because binder functions—i.e. to settle claims—can be carried out more effectively by an underwriting manager than an insurer, the underwriting manager may share in the profits of the insurer. Simple formulae to calculate profits are not subject to the Companies Act 2008, as the declaration of profits does not depend on Section 4 of this Act or any other company law regulation pertaining to dividends.

9.2 These formulae are not linked to shares; therefore, any profit payment received from an insurer cannot be classified as a dividend. A cell captive underwriting manager, however, is directly linked to shares and should therefore be subject to Section 4 of the Companies Act and/or any other company law principle relevant to the recommendation and declaration of dividends.

9.3 A sliding scale penalty may be part of either a binder agreement or treaty when the loss ratio exceeds a certain percentage. In this respect, we believe that the penalty calculation should be subject to the Penalties Act and it should therefore be possible to reduce the penalty percentage in terms of an application made to a court of law of South Africa.

DISCLAIMER

The views stated in this article are the researcher's own views and not those of the affiliated institution of the researcher. Reinsurance parties in treaty contracts and insurer parties in binder contracts remain confidential and undisclosed in this article, except relevant sliding scale penalties or loss ratio calculations in the form of tables based on binder or treaty clauses between the confidential contractual parties.

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