Esther Pieterse

Partner
Department of Professional Practice
Tel: 27 82 719 5806
Email: esther.pieterse@kpmg.co.za

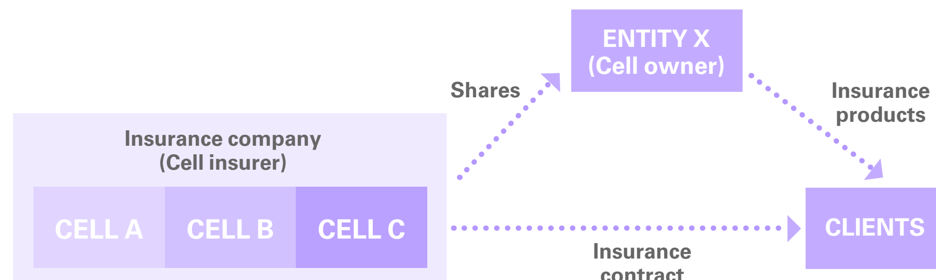
IFRS 17 and third-party cell captive arrangements

Cell captive insurance business is unique to South Africa. Like all other insurance companies, these insurers are required to comply with *IFRS 17 Insurance Contracts* (IFRS 17), which is effective for annual reporting periods beginning on or after 1 January 2023.

How does a typical third-party cell captive arrangement operate?

A registered insurance company (cell insurer) and a corporate entity (entity) enter into a shareholders' agreement. The entity subscribes for shares (ordinary or preference) issued by the cell insurer to "purchase" the cell to become a cell owner. The subscription price of the shares will provide initial capital to the cell. The cell insurer will administer the cell for an administration fee.

A typical third party cell captive arrangement in the South African environment



The cell owner (or a related entity to the cell owner) "sells" insurance policies to its clients, the policyholders, in the form of a complementary product to its current service or product offering. These insurance policies are sold in terms of a binder agreement between the cell owner (or a related entity to the cell owner) and the cell insurer and are underwritten by the cell insurer. The cell insurer is legally responsible for any claims submitted by the cell owner's clients (i.e. policyholders).

The cell owner collects insurance premiums from its clients and pays these premiums to the cell insurer that then allocates these premiums to the cell. Assets purchased with the premiums of the cell owner's clients, are also allocated to the cell, but are legally in the name of the cell insurer. If these assets are insufficient to settle claims received from the cell owner's clients, the cell insurer is required to contribute cash to the cell to meet these obligations. The cell insurer then has the right to require the cell owner to recapitalise the cell, generally through a further subscription of shares.

The cell owner is entitled to excess profits in the cell, i.e. any residual balance remaining in the cell after claims have been paid. During the life of the cell captive arrangement, the cell insurer, at its discretion, may distribute profits in the cell to the cell owner in the form of dividends.

On termination of the cell captive agreement, the cell insurer is required to redeem all the shares held by the cell owner. Generally, it will be at a price based on the net asset value of the cell.

Despite these contractual arrangements between the cell owner and the cell insurer, there is no legal ring-fencing of the funds held in the cell in the case of liquidation of the cell insurer. The current legislative framework regards all the assets and liabilities of third-party cells as part of the assets and liabilities of the cell insurer.

Should the cell be consolidated by the cell owner?

Before we explore the impact of IFRS 17 on cell insurers, we first need to consider whether the cell should be consolidated by the cell owner.

The assets of the cell insurer are required to be used to settle claims received from the cell owner's clients if there are insufficient funds within the cell, as the insurance contract is between the cell insurer and the cell owner's client. In addition, if the cell insurer is liquidated, the assets of the cell will not be protected from the rest of the cell insurer's creditors, including the other cells on the cell insurer's books. Therefore, the cell does not meet the definition of a silo (deemed separate entity) in terms of *IFRS 10 Consolidated Financial Statements* (IFRS 10) because claims from the cell owner's clients are not only paid from the assets of the cell, but potentially from the other assets of the cell insurer. Therefore, the cell will remain part of the cell insurer's financial statements and the cell owner will not consolidate its cell.

We will now discuss the impact of IFRS 17 on cell insurers in a cell captive arrangement.

Accounting treatment of the shareholders' agreement between the cell insurer and the cell owner under IFRS 17

The cell owner is exposed to insurance risk because it is required to recapitalise the cell if there are not enough assets in the cell to settle claims. The insurance contracts issued by the cell insurer generally expose it to significant insurance risk. This significant insurance risk is transferred to the cell owner by way of the shareholders' agreement between the cell insurer and cell owner. This agreement meets the accounting definition of a reinsurance contract, which should be accounted for in terms of IFRS 17. Like any other commercial reinsurance contract, the cell insurer is exposed to the risk of non-performance of the cell owner.

Complexities when applying IFRS 17

The challenge is that the cell insurer has to account for the shareholders' agreement as an in-substance reinsurance contract, even though the shareholders' agreement was not legally drafted to be a reinsurance contract. It is therefore important for the cell insurer to review the relevant clauses set out in the shareholders' agreement to understand the impact of IFRS 17. The cell insurer should consider whether amendments need to be made to any of the clauses contained in the shareholders' agreement, if for example the current clauses have unintended consequences as a result of applying IFRS 17.

The following are key considerations when applying IFRS 17 to the in-substance reinsurance contract:

Contract boundary

IFRS 17 requires an entity to include in the measurement of the reinsurance contract all the future cash flows within the boundary of the contract (IFRS 17.33). As a result, determining the contract boundary of the shareholders' agreement is one of the most important assessments that needs to be made, as this will impact which IFRS 17 measurement model has to be applied to the in-substance reinsurance contract held.

Cash flows are within the contract boundary of a reinsurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the cedant (cell insurer) is compelled to pay amounts to the reinsurer (cell owner) or has a substantive right to receive services from the reinsurer (IFRS 17.34).

A substantive right to receive services from the reinsurer ends when the reinsurer:

- has the practical ability to reassess the risks transferred to it and can set a price or level of benefits for the contract to fully reflect the reassessed risk i.e. the contract can be re-priced; or
- has a substantive right to terminate the coverage.

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If the cell owner and the cell insurer both have a unilateral right in the shareholders' agreement to cancel the coverage at any time without penalty, then the cell insurer does not have a substantive right to receive future services related to the additional insurance coverage and does not have any substantive obligation to pay future premiums. For example: The shareholders' agreement contains cancellation clauses allowing either the cell insurer or the cell owner to cancel (without reason) by providing a twelve month notice period. In this case the contract boundary will be twelve months.

However, there are shareholders' agreements in place where the cell owner has the right to redeem shares after a certain period, but the cell insurer does not have the right to cancel the shareholders' agreement or the binder agreement, making the contract boundary open-ended. In order to determine which cash flows should be included for measurement purposes, the cell insurer and the cell owner should evaluate if there are other clauses in the shareholders' or binder agreement that may allow the cell insurer or cell owner to terminate the cession of new business by giving a notice period.

There are also cases where the shareholders' agreement is written like a risk-attaching reinsurance contract. For example, both the cell insurer and cell owner can cancel the shareholders' agreement with a year's notice after all liabilities in respect of third-party insurance policies (issued by the cell insurer) are extinguished. The coverage period of the in-substance reinsurance contract will then be longer than a year. If the underlying insurance contracts (issued to the cell owner's clients) all have a contract boundary of two years, the coverage period of the in-substance reinsurance contract will be three years (two years plus the notice period of one year).

Separation

More than one class of business can be written in a cell, for example funeral and credit life insurance. The question is whether the cell insurer should separate the in-substance reinsurance contract for each type of business and account for them as two contracts.

The lowest unit of account under IFRS 17 is the legal contract. There may be circumstances in which the substance of the contractual rights and obligations included in a single legal contract is that of multiple reinsurance contracts. In these circumstances, an entity should separate the legal contract into the different reinsurance components to reflect the substance of the contractual rights and obligations.

Assessing the substance of a contract and concluding that it differs from its legal form as a single contract involves significant judgement and careful consideration of all the relevant facts and circumstances - i.e. it is not a matter of policy choice. Considerations that might be relevant in the assessment include:

- interdependency between the different risks covered;
- whether components lapse together;
- whether components are and can be sold separately; and
- whether insurance components are bundled together solely for the administrative convenience of the policyholder.

A cell insurer may consider in respect of the in-substance reinsurance contract whether:

- There are interdependencies between the different risks covered in the cell (in our example, funeral and credit life cover) – generally there are not.
- The cell owner and the cell insurer are only able to cancel or terminate the whole shareholders' agreement and not individual components of it, i.e. only credit life or only funeral – that is normally not possible.
- The cell owner issues separate funeral and credit life reinsurance contracts – this is not the case (although the cell owner may sell separate funeral and credit life policies on behalf of the cell insurer).
- The funeral and credit life products are bundled together for administrative convenience – this is generally not the case as the insurance business is written in the cell.

Therefore, separation of the in-substance reinsurance contract into further components is not considered to be appropriate.

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Application of the applicable measurement model

Once the contract boundary has been determined and the assessment of the separation of the shareholders' agreement into components has been concluded, an evaluation of the IFRS 17 measurement model is required. The default measurement model in IFRS 17 is referred to as the general measurement model (GMM). A simplified measurement model, the premium allocation approach (PAA), may be applied if certain criteria are met.

We expect that a cell insurer will apply the measurement model to each in-substance reinsurance contract issued by a cell owner and will not group in-substance reinsurance contracts issued by different cell owners in one portfolio. This is because IFRS 17 defines a portfolio as follows:

"A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together" (IFRS 17.14).

Shareholders' agreements with each cell owner are not managed together, although they may be subject to similar risks.

An entity may use the PAA to simplify the measurement of a group of reinsurance contracts held (in this case one in-substance reinsurance contract held), if at the inception of the group:

a) the entity reasonably expects that the PAA would produce a measurement of the asset for remaining coverage for the group that would not differ materially from the one that would be produced applying the GMM; or

b) the coverage period of each contract in the group of reinsurance contracts held (including insurance coverage from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less (IFRS 17.69).

We have seen many cell insurers argue that an in-substance reinsurance contract with a coverage period of longer than a year meets the requirements of the PAA measurement model. These cell insurers would have performed PAA eligibility testing to prove that the asset or liability for remaining coverage in terms of the PAA and the GMM will not be materially different and therefore application of the PAA measurement model to the in-substance reinsurance contract is appropriate.

If there is a difference in the contract boundary of the underlying insurance contracts issued and the in-substance reinsurance contract held, different measurement models may have to be applied to each contract or set of contracts. For example, the underlying insurance contracts may meet the requirements to apply the PAA, while the in-substance reinsurance contract is accounted for using the GMM.

We have seen that some cell insurers were able to apply the PAA to both the underlying insurance contracts issued and the in-substance reinsurance contract held (based on terms of the respective contracts).

The impact on the cell insurer's financial statements may be very different to the current accounting in terms of *IFRS 4 Insurance Contracts* (IFRS 4). Under IFRS 4, the net impact between accounting for the underlying insurance contracts issued in the cell and the in-substance reinsurance contract held is the fee charged by the cell insurer to the cell owner. The same accounting outcome may not materialise when IFRS 17 is applied.

What should cell insurers do next?

Cell insurers with December year-ends should ensure that they have resolved all complexities and outstanding issues by the end of the year. They may also need to communicate their decisions to cell owners to assist them with IFRS 17 compliance.

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