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Dear Mr Clark

Exposure Draft 5 on Insurance Contracts

The South African Insurance Association is the trade association for non-life insurers in South Africa. The Finance and Regulation Committee of the SAIA has considered the Exposure Draft 5 on Insurance contracts and understand from the accounting profession that there is an intention to introduce Fair Value Accounting in Phase Two of the implementation of the Guidelines on Accounting in the non-life industry.

The SAIA has considered the submission on ED5 from SAICA and fully support the contents of that submission but as the trade association of the industry we wish to make some additional general comment, which we hope you will give your serious consideration.

The SAIA has a number of concerns regarding the practical application of the Fair Value Accounting principle to the non-life industry and to non-life insurance contracts, which are short-term and cancellable by their very nature.

Some of these contracts are issued for a period of less than a month and the majority of these contracts do not extend beyond a year and as mentioned, all are cancellable. The implementation of Fair Value Principles will involve complex calculations requiring expertise currently not necessarily employed by the worldwide industry with regards to these types of contracts.

In respect of short tail risks, the result produced by such calculations is unlikely to differ materially from the result produced by the deferral-matching concept. Consequently the additional cost and effort are inappropriate.

There is an acknowledgement that there is good argument for applying Fair Value Accounting to long-term risk and to a large extent we understand that this is already applied to long-term contracts.

The SAIA feel strongly that there needs to be a separation of long-term and short-term risks and if this is done it will solve the majority of concerns raised by the industry role players to date.

We thank you for giving consideration to the SAIA comments.

Regards

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#31487

COMMENT LETTER OF THE NON-LIFE INSURANCE INDUSTRY PROJECT GROUP OF THE SOUTH AFRICAN INSTITUTE OF CHARTERED ACCOUNTANTS (SAICA)

In response to your request for comments on the exposure draft on insurance contracts, attached please find the comment letter prepared by the Non-life/Short-term Insurance Industry Project Group of SAICA. The project group is an industry interest group, which is represented by non-life insurers, regulators and industry auditors. This project group considers accounting, auditing and reporting matters of relevance to the non-life insurance industry.

Please note that this comment letter also includes the following appendix:

GENERAL COMMENTS

The SAICA Non-Life Insurance Industry Project group, hereafter referred to as the project group, are of the view that:

1. **There is a lack of examples for the non-life insurance industry**

   The draft IFRS addresses insurance contracts pre-dominantly in the life insurance industry rather than the non-life insurance industry. This is evident, when looking at the implementation guidance examples which are almost 90 % related to the life industry.

   We have highlighted below some of the differences between life and non-life contracts in South Africa:

   - Life insurance consists both of risk business and investment business. In contrast, although some non-life contracts sold in South Africa have funded components, very few, if any, have investment components.

   - Payments to intermediaries are viewed differently by the life and non-life industries. Commission payments to intermediaries in the non-life industry are seen as payments for future services to be delivered by the intermediary as well as a fee for introducing the business to the insurer. In the life insurance industry commissions are not paid for future services but only for an introduction of the new business to the insurer.

   - The assumptions underlying the valuation of life insurance policy liabilities are very different from non-life insurance. The differences arise from separate legislation and actuarial involvement applying to the different industries.

Recommendation 1

There are numerous unique complexities to the non-life industry that need to be addressed by way of example in the implementation guidance, including but not limited to:

a. The concept of risk transfer and what constitutes *"significant"* risk transfer is not as clear as in the life industry;
b. The use of risk-management vehicles (including retrospectively-rated policies, captive and cell-captive insurers, partial self-insurance, etc.) is more common in the non-life industry;
c. Non-life business has no or significantly smaller investment components and contracts are generally of shorter term, cancellable and reviewable at short notice;
d. Non-life results are subject to greater volatility;
e. In most countries the differences between life and non-life are recognised; through specific non-life regulation;
f. Differing accounting standards have been applied in South Africa between life and non-life business.

Recommendation 2

The draft IFRS should be expanded to include a variety of examples covering the non-life insurance industry. Such examples should include:

- Unbundling - Although one example of unbundling is included in the Implementation Guidance, additional examples should be included to illustrate where the cash flows from deposit/funded components are not separate from the cash flows from the insurance components.

- Embedded derivatives - Examples should be included to illustrate the applicability of embedded derivatives for non-life insurance contracts.

- Risk transfer - Additional examples should be set out where non-life contracts do not include sufficient risk transfer to meet the definition of insurance and examples of where they do not meet the definition.

2. **There are inconsistencies in the definition of an insurance contract**

The draft IFRS is accompanied by guidance on implementing the document as well as a basis for conclusions. When these documents are read together, varying interpretations could result in inconsistencies of accounting treatment because the definition of an insurance contract, whilst it seems to be precisely stated in Appendix A to the draft IFRS, becomes unclear when one reads Appendix B together with examples and the Basis for Conclusions. In the examples of insurance contracts, under B18, it speaks specifically of certain insurance contracts that may fall foul of the definition because of the risk partnership that exists between the policyholder and the insurer, particularly in captive insurance arrangements including wholly owned captives, cell captives and rent a captive arrangements. A definition of each of these arrangements is in Appendix A to this letter.

Recommendation 3

The definition of risk transfer should be narrowed and clearly defined. Detailed guidance is required on how to test for the transfer of *"significant insurance risk"* in the non-life insurance environment. Guidance should be provided on what *"significant"* is and explained in the context of the contract being assessed.

More examples should be included in the implementation guidance for specific instances where significant insurance risk is <u>not</u> transferred. For example, the project group suggests open ended premium adjustment clauses where the insurer can call for additional premium income to reimburse the insurer for losses suffered does <u>not</u> transfer significant insurance risk. We believe that there is insufficient clarity in item 1.18 of IG2 of the Implementation Guidance.

Examples of detailed risk transfer tests that could be applied by preparers of financial statements will be useful.

3. **Misinterpretations may occur from the requirement that an entity is distinct from the policyholder**

The Appendix B definition of insurance contracts B3 states that *"the definition of an insurance contract requires the insurer to accept significant insurance risk from the policyholder. This is possible <u>only if</u> the insurer is an entity <u>distinct</u> from the policyholder"*.

The project group is of the opinion that contracts issued by wholly owned captives and cell captives would meet the definition of an insurance contract. However, we believe, because of the requirement for the entity to be distinct from the policyholder, these contracts could be misinterpreted. Such captive contracts could be interpreted to be self insurance, which is scoped out of the draft IFRS in B18(c). Further B18(b) refers to "*contracts which pass significant insurance risk back through mechanisms that adjust future payments*" such contracts are often issued by the captive industry. This is best illustrated by an example. An example of a wholly owned captive insurance arrangement is also included in Appendix A.

Recommendation 4

Wholly owned captive insurers and cell captives constitute a large part of the insurance market in South Africa. We believe that these arrangements should still be treated and accounted for as insurance business, provided that the individual contracts contain sufficient risk transfer. We therefore believe that the draft IFRS should make reference to the kinds of arrangements that do not constitute insurance business.

Recommendation 5

The example of a wholly owned captive in Appendix A requires clarity, especially for the cell captive and captive insurance industry as in these cases the insurer and the policyholder may be interpreted as being the same entity as they are in a group (holding company / subsidiary) relationship. The draft IFRS should also clarify what self insurance is and what is envisaged in terms of accounting for this.

SPECIFIC COMMENTS ON QUESTIONS RAISED

Question 1 – Scope

(a) *The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).*

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 Financial Instruments: Recognition and Measurement and IAS 40 Investment Property.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

Yes, the scope is appropriate. However as noted above, the implementation guidance examples need to be expanded to include more examples of non-life insurance contracts.

Furthermore the scope of this guidance should to some extent include accounting by policyholders, this should not be entirely delayed to phase II of the project. This is predominantly due to the proposed concept of unbundling insurance contracts. If the insurer does not recognise the proposed unbundled investment component as premium, the accounting should be mirrored in the policyholder's accounts.

(b) *The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?*

Yes. However, the example in Appendix B18 paragraph (g) states "*contracts that require a payment based on climatic, geological or other physical variables regardless of any adverse effect on the holder of the contract (commonly described as weather derivatives).*" We are of the opinion that the words "*regardless of any*" should be removed OR this paragraph should include the full clarification of the principles as contained in BC38. The reason would be to ensure that in a case where the payment in terms of the contract is based on climatic, geological or other physical variables and has an adverse effect on the policyholder, this would then meet the definition of an insurance contract. The most important element being that the policyholder is adversely affected. Alternatively we can replace the words *"regardless of any"* with the word "unless" and it will achieve the same meaning.

Question 2 – Definition of insurance contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

The definition may be appropriate, however clarity is sought on the following issues:

- Implementation Guidance Example 1 needs to be expanded to include more non-life (conventional <u>and</u> non-conventional) insurance contract examples and suggested accounting treatment in respect of phase I.
- B3 – acceptance of a significant insurance risk from the policyholder is only possible if the insurer is an entity distinct from the policyholder – refer cell captive and captive industry comments in general comment 3 above.
- Present value of cash flows (as per B24). This principle of present valuing cash flows addresses contracts where the amount of the loss by the insurer is <u>known</u>**,** but its timing is unknown. More clarification is needed regarding when the amount of the loss is <u>unknown</u> to determine what significant insurance risk is on these contracts. In the case of non-life insurance contracts, the timing of loss is never known as fortuity is necessary for an insurance arrangement to exist.
- Further clarification of what is significant and what is not should be given in the implementation guidance. We accept that quantitative guidelines create an arbitrary dividing line and presents opportunities for accounting arbitrage. To provide no quantative guidance however does not alleviate this problem, and adds the additional problem of the inconsistency of the application, and reporting of what is significant and what is not. Further examples of where a contract meets the definition are required to those provided in the draft Implementation Guidance, as well as examples of contracts that do not meet the definition.

Question 3 – Embedded derivatives

(a) IAS 39 Financial Instruments: Recognition and Measurement requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

The project group are of the view that paragraph 5 and 6 regarding embedded derivatives apply only in a limited number of cases to non-life insurance contracts.

Where embedded derivatives do apply to the non-life insurance industry, an explanation on how they apply and examples/guidance of where they apply within non-life insurance industry is required. It is however noted that (i) above requires the separation of an embedded derivative and fair value accounting when the surrender value varies in response to a change in equity or commodity price or index, however where the value varies in response to an interest rate, fair value and separation of the embedded derivative is not required. This may be appropriate but does create some inconsistency with the requirements of IAS39.

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

The project group are of the view that paragraph 5 and 6 regarding embedded derivatives apply only in a limited number of cases to non-life insurance contracts.

Where embedded derivatives do apply to the non-life insurance industry, an explanation on how they apply and examples/guidance of where they apply within non-life insurance industry is required.

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs

IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

The project group are of the view that paragraph 5 and 6 regarding embedded derivatives apply only in a limited number of cases to non-life insurance contracts.

Where embedded derivatives do apply to the non-life insurance industry, an explanation on how they apply and examples/guidance of where they apply within non-life insurance industry is required.

(d) *Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?*

The project group are of the view that paragraph 5 and 6 regarding embedded derivatives apply only in a limited number of cases to non-life insurance contracts.

Where embedded derivatives do apply to the non-life insurance industry, an explanation on how they apply and examples/guidance of where they apply within non-life insurance industry is required.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) *Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:*

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

Yes.

(b) *Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:*

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

Yes.

Question 5 – Changes in accounting policies

The draft IFRS:

(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate/ If not, what changes would you propose and why?

Yes, however it is noted that to allow a change in accounting policy to a discounting method, when no guidance has been given with regards the method of determining probability of cashflows, as well as discount rates to be used, that this may present an opportunity to manipulate results.

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

(b) Should unbundling be required in any other cases? If so, when and why?

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

The guidance given in paragraph BC30 to BC37 does not come to a clear conclusion. Indeed, in paragraph BC35, the Board acknowledged that there was no clear conceptual line between cases where unbundling is required and cases where it is not required. It is important that a line be established so that a consistent interpretation is applied in unbundling contracts in the non-life industry. In addition, the reasons therefore should be clearly stated. Given the indefinite nature of the definition of insurance read together with the examples under the guidance, it is important that clear examples be given as to when unbundling would be required.

From the draft IFRS and supporting documentation it would seem that captive insurance arrangements may be considered for unbundling.

Captive insurance contracts assist insureds that enter into partnerships with their non-life insurers in a cost efficient and business effective way. The focus is on application of risk management principles and decreasing the overall cost of risk in an organisation in order that the most efficient insurance contract is put into place. Because of the fact that certain components of captive insurance arrangements in effect provide cover equal to premium paid an interpretation that requires unbundling could be placed upon what is essentially an insurance contract. In our opinion, ED5 does not adequately address the unique aspects which pertain to captive insurance contracts and certain burning cost conventional insurance contracts.

We believe that the IASB has no intention to negatively impact the efficient captive market nor the burning cost reinsurance market through proposed accounting standards nor do they wish to promote accounting practice which prevents business from conducting its affairs in a cost-efficient and effective manner.

<u>Recommendation</u>

We recommend that the definition of risk transfer be reviewed as suggested under our general comments at the beginning of this letter and that a clear statement be made that should an insurance contract be defined as a risk bearing insurance contract, that no further work is required to unbundle components of that contract. In other words, the only test in respect of an insurance contract when it comes to unbundling is whether it is a risk-based contract or not. In the case of the life industry it would appear that the intention of the drafters of the exposure draft is to separate out investment components of life contracts. Herein lies the major distinction between the life and the non-life industry referred to earlier. There are seldom investment components in a non-life contract even if it contains elements of a partnership between the insurer and the insured. We suggest that should the contract not comply with the risk transfer rules contained in the draft IFRS then the whole contract should not be accounted for as an insurance contract. Should it comply with the risk transfer rules, then it will be accounted for as an insurance contract.

Question 7 – Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

Yes. However with reference to paragraph 18 (a) of the draft IFRS, it was not fully understood by the project group what practices the IASB is trying to stop, and it was felt that BC90 might only partially address the problem. Further, 18(a) appears to contradict BC78 which encourages recognizing insurance liabilities on a discounted basis.

Question 8 – Insurance contracts acquired in a business combination or portfolio transfer

IAS 22 Business Combinations requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 Business Combinations proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 Impairment of Assets and IAS 38 Intangible Assets. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

Yes. However it is not clear whether there is an assumption that a negative asset can never arise, and if a negative asset can arise whether the treatment would be different.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

The project group are of the view that discretionary participation features referred to in the draft IFRS apply to, in a limited number of cases, non-life insurance contracts.

Where discretionary participation features do apply to the non-life insurance industry, an explanation on how they apply and examples/guidance of where they apply within non-life insurance industry is required.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

Fair value is difficult to apply consistently for the insurance industry. In order to apply the fair value principle within the non-life industry further definitive guidance and practical examples need to be provided as these contracts are not normally traded and so fair value is not consistently applied in the industry. For example, different values might arise if the policies are valued individually or as a portfolio. Refer to the arguments in BC139 and BC140.

It is extremely difficult to require the disclosure of the fair value of assets and liabilities without providing guidance on the measurement of such fair values. We also question the wisdom of such application in non-life contracts which are predominantly by nature short term and cancellable. This comment does not apply to long tail insurance business. The fact that a date of 31 December 2006 has been used does not alleviate the issue, as phase II of the project may not yet have determined how to measure fair values. We therefore recommend that the draft IFRS should not specify a date, but rather refer to when adequate guidance has been given on fair values by phase II of the project.

Question 11 – Other disclosures

(a) *The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).*

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

The project group agree with the principle of requiring further disclosure for insurance contracts, however for a disclosure standard the disclosures are far too broad. The IASB should be more specific and have a clearer statement on their purpose. They should also give consideration to the cost/benefit test which would prescribe the level of detailed disclosure required.

(b) *The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.*

Is this approach appropriate? If not, what changes would you suggest, and why?

Yes. The project group agree with the principle of requiring further disclosure for insurance contracts, however for a disclosure standard the disclosures are far too broad. The IASB should be more specific and have a clearer statement on their purpose. They should also give consideration to the cost/benefit test which would prescribe the level of detailed disclosure required.

(c) *As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).*

Should any changes be made to this transitional relief? If so, what changes and why?

No changes are required.

Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 Financial Instruments: Recognition and Measurement to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

Yes.

Question 13 – Other comments

Do you have any other comments on the draft IFRS and draft Implementation Guidance?

No.

APPENDIX A

DEFINITIONS OF CAPTIVE ARRANGEMENTS

Captive Insurance Company – An insurance company owned by a parent company of a group of companies and writing its owner's insurance.

Captive insurers are formed where insurance is not obtainable from the conventional market or where a company wishes to put its insurance programme into a tax effective vehicle to improve the overall profitability of the group.

Cell Captive Insurer – An insurer that is structured with separate cells. Each cell, through a shareholders agreement, is separate and independent from the other cells in the insurer. The assets allocated to each cell may be used only to settle the liabilities incurred by such cell and thus should not be attached by the creditors of the other cells. Positive returns on the net assets in the cell and on insurance business introduced by the cell owner to the insurer are attributable to the cell owner. However, the cell owner may be held accountable for losses incurred in the cell in certain instances. The cell owner is an entity or person that owns a cell in cell captive insurer. The relationship between the cell owner and promoting company is via a contractual agreement in South Africa. There is no Protected Cell Company (PCC) legislation applicable to South African insurance companies.

Rent A Captive – A rent a captive is a policy issued by an insurance company generally to insure the retained portion of risk an insured has in respect of its own assets and liabilities. The insurer enters into a risk partnership with the insured whereby it shares and profits in relation to the performance of the aforesaid insurance programme, which generally covers high frequency, low value losses.

EXAMPLE OF A WHOLLY OWNED CAPTIVE INSURANCE ARRANGEMENT

Company A, being a large group, owns 100% of the share capital of Company B, a registered insurer (called "captive insurer") or owns a cell in company B a cell captive insurer. For purposes of the example cell captive and captive are used interchangeably. Company B was set up for the sole purpose of underwriting the insurance risks of Company A. Company B does not underwrite any other insurance business outside that of the group.

Company A enters into insurance arrangements with Company B. These contracts are negotiated at market terms and all contain significant risk transfer. Company B may then decide to reinsure some of these risks with the market. The insurance contracts between Company A and Company B do not contain any arrangement which requires A to make good any underwriting losses in B by way of future premiums. Company A may of course voluntarily assume an obligation to recapitalise its subsidiary or cell B in the event of losses.

Company B prepares its own financial statements and complies with the local insurance legislation and regulations.

In terms of the definition of insurance in ED5, will Company B be an entity distinct from Company A, the policyholder?

In addition in terms of Appendix B in ED5, paragraph B18 (b) and (c), the following is not regarded as insurance business:

(a) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or group contracts (such contracts are non-insurance financial instruments);

(b) self-insurance, in other words retaining a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party).

Would the above captive insurance arrangements classify as non-insurance financial instruments or self insurance in terms of the above two paragraphs? If so, would this mean that neither Company A nor Company B can account for these transactions as insurance business? How would this then affect the reinsurance transactions entered into by Company B?

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