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APPENDIX A

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.

(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, it would be appropriate.

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?

We agree with the spirit of the definition, however further clarification is required for the following:

1.) <u>Definition of insurer:</u>
According to the definition in B3 per Appendix B, an insurance contract "is possible only if the insurer is an entity distinct from the policyholder." This causes a problem for insurance companies within a group structure, where subsidiaries for example reinsure with their holding company or fellow subsidiaries, on a normal arm's length basis. In terms of this definition, this reinsurance relationship will not be viewed as being distinct, thus implying that when the subsidiary or the holding company drafts its entity financial statements (non-consolidated), the reinsurance arrangements will not fall within the definition of an insurance contract, thus further implying the transaction will not be accounted in terms of ED5.

Similarly, the above interpretation may result in the global multi-billion US dollar captive and cell-captive industry no longer falling within the scope of insurance contracts, with obvious untenable consequences to the industry. To our mind it is not the intention of the definition to prevent companies within the same group structure, captives and cell captives from accounting properly for insurance and reinsurance contracts in the individual entity financial statements in terms of ED5.

Recommendation

Our recommendation is that the sentence in B3 be amended to read as follows: "This is possible only if the insurer is a legal entity or persona distinct from the policyholder."

This amendment will remove the uncertainty surrounding the classification of reinsurance arrangements in a group of companies as well as captive and cell captive insurance arrangements.

2.) Significant insurance risk - scope

We are in agreement with the principle objective of the definition of significant insurance risk. However, we need further clarification on the matter of the application of the scope of the definition.

With regard to the definition of significant insurance risk per par. B21, there are several inconsistencies within the same paragraph as well as when compared with the equivalent definitions in the 'Basis for Conclusions', par. BC24. For example:

The first sentence in par. B21 states that "insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from the contract".
In the second sentence of B21 it is stated that the "condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected present value of all the contractual cash flows."
And, par. B22 states that risk is not significant if the occurrence would cause a trivial change in the present value of the insurer's contractual cash flows.

Clearly, the second sentence in B21 appears to contradict the first sentence in par. B21 and B22, as well as in par. BC24 (a) & (b) of the Basis for Conclusion.

Recommendation

We recommend that the second sentence of par. B21 be removed and the terms used be clarified further. This should address inconsistencies in the definition as well as between the definition in the main body of the ED and the Basis for Conclusion.

3.) Significant insurance risk – defining significant

For this definition to be implemented in practice, some practical guideline should be given to insurers. We acknowledge the Board's reasoning for not providing a quantitative guideline in the ED (BC24 - BC29), but are of the opinion that the existing definition of significant risk calls for extensive arbitrary judgements in determining if an insurance contract will cause significant risk transfer to take place. This could result in similar contracts being accounted for differently. This is in contrast to the Board's reasoning for not providing a guideline, and would impact on the comparability of insurers' financial statements.

Insurers have always viewed risk to be incurred if there is a probability of deviation from the expected outcome. Once risk has been incurred it is necessary to be classified as significant or non-significant risk. As the expected outcome for any insurance contract should always be positive (otherwise, why write the contract?), any indication of a loss is viewed as significant risk.

Recommendation

We recommend that further practical guidance be provided i.e. that the definition of significant insurance risk be further enhanced to clearly require insurers to assess the probability of incurring a loss per insurance contract. If there is even a remote probability of a loss, significant risk will transfer and the insurance contract will fall within the ambit of par. B21.

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?

Yes

(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?

Yes

(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?

Yes

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

No

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

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (i.e. 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?

Yes

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

No

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

We agree with the principles for unbundling, but would appreciate the provision of more examples in the Implementation Guidance covering the non-life insurance environment so as to ensure that non-life insurers can properly identify such contracts in need of unbundling, and in which circumstances unbundling would be required.

Recommendation

Examples should refer to non-life contracts that are not required to be unbundled where the contract in its entirety falls under the definition of an insurance contract and passes the risk transfer test, as well as to contracts where there are clear deposit components that do not pass the insurance contract definition and risk transfer test and therefore require unbundling.

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

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

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?

Yes, from a non-life insurance point of view.

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?

No, the requirement is not appropriate due to the following reasons:

1.) <u>Fair value concept</u>

a) Clear guidelines for determining fair values for disclosure are not yet available . The Board made it clear that this would be finalised in Phase II only.
<u>Recommendation</u>
In order to avoid any significant, unnecessary system changes and insurers having to incur costs in laying down fair valuation processes, it is recommended that the whole fair valuation process be postponed to Phase II. Clearly, it is not the intention of the Board to force insurers to incur system planning and development expenses in Phase I just to change it all after Phase II.

b) Due to the complexities surrounding the implementation of the fair value concept, cognisance should be taken of the time period large insurers would require to fully implement the requirements. Completing large system changes of this magnitude currently requires 24 months on average. It is also envisaged that severe pressure would be placed on service capacity (IT consultants, actuaries), which would add to the time lag for implementation. This is applicable in South Africa especially.

Recommendation
It is recommended that the 31 December 2006 date for disclosing fair value information on insurance contracts be reconsidered, and replaced with a date equal to 24 months after guidance is available in order to enable the implementation and testing of proper systems to facilitate fair value disclosures.

2.) Loss recognition concept
The ED does not make reference to the basis or grouping on which the loss recognition test ought to be based/applied. This is only clarified in the Basis for Conclusion, par. BC67 (b).

Recommendation
It is proposed that the basis and grouping rather be reflected in the main body of the ED so as to ensure more prominence and the enforcement of compliance.

The wording of paragraph 12 (b) of the draft IFRS requires an insurer to "recognise the difference by decreasing the carrying amount of the related deferred acquisition costs **or** intangible assets **or** by increasing the carrying amount of the insurance liabilities." In order to avoid fiscal arbitrage stemming from different tax treatment of deferred acquisition costs, intangible assets and insurance liabilities, it is further recommended that no election be allowed and that the adjustment should be limited to insurance liabilities only.

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.

We recognise the Board's aim to improve disclosure of insurance contract information so readers of financial statements can better evaluate the extent of insurance transactions as outlined in par. 26 – 30 in the main ED. However, in terms of the detail disclosure proposals, as outlined in the Implementation Guidance, concern arises regarding insurers being forced to disclose strategic confidential information to competitors, in particular:

Amount, timing and uncertainty of future cash flows
IG31 (b), IG35 – IG37
Sensitivity analysis
IG41 – IG43
Concentration of insurance risk
IG44 – IG47

The reason we are extremely concerned about the disclosure of strategic confidential information is due to the South African short-term insurance sector being a small and highly competitive market with limited insurers servicing existing and potential policyholders. Disclosing the above-mentioned information to the public and competitors would disadvantage any South African short-term insurer in relation to its competition, ultimately jeopardising profitability and sustainability. European requirements would not necessarily fit all other countries. Flexibility needs to be brought in to accommodate local requirements.

Recommendation
It is recommended, in line with our proposal below (Question 11(b)), that the disclosure requirements in the Implementation Guidance be viewed as guidelines rather than as strict requirements, thus allowing insurers to use discretion concerning what to disclose and in what detail, while complying with the overall requirements set by the main ED5 (par. 26 – 30). Insurers should be required to disclose high-risk areas with resultant additional disclosure.

(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?

Reading the main ED5 and Implementation Guidance jointly it is not clear to what extent the detail disclosure as stipulated in the IG should be followed to the letter.

Recommendation
It is proposed that the requirements as listed in the Implementation Guidance be made less prescriptive and be clearly highlighted as such in the main body of the ED. This will allow insurers to use dscretion in deciding on the level of disclosure whilst complying with the overall disclosure requirements of the main ED (par. 26 - 30).

(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?

Par. 29.c) requires that insurers disclose claims development information, both before and after risk mitigation by reinsurance. Claims development information for at least the preceding five years needs to be disclosed.
We are concerned about the level of detail required for disclosure and question whether it would add value to readers. In our opinion, by disclosing an abbreviated version of claims run-off, readers will still be in a position to evaluate the effectiveness of the reserving techniques applied.

Currently, claims development information is being retained in terms of regulator insurance classes. These classes are, however, different from management reporting classes and would need arbitrary manipulation to convert. This would jeopardise the validity of the information. By starting anew with the recording of claims development information, insurers would be able to disclose accurate claims development information.

Recommendation

- It is recommended that claims development only be developed on a net basis and reported as from the first year in which the proposed IFRS statement is applied. This will ensure meaningful disclosure going forward.
- It is proposed that the claims run-off information to be disclosed be limited to an abbreviated net format, allowing readers of the financial statements to reach conclusions on the effectiveness of reserving techniques used.

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?

Yes

Other comments:

1. Definition of "financial risk" in Appendix A:
   This definition extends beyond what we believe the Board's intention was for the scope of financial risks, as it mirrors the definition contained in IAS 39. As it currently reads, this definition will include all weather derivatives and defeats the intention of bringing weather derivatives that meet the definition of an insurance contract into the scope of this ED.

   Recommendation
   Consider narrowing the scope of the definition of financial risk in both this ED and in IAS 39 to remove any ambiguity.

2. Examples of items that are not insurance contracts in Appendix B 18 (d):
   In terms of a strict interpretation of the wording many stated benefit policies, such as personal accident cover, are not insurance contracts. These policies undertake to pay policyholders predetermined amounts in the event that, for example, a digit is severed accidentally. Such policy wordings do not as a "contractual precondition for payment" require that the policyholder should be adversely affected.

   Recommendation
   As the concept of insurance risk and risk transfer has been well established in the definitions per Appendix A and B, this example 18 (d) should be deleted.

3. Examples of items that are not insurance contracts in Appendix B 18 (h):
   The words "regardless of any" are inclusive and can be interpreted also to include contracts where the holder is in fact adversely affected.

   Recommendation
   Replace the words "regardless of any adverse effect on" with "that do not adversely affect".