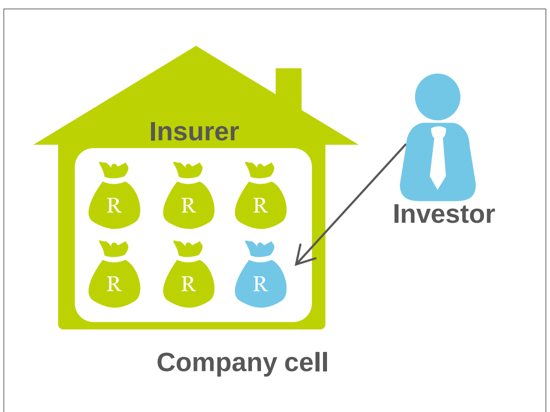
Insurance cell captives
The consolidation conundrum

Introduction

In the South African environment, many companies have made use of cell captive arrangements housed within insurance companies. Under these arrangements, companies insure against future adverse events by investing in shares issued by an insurer. The insurer utilises the capital received from the company to purchase a portfolio of income-generating assets. Claims initiated by the company against the insurer are settled from the portfolio of assets and are typically limited to the funds available from the portfolio. Historically, cell captives have often been consolidated by the investor, but with the introduction of new International Financial Reporting Standards (IFRSs), this may no longer be the outcome.



IFRS 10 *Consolidated Financial Statements* requires entities to reassess control for all investments in subsidiaries, which includes investments held in cell captives, from December 2013 year-ends. IFRS 10 has provided clear guidance with regard to multiple entities housed within a single entity, also known as the **deemed separate entity** guidance.

This publication aims to highlight the impact of the above change in the standards, as well as how these changes could affect you.

What is a deemed separate entity?

IFRS 10 requires the investor to determine whether it controls a portion of an investee as a deemed separate entity. To be classified as a deemed separate entity, all of the following criteria need to be met:

1. Specified assets of the investee are the only source of payment for the specified liabilities.
2. Parties other than those with the specified liability do not have rights or obligations related to the specified assets.
3. None of the returns from the specified assets can be used by the remaining investee, and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

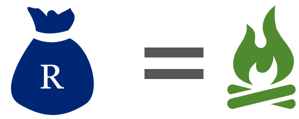
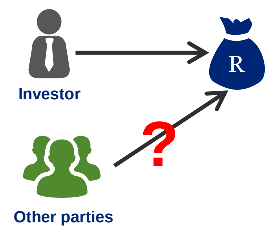
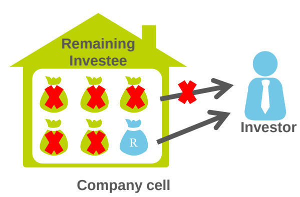
The legal rights and obligations

The contractual terms of cell captive arrangements typically stipulate that claims and expenses would be settled by capital and returns of the cell. This would indicate that cell captive arrangements are contractually ring-fenced. However, the Financial Services Board has issued a discussion paper on cell captive arrangements which states that, despite these contractual arrangements, there is no legal ring-fencing of the arrangements in the event of liquidation, as current insurance legislation in South Africa regards all assets and liabilities of cell captive entities as assets and liabilities of the insurance company.

Therefore, South African cell captive arrangements derived via contractual arrangements do not provide for legal ring-fencing of the investee's funds in the cell captive. Therefore, these arrangements would not be deemed separate entities under IFRS 10. These cells should no longer be consolidated by the investor and would rather be consolidated by the insurer.

Example:

Company A invests R1 million in preference shares issued by the insurer. The insurer uses the proceeds received to purchase and invest in a portfolio of income-generating assets. Company A utilises this investment portfolio to settle claims against it. Company A and the insurer have agreed that, in the event that the portfolio has insufficient funds to settle the insurance claim, the insurer has no obligation to settle the claim. The returns of the portfolio may only be distributed to Company A as the sole holder of the preference shares.

Requirements of IFRS 10	Application of requirements to the example
1. The ***specified assets*** of the investee are the only source of payment for the ***specified liabilities***. 	The insurer would utilise the income-generating assets invested by Company A to settle any insurance claims. The insurer is not able to use any other assets to settle these claims. Therefore, this criterion would be satisfied in this scenario.
2. ***Parties other*** than those with the *specified liability* do not have rights or obligations related to the ***specified assets***. 	In the event of liquidation of the insurer, Company A's portfolio is not legally ring-fenced from other creditors of the Insurer. Regardless of the probability of these events, this criterion would **not** be satisfied in this scenario.
3. None of the ***returns*** from the specified assets can be used by the remaining investee, and none of the ***liabilities*** of the deemed separate entity are payable from the assets of the ***remaining investee***. 	The investment in the insurer's preference shares entitles only Company A to profits on the portfolio and return of capital after payment of claims submitted by Company A. In the event that the income-generating assets would not be sufficient to settle any insurance claim made by Company A, the insurer is not required to fund the payment of any liabilities from any other income-generating assets it may hold. Therefore, this criterion would be satisfied in this scenario.

Conclusion

In applying the example and requirements above, the cell captive established for Company A would not be a deemed separate entity under IFRS 10, as the assets and liabilities are not legally ring-fenced from the insurer.

Next steps

Due to the introduction of IFRS 10, cell captive arrangements are unlikely to be consolidated by the investor. Therefore, depending on the nature and structure of cell captive arrangements, there would be differing accounting treatments for the investor and the insurer in a cell captive arrangement.

If you would like to discuss any aspect of this publication, please do not hesitate to get in touch with one of the contacts below:

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