

## **COMMENT LETTER 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 South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not just a professional body, but also secretariat for the Accounting Practices Board (APB), which is the official accounting standard setting body in South Africa.

### **GENERAL COMMENTS**

We fully support the development of an International Financial Reporting Standard (IFRS) that will provide a globally consistent measurement and disclosure basis for the liabilities arising from insurance contracts.

We are of the opinion that issuing an IFRS in a phased approach, with phase 1 and phase II so far apart, could cause a number of problems and could undermine IFRS. The draft IFRS is loosely worded and not of the high quality expected of the IASB, for example, the draft IFRS has little guidance on recognition and measurement. As a result some of the qualitative characteristics of financial statements as contained in the Framework, namely comparability and the neutrality and prudence aspects of reliability might not be achieved. In addition, by allowing an insurer to measure liabilities with excessive prudence (see paragraph 16(b), the draft IFRS is not complying with the Framework nor IAS 37 - *Provisions, Contingent Liabilities and Contingent Assets*. Furthermore, we are concerned that phase II could result in amending the definition of insurance contracts and some of the principles set out in this draft IFRS.

Whilst we understand that it is not the intention of the IASB to address measurement principles in phase 1 of the insurance project and that this draft IFRS deals mainly with disclosure issues for insurance contracts, this also causes concerns. The extent of disclosure requirements are similar to those required in other IFRS, but because of the lack of measurement principles in this draft IFRS, we would expect that additional disclosure requirements would be required to compensate for this. This is illustrated in our response to questions 4(b), 5, 10 and 11. We are concerned about the various interpretations of how to disclose the fair value of insurance liabilities and assets, as is required in paragraph 30 of the draft IFRS, when no measurement principles have been established.

## 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, except as noted below.

The scope of this draft IFRS excludes the accounting by policyholders and we note the comments in B 51. However, we are of the opinion that it should be stated that policyholders are to assess whether they have insurance or investment contracts and that, if they hold investment contracts, they should be accounting for these in terms of IAS 39 - *Financial Instruments: Recognition and Measurement*. This would ensure equal but opposite accounting treatment by the policyholder for investment contracts. If the contract is an insurance contract, then the contract should be accounted for in line with the current accounting policy applied by the policyholder, until the introduction of phase II.

- (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?*

In our view this 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?*

In our view, the definition is not appropriate.

We concur with the Board that the draft IFRS should be more of a principled-based standard. The definition of “*significant insurance risk*” in B21 has a statement of principle – significant risk of a significant loss. However, the lack of further guidance regarding what constitutes “*significant insurance risk*” means that each insurer (and their auditors) has to separately agree on what is significant. This could cause a lack of comparability of the results of insurers, and can make the interpretation of those results problematic, especially in the interim period until phase II is finalised.

The inclusion in B22 of the sentence ‘*insurance risk is not significant if the occurrence of the insured event would cause a trivial change in the present value of the insurer’s contractual cash flows in all plausible scenarios*’ suggests that we now have to deal with two terms, being significant and trivial. The Collins dictionary defines the word trivial as “of little importance; petty or frivolous” or “ordinary or commonplace; trite.” In our opinion, the main motivation behind the chosen wording is to prevent insurers from adding insignificant amounts of life cover to contracts to enable such contracts to be classified as insurance contracts (whilst they should in reality be classified as investment contracts). There can be no doubt that trivial constitutes less than significant and also less than material. Furthermore, the intuitive feeling is that the difference between trivial and significant is not marginal. If an amount is considered significant, trivial has to be somewhat removed from that amount. We believe there should be further guidance on this to ensure that it is applied in a consistent manner. The risk of leaving the draft IFRS and guidance in B21 and B22 is that it will provide a shelter for those that have insurance risk, but escape IAS 39 on the trivial clause. Strong loss recognition tests may assist to some degree and should be required.

Further, the word “*plausible*” referred to in B21 is too vague and requires definition.

From the above arguments it can be seen that the definition requires levels of interpretation from “*significant*” to “*trivial*” to “*plausible*”. This is at best confusing where English is your first language. For non-English speaking countries the definition could easily be misinterpreted and not applied consistently. We therefore recommend

that the Board consider the use of simple, clear and consistent language when re-assessing the definition.

There is no reference to premium in the definition and there is the view that you may achieve a narrower application of the insurance principle if the word is referred to in the definition. We understand that risk should be linked to the potential liability and not the premium, but that is only true if the unbundling provisions are adequately addressed.

If the Board decides to address policyholders in phase I, the definition would have to be amended accordingly.

Furthermore the alternative risk transfer industry should be considered and guidance given as to whether, in fact, insurance risk has passed.

### **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. However there should be a cross reference to IAS 39 paragraph 25(e).

(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. However it should be stated that the same principles as those in IAS 32: Financial Instruments: Disclosure and Presentation should be applied where possible.

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

We are not aware of any others.

#### **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.*

We are concerned about an apparent contradiction within the draft IFRS. Here there is the requirement that catastrophe and equalisation provisions be eliminated, yet paragraph 16(b) allows the insurer to continue its existing practice of measuring insurance liabilities with excessive prudence. Condoning this questionable practice is further exacerbated by the fact that insurers are not required to comply with IAS 37 - *Provisions, Contingent Liabilities and Contingent Assets*. If the Board allows this, at the very least, additional disclosure should be required.

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

We believe that the draft IFRS should at least require disclosure of the following in regards to a loss recognition test:

- a definition of the cashflows used,
- whether the cashflows were discounted, and
- how deferred acquisition costs were determined.

Whilst we acknowledge that the draft IFRS does not address measurement criteria, hence not defining the loss recognition test, we would recommend that detailed disclosure be required of how the test has been performed.

In addition, we believe the implementation guidance examples should be expanded to state whether the loss recognition test should be carried out on a portfolio basis or for individual contracts, with the additional disclosure we refer to above.

Paragraph 11 of the draft IFRS does not state whether it takes into account any regulatory or solvency requirements. We believe that consideration should be given to include guidance to the effect that regulatory requirements are not to be taken into account.

Paragraph 12 of the draft IFRS allows an option of reducing the asset as opposed to increasing the liability (i.e. allows offsetting). This appears to contradict paragraph 10(d) which does not allow offsetting.

(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?*

We agree with this proposal.

### **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).*

There are two issues we do not support:

- Allowing the insurer to continue “*measuring insurance liabilities with excessive prudence*” as this is not in terms of the Framework and condones questionable practice, as noted in our comment in Question 4 above.
- The requirement of paragraph 16(e) which allows companies within a group to have different accounting policies for their insurance liabilities. At the very least there should be full disclosure of the different basis used. We are of the opinion that segment reporting may address this to some extent. However if not, there should be a requirement to provide detailed disclosure of the amounts on the different bases.

- (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?*

We believe that narrower wording should be used to ensure that this is a one way only option, once an entity has made the change, it cannot change back.

### **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?*

We support the unbundling principle in these cases.

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

We are of the opinion that the unbundling principle should be broadened to more than just the deposit components of insurance contracts. We believe that all non-insurance components should be recorded if they are presently excluded from the balance sheet.

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

Our concern is that the heading of the section is misleading in that it implies that elements of an insurance contract should be unbundled, when it more accurately deals with the non-recognition of assets and liabilities where unbundling has occurred. Accordingly we believe the heading should be reworded.

#### **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?*

We do not believe that accounting of reinsurance should be specified in phase I. The draft IFRS does not address the measurement principles for the insurer when accounting for insurance liabilities, yet when the insurer buys reinsurance rigorous rules are applied. We believe this is inconsistent and inappropriate, despite the comments in BC92. It is also not consistent with the scoping out of accounting by policyholders, as in effect, the insurer has become the policyholder. If there are certain practices which are regarded as unacceptable then the draft IFRS should be specific on these.

#### **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?*

Although paragraph 20 of the draft IFRS “permits, but does not require an expanded presentation” of a liability and an intangible asset, paragraph 22 exempts the intangible asset from IAS 36 - *Impairment of Assets*, and IAS 38 - *Intangible Assets*. We believe this is not appropriate as it is not clear how the proposed accounting in this regard be achieved without guidance on how to fair value insurance liabilities and assets. In addition, it is not clear how the intangible assets should be determined, nor when or how the intangible asset should be increased or decreased. Furthermore, it is not clear whether a negative asset has been considered as a possibility and whether the accounting for this is expected to differ from that of intangible assets.

Having accounted for the business combination, the reporting entity has an option to split the insurance liabilities into components based on its accounting policies.

For a business combination, consider:

	Undiscounted	Discounted
Consideration	1000	1000
Assets (at fair value)	3000	3000
Insurance liabilities	2500	2000
Net assets acquired	500	1000
Goodwill	500	-

Proposed accounting in group financial statements:

Insurance liabilities	2500	2000
Intangible asset	500	-

This disclosure seems to contradict the general principle of offsetting that this draft IFRS seeks to eliminate.

### **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?*

We are of the opinion that paragraph 25 of the draft IFRS is bending the IFRS rules, as these are financial instruments. IAS 39 should therefore be applied in full, not to some extent only. We recommend that paragraph 25 should be deleted, which would therefore mean that IAS 39 would be applicable.

### **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. It is not possible to require the disclosure of fair values, when no guidance is given on how to measure fair values. This is particularly relevant for insurance liabilities. We recommend, that if measurement of fair value principles is not given, that at least examples of disclosure should be provided as to how fair value was arrived at. This is needed in order to prescribe some standardisation. Furthermore, this disclosure should align with that required in IAS 32.

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 have determined how to measure fair values by that date. We therefore recommend that the draft IFRS should not contain such a requirement, but rather be amended when adequate guidance has been given on the determination of fair values in 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 requirement within the draft IFRS paragraph 29(c)(iii) to disclose claims development for a period of up to ten years is excessive and unnecessary for purposes of the audited financial statements. It is interesting to note, that experience indicates that some companies, who have been required to provide this information, have had significant difficulties in providing data in the format required. In many cases, the 10-year information is developed only after substantial systems modifications.

We would support a requirement that the notes to the financial statements disclose, for each year for which an income statement is presented, for example two or three years, incurred claims related to the provision for losses of the current fiscal year and the increases or decreases in the provision for losses of prior fiscal years. To supplement this numerical analysis, the enterprise should qualitatively discuss the reasons for the changes in incurred claims recognised in the income statement attributable to insured events of prior fiscal years. If more information is required, the ten-year table could be presented outside of the audited financial statements.

- (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?*

These proposals are considered reasonable. However as this is a disclosure IFRS, more detailed guidance should be provided around disclosure aspects. As no measurement principles have been given for fair value, loss recognition tests, etc, we believe that more disclosure is required on how these items have been measured.

- (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?*

None.

## 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:

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A: Definitions and examples of captive insurance arrangements	15

### 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.

## **22. 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 not 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 not 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.

### **33. 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 only if the insurer is an entity distinct 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)(iii)~~ *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)(c)~~ *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 and 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 known, but its timing is unknown. More clarification is needed regarding when the amount of the loss is unknown 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 quantitative 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)~~(ii) *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.

## Recommendation

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?

## COMMENT LETTER OF THE LONG-TERM/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 Long-term/Life Insurance Industry Project Group of the South African Institute of Chartered Accountants (SAICA). The project group is an industry interest group, which is represented by long-term/life insurers, regulators and industry auditors. This project group considers accounting, auditing and reporting matters of relevance to the long-term insurance industry of South Africa.

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

	<i>Page</i>
A: Examples of Captive Insurance Arrangements	14 – 16
B: Professional Guidance Note PGN 103 <i>The Report by the Statutory Actuary in the Annual Financial Statements of South African Long-term Insurers</i>	17 – 27
C: Professional Guidance Note PGN 104 <i>Life Offices – Financial Soundness Valuation</i>	28 – 53
D: Professional Guidance Note PGN 107 <i>Embedded Values and Value of New Business</i>	54 – 66

### GENERAL COMMENTS

The SAICA Long-term/Life Insurance Project Group, hereafter referred to as the project group, in the main, supports this draft IFRS. However, the project group believes the following needs to be addressed by the International Accounting Standards Board (IASB):

1. The inconsistent definitions of insurance contracts in IAS 32 – *Financial Instruments: Disclosure and Presentation* and this draft IFRS (see our comments under Question 1).
2. The fundamental principles that:
  - insurance assets and liabilities must be valued consistently; and
  - that the assets of the shareholders and policyholders must be kept separately.(See our comments under Question 1).
3. The definition of an insurance contract needs to be made clearer with regard to risk transfer (see our comments under Question 2).

4. The measurement of fair values of liabilities. It is extremely difficult to require the disclosure of the fair value of liabilities without providing guidance on the measurement of such fair values (see our comments under Question 10).
5. The anomaly of prescribing the accounting by the cedant for reinsurance, but not prescribing accounting for direct insurance contracts (see our comments under Question 7).

## 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.*
- (iv) *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?*

The project group believes that the scope is appropriate, subject to the comments below.

We understand that, at this stage, there will not be a consequential amendment to IAS 32 – *Financial Instruments: Disclosure and Presentation* with regards to the definition of an insurance contract. Therefore there should be some clarity provided regarding the different definitions of insurance contracts in this draft IFRS and IAS 32. At least, there should be a cross reference to the definition in IAS 32.

A view was expressed that it should be a fundamental principle that the assets and liabilities be valued consistently and that the assets of the shareholders and policyholders be kept separately. This is not clear in the draft IFRS and affects in the main following:

- own shares in policyholder funds;
- associate companies;
- owner occupied properties;
- subsidiary companies.

Transactions between shareholders and policyholders, on the basis that they are arms length, should be properly accounted for between these two parties as separate and independent entities.

Consider for example that participating policyholders share in risk and get some return and that portion “belongs” to the policyholders and should not go to the shareholders but should be disclosed separately.

- (d) *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.

## **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?*

In principle there was agreement on the definition of an insurance contract, however the project group is of the opinion that the definition should provide some additional guidance how to measure risk transfer. It is believed there should be a measurement hierarchy from “trivial,” referred to in B22 to “significant,” as noted in the definition, which should include a definition for “plausible” referred to in B21.

Further clarification of what is significant and what is not should be given in the implementation guidance where examples for the life and non-life insurance industry are illustrated. These examples should be of a fringe nature and refer back to the definition.

B18(b) refers to “contracts which pass significant insurance risk back through mechanisms that adjust future payments.” Guidance is needed to address whether “mechanisms” would include wholly owned captive insurers and cell captive arrangements. In order to assist the IASB in understanding the issues of concern to the project group, set out in Appendix A are examples of captive insurance arrangements typically found in South Africa.

## **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:*

- (iii) 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?*

Although the project group was comfortable with the recommendations contained herein, the IASB should be aware that there is a risk that the proposals may result in an insurer having to separately fair value and disclose a 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, which should not be the case. This concept is further explained below.

In terms of IAS 39, the definition of a derivative requires that no or little net investment be made. In the case of the surrender value, this represents the value of all the premiums already paid by the policyholder, and therefore does not represent a small investment relative to the value of the contract.

In addition if:

- the economic characteristics of the embedded derivative are closely related to the host contract (which it is in this case); and
- the surrender value does not meet the definition of a derivative (which we do not believe it does, see above); and
- the combined instrument is already reflected at fair value (or what we currently regard as fair value until phase II),

then the surrender value need not be separately disclosed as an embedded derivative.

- (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. However some of those embedded derivatives may be totally immaterial, therefore some guidance should be provided on the disclosure materiality of embedded derivatives. We do not believe it will be useful information to provide disclosures of immaterial embedded derivatives.

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

We are not aware of any others.

#### **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.*

Yes, this proposal of eliminating catastrophe and equalisation provisions is appropriate, however the project group considers that this is more relevant to the non-life insurance industry.

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

We agree with this principle of a loss recognition test.

(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?*

We agree with this proposal.

## **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?*

Whilst the project group was comfortable with the recommendations it was considered that a greater understanding of all guidance should be given in relation to paragraph 16(b) of the draft IFRS “*measuring insurance liabilities with excessive prudence*”. Further what is the meaning and measurement of “excessive”?

We support the requirement of paragraph 16(e) of the draft IFRS which allows companies within a group to have different accounting policies for their insurance liabilities, only in so far as there are multinational subsidiaries in the group. We do not support different accounting policies for insurance liabilities for subsidiaries within the same country as this could distort the group results and make comparisons meaningless. We believe this distinction should be made clear in the draft IFRS.

We wish to draw the IASB's attention to the fact that having different accounting policies within a group provides the opportunity for regulatory arbitrage.

Regulatory arbitrage can be defined as concluding business arrangements in a manner that is primarily driven by a desire to provide capital for liabilities in a different jurisdiction which prescribes the least amount of capital for writing the business. The lower the capital, the lower the cost. This creates an opportunity for an arbitrageur to make a risk-free profit from such a situation.

For example, an insurer has liabilities of R100m, with a capital requirement of R10m. This capital will cost him R1.5m per year, at 15% per annum cost of capital. If he can reinsure the business to another jurisdiction where the capital requirements would only be R5m, he would save R750 000 every year, which can be shared between the reinsurer and reinsured. The point is that the liabilities are now backed with only half the capital, and therefore, half the security.

This needs to be distinguished from a reinsurer retroceding liabilities to its parent company, which may or may not have a lower capital requirement. In this case, the reinsurance is being placed where the capital is and the alternative would entail the parent company making an additional investment in its subsidiary to finance the arrangement.

## **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?*

The project group considers that unbundling should be allowed, if not actually required, as it provides for better disclosure. Detailed below are specific answers to 6(a) to (c).

Although we support the unbundling principle, paragraph 7 of the draft IFRS only refers to the one specific issue; where the cash flows for the insurance contract are independent from the cash flows of the deposit component. By implication, if the cash flows of the deposit and the insurance components are closely related then there is no need to unbundle the contract. This should be clearly stated, rather than by implication. In addition, the IASB has not recognised the effect of unbundling to the income statement. We believe the income statement effect should be referred to.

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

The unbundling principle refers to the “*deposit component*” of insurance contracts. We are of the opinion that the terminology used is incorrect and that the unbundling principle should rather refer to the “*investment component*.”

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

No, refer to our answer to question 6(a) above.

It was however considered that non-life insurers and reinsurers may have difficulty in applying the unbundling principle and the IASB should give clarity to them. We refer you to the comment letter from the SAICA non-life insurance industry project group.

## **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?*

We do not believe that accounting for reinsurance should be specified in phase I. The draft IFRS does not address the measurement principles for the insurer when accounting for insurance liabilities, yet when the insurer buys reinsurance rigorous rules are applied. This will result in the inconsistent treatment by the insurer of two closely related balance sheet items. We believe this is inconsistent and inappropriate, despite the comments in BC92. It is also not consistent with the scoping out of policyholders, as in effect, the insurer has become the policyholder.

## **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?*

We are of the opinion that paragraph 25 of the draft IFRS was incorporated to curb the industry practice of negative bonus stabilisation reserves. It is believed that these discretionary participation features would be addressed under the loss recognition tests. We therefore recommend that paragraph 25 should be deleted and this issue addressed in

phase II. It must be clarified that the exemptions pertaining to these contracts applies to valuation, as well as disclosure, until phase II is clarified.

#### **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. We believe the requirement to disclosure of fair values cannot be implemented when no guidance is given on how to measure fair values. This is particularly relevant for insurance liabilities. The risk is that there will be inconsistencies between insurance companies and the fair values across companies. Clarification is needed as regards the definition of insurance assets in the context of a long-term insurer.

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 at that date. 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.*

- (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?*

The project group agree with the principle of requiring further disclosure for insurance contracts, however, for a disclosure standard the disclosure requirements are far too broad. The IASB should be more specific and have a clearer statement on their purpose.

Consideration should be given to the cost/benefit test which would prescribe the level of detailed disclosure required. It is necessary to guard against over disclosure for the sake of it and which over disclosure could be meaningless. There is also a big challenge particularly in the areas of insurance contracts versus investment contracts. What value will it really add? For example, would paragraph 27b of the draft IFRS expect further and fuller disclosure (and indeed separate balance sheets and cash flow statements) for different types of businesses?

In South Africa the Actuarial Society of South Africa has given guidance to the industry in the form of Professional Guidance Notes PGN 103 “*The Report by the Statutory Actuary in the Annual Financial Statements of South African Long-term Insurers*” and PGN 104 “*Life Offices – Financial Soundness Valuation*” which form an integral part of valuation and disclosure. Further guidance is provided in PGN 107 “*Embedded Values and Value of New Business*” as additional supplementary reporting. We would encourage the IASB to further address this issue, by referring to these three documents attached as appendices B, C and D.

- (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, we concur with this treatment.

## **Question 13 – Other comments**

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

- (i) From a South African context the proposed split of insurance and investment contracts may drive South African Revenue Service (SARS) to ultimately review the whole trustee basis of taxation known in South Africa as the 4 fund approach. This may have a material impact on the basis of taxation in the future.
- (ii) In the light of (i) above, it would be appropriate to see the whole picture before the separation of insurance contracts and financial instruments.
- (iii) In the case of the draft IFRS paragraph 29(c)(iii) it was suggested that this paragraph would impact non-life insurers rather than life insurers. Does it make sense given the nature of the life insurance business to go back ten years? Why only ten?
- (iv) The question was raised as to whether or not there was enough emphasis on the difference which exists between non-life and life insurers. For example the draft implementation guidance paragraph IG39. Would this analysis referred to in (ii) above be required for life insurers and what value would it add? With this in mind it was suggested that there should be greater emphasis in distinguishing between non-life and life insurers and possibly reinsurers as well.
- (v) It was suggested that there was inadequate guidance on a group of contracts versus individual contracts.

## **APPENDIX A**

### **EXAMPLE OF A WHOLLY OWNED CAPTIVE INSURANCE ARRANGEMENT**

Company A, being a large corporate and mining group, owns 100% of the share capital of Company B, a registered insurer (called “captive insurer”). 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 mining 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 B prepares its own financial statements and complies with the local insurance legislation and regulations.

At the end of each financial year, Company A consolidates the financial results of Company B.

In terms of the definition of insurance in the draft IFRS, Company B would be an entity distinct from Company A, the policyholder.

In terms of Appendix B in the draft IFRS, 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?

Wholly owned captive arrangements are very common in South Africa. These arrangements could 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 these kinds of arrangements and provide implementation examples.

## **EXAMPLE OF A CELL CAPTIVE STRUCTURE**

### **Overview**

The cell structure gives an ability to offer clients an equity participation in a licensed insurer through a shareholder agreement. The structure is a number of separate classes of shares, where each class comprises a business cell. Each cell is represented by a separate class of ordinary shares with specified dividend rights. Clients subscribe for these shares and the client as cell owner is afforded the risk financing and conventional insurance capabilities enjoyed by a licensed insurer.

### **Product features**

The shares issued to cell participants provide the cell owners the ability to underwrite their own risks or those of connected third parties. Risks taken on by the cell are covered by “stop loss” and “catastrophe” reinsurance and solvency.

For example, a cell owner would pay a premium into a cell and this premium would be market related. The cell owner will then claim against this premium. In addition the cell owner would have made an “investment” in terms of contributing/ buying shares in a cell where the cell owner is of the opinion that it could do its risk management on its own. This capital contribution is also at risk.

## **EXAMPLE OF A RENT-A-CAPTIVE (CONTINGENCY) STRUCTURE**

### **Contingency policy**

A contingency policy is a normal insurance policy that affords the insured the protection of insurance and the opportunity to share in the underwriting profits of their programme based on favourable claims experience and implementation of sound risk management principles. The benefits are:

- A **Management tool** for risk management and for controlling the company’s risks, losses and exposures.
- The **facility for sharing** in underwriting profits at the discretion of the insurer.
- **The creation of self-insurance capacity** for difficult or expensive to insure risks. (Helps provide sufficient reserves to absorb and facilitate larger retentions of losses in the future)

**At Renewal or cancellation**

A performance bonus is declared, at the discretion of the insurer and is dependent upon a favourable claims experience. This bonus comprises the underwriting surpluses and the time value of money.

## APPENDIX B

### PGN 103: THE REPORT BY THE STATUTORY ACTUARY IN THE ANNUAL FINANCIAL STATEMENTS OF SOUTH AFRICAN LONG-TERM INSURERS

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#### 1. BACKGROUND

- 1.1. Paragraph 12 of Schedule 4 of the Companies Act states that, in the case of a long-term insurer, a report by the Statutory Actuary shall be included in the financial statements, in accordance with a guideline issued by the Actuarial Society of South Africa.
- 1.2. AC 121 issued by the South African Institute of Chartered Accountants (SAICA) prescribes the specific disclosures necessary in the annual financial statements of South African long-term insurers. Within AC 121 there is reference to the Report by the Actuary.
- 1.3. PGN 103 provides guidelines to Statutory Actuaries regarding the format and content of this report to be included in the annual financial statements of the long-term insurer.
- 1.4. If any embedded value information is provided in the financial statements or annual report, the actuary shall be guided by PGN 107 (embedded value guidelines).
- 1.5. The purpose of the report by the Statutory Actuary is to give readers of the annual financial statements a fair picture of the overall financial strength of the insurer, as well as its profitability. The purpose of this guideline is to help ensure consistency and completeness of disclosure in the annual financial statements of long-term insurers.
- 1.6. The inclusion of a Statutory Actuary's Report in the annual financial statements is mandatory for all South African long-term insurers. Compliance with this version of PGN103 is **mandatory** for Statutory Actuary Reports included in the financial statements of South African long-term insurers **for financial years ending on or after 31 December 2002**.
- 1.7. SAICA has drawn up an audit guide entitled "Auditor's Relationship with Actuaries in the Long Term Insurance Industry". This audit guide requires the auditor and the Statutory Actuary to work closely together. It can be expected that the auditor would wish to discuss the Statutory Actuary's report in the annual financial statements with him/her in the context of this ASSA guidance note.

#### 2. GENERAL COMMENT

- 2.1. The Actuarial Society of South Africa is not able to prescribe the nature of the disclosure in annual financial statements, but the Statutory Actuary is nevertheless encouraged to seek to influence the content of the annual financial statements to be consistent with PGN 103 and PGN 104.

- 2.2. It should be noted that the board of directors is responsible for the annual financial statements. The information contained within a Statutory Actuary's report and the manner in which it is presented is, however, the responsibility of the Statutory Actuary. If part of the information that would have been included in the Statutory Actuary's report is instead provided elsewhere in the financial statements (see start of section 4 below), then the Statutory Actuary must be satisfied with the manner in which this information is presented elsewhere in the financial statements.
- 2.3. It is emphasised that every Statutory Actuary bears a personal professional responsibility for the reports he/she signs. He/she must take all relevant facts into account and consider them in the light of the unique and specific circumstances applying to the insurer at the time he/she compiles the report. This guidance note cannot cover all possibilities and should therefore be interpreted and followed in the spirit of the guidance given where a particular circumstance is not covered specifically.
- 2.4. This guidance note does not require the disclosure of items that are not material. Materiality guidelines must be the same as for other items in the financial statements, as decided by management and approved by the auditors.

### **3. CONCERNS AROUND ANNUAL FINANCIAL STATEMENTS**

- 3.1. In the event that the Statutory Actuary materially disagrees with the content of the annual financial statements, or has experienced pressure from the board or management to change the valuation basis, or the manner in which the financial results are presented, and is uncertain as to his/her correct course of conduct, he/she should contact the ASSA through its President, President-Elect or Honorary Secretary.
- 3.2. If, in the Statutory Actuary's opinion, the financial results presented in the annual financial statements are materially inconsistent with PGN 103 or PGN 104, the Statutory Actuary is required to report this inconsistency to the Registrar of Long-term Insurance within seven days of the publication of the annual financial statements.

### **4. REQUIRED DISCLOSURE**

The Statutory Actuary's Report shall contain the following minimum information, unless it is satisfactorily provided elsewhere in the annual financial statements in compliance with these requirements:

#### ***Statement of Assets, Liabilities, Excess Assets and Capital Requirements***

- 4.1. A statement reflecting the values of assets and liabilities as determined by the Statutory Actuary on the financial soundness basis, the excess of the value of assets over the value of liabilities (excess assets), the total amount of the capital adequacy requirements and the ratio of excess assets to capital adequacy requirements. The values of assets and liabilities and the amount of

the capital adequacy requirements shall be determined in accordance with PGN 104. The statement shall reflect the values as at the current reporting date and as at the previous reporting date.

- 4.2. The Statutory Actuary's valuation of liabilities should include all liabilities incurred but not included under current liabilities or provisions in the balance sheet.

### ***Certification of Financial Position***

- 4.3. A certificate signed by the Statutory Actuary that the valuation has been conducted and that the Statutory Actuary's Report has been produced, in accordance with applicable ASSA Professional Guidance Notes (including PGN103 and PGN104), that the Statutory Actuary's Report, read together with the annual financial statements, fairly presents the financial position of the long-term insurer, and that the long-term insurer is financially sound and is likely to remain financially sound in the foreseeable future.
- 4.4. If the financial position is such that the excess assets are less than the capital adequacy requirements, or that the Statutory Actuary is unable for any other reason to certify that the long-term insurer is financially sound or is likely to continue to remain financially sound, then the certificate shall be amended accordingly, and explanatory commentary shall be provided setting out the reasons for the insurer's financial condition and the steps required to restore or ensure financial soundness.

### ***Analysis of Change in Excess Assets***

- 4.5. An analysis of the change in the excess of the value of assets over the value of liabilities over the reporting period, split into at least the following components:
- Any capital raised.
  - Any dividends paid.
  - Investment returns (including realised and unrealised capital appreciation or depreciation) generated by the excess of assets over liabilities. Where funds are 'borrowed' from shareholder funds to finance the business (such as for unamortised acquisition expenses), this reduces the shareholder funds that are invested externally, and a notional interest payable on this 'loan' should be charged against operating profit and included here. A split of the investment return between investment income and capital appreciation (where capital appreciation includes realised and unrealised gains or losses) should be provided.
  - Operating profit, excluding the effect of changes in valuation methods or assumptions.
  - The financial effect of changes in the valuation methods or assumptions. This is the capitalised value of the corresponding profit or loss that would

have arisen in future years if the method or assumption change had not been made.

- Shareholder tax. *The above items may alternatively be shown net of tax, if preferred.*

#### ***Reconciliation to Reported Earnings***

- 4.6. Where reported earnings provided elsewhere in the annual financial statements differ from the change in the excess assets, after excluding the effect of any capital raised or any dividends paid, a reconciliation between these two items shall be provided.

#### ***Changes in Valuation Methods or Assumptions of Assets or Liabilities***

- 4.7. A brief description of any material changes in methods or assumptions since the previous reporting period shall be provided. Disclosure of the financial effect thereof is provided for in 4.5 above.

#### ***Liability Valuation Methods and Assumptions***

- 4.8. A description of the valuation methods and assumptions according to which various broad categories of liabilities were valued shall be given. For items such as mortality and expenses, the report shall state how each of the main assumptions compare with recent actual experience. The nature of and dates of the most recent experience investigations for the main classes of business should be provided. Should there be expected future deviations, e.g. the effect of AIDS on mortality, the way in which this is taken into account shall be stated. The assumptions for items like investment return, bonuses assumed for discounted cash flow valuations, expense inflation, discount rates and growth of dividends/rents as well as the relationship between the different items shall be disclosed.
- 4.9. The way in which policyholders' reasonable benefit expectations were provided for shall also be shown. For example, the level of future bonus rates (e.g. supportable or last declared) provided for. Supportable bonuses are those that could be declared if investment returns assumed in the valuation were earned, before taking account of any bonus stabilisation reserves. Where a bonus rate for any of the ensuing three annual bonus declarations is assumed that is lower than the lesser of the supportable bonus rate and last declared bonus rate, or where a bonus rate beyond three years is assumed that is lower than the supportable bonus rate, this shall be disclosed with details of the reductions in bonus rates assumed.
- 4.10. A description shall be provided of the way in which any bonus stabilisation reserves are determined and have been allowed for. For a prospective valuation, where it is assumed that future bonuses differ from supportable bonuses (as defined above in 4.9), there is an implicit bonus stabilisation reserve that must be quantified for the purposes of 4.11 below. This implicit



bonus stabilisation reserve is defined as the difference between the reserve based on supportable bonuses and the reserve based on assumed bonuses. When calculating bonus stabilisation reserves, appropriate allowance shall be made for bonuses accrued up to the valuation date (at declared, interim or expected bonus rates, depending on the timing of the valuation and the timing of the bonus declarations).

- 4.11. Where the bonus stabilisation reserve for any class of business is more negative than  $-7.5\%$  of corresponding liabilities at the valuation date, this fact shall be disclosed. It is recommended that an explanation of what caused this to occur be provided. If the bonus stabilisation reserve is more negative than  $-7.5\%$  of corresponding liabilities at the valuation date, the Statutory Actuary shall also state why he/she believes that this can be recovered through under-declaration of bonuses during the ensuing three years.
- 4.12. Any reduction, whether by cancellation or temporary suspension, of previously declared non-vested bonuses shall be described, and the financial effect thereof shall be quantified and disclosed. The extent to which the financial effect of such reduction of previously declared non-vested bonuses differs from the underlying asset value movement shall be quantified and the accounting treatment thereof described, with specific reference to its effect on bonus stabilisation reserves and disclosed earnings. Similar disclosures shall be made in the event of the reversal of any such reduction in non-vested bonuses.
- 4.13. The nature of and reason for any material second-tier margins shall be described. If no embedded value information is provided in the company's or group's annual report, then the present value of the second-tier margins shall be disclosed.
- 4.14. The description of the liability valuation methods and assumptions may be succinct and may cover broad principles for major classes of business only, provided these classes account for at least 75% of total liabilities.

#### ***Asset Valuation Methods and Assumptions***

- 4.15. A brief description of the methods and assumptions used for valuing the assets, including a description of the way in which asset values are smoothed, if applicable.
- 4.16. There may be intangible assets included in the balance sheet that are not available to meet current and future liabilities. They could include goodwill, unamortised acquisition expenses and/or unamortised development expenses. The Statutory Actuary should state whether he found it appropriate to exclude any of them from the assets shown in the statement of value of assets and liabilities, or to reduce the value at which they are shown.
- 4.17. Any difference between the fair value and actuarial value of assets shall be split appropriately between the portion relating to excess assets and the portion backing policyholder liabilities.

- 4.18. The description of the asset valuation methods and assumptions may be succinct and may cover broad principles for major classes of assets only.

### ***Capital Adequacy Requirements***

- 4.19. A brief summary of the main assumptions adopted for calculating the capital adequacy requirements shall be provided. These assumptions include the material off-setting management actions assumed (including those actions that may already have been assumed in calculating the liabilities), the circumstances in which these actions would be taken, and the manner in which the capital itself is invested. The financial effect on the capital adequacy requirements of all the assumed management actions shall be provided, and the management actions described shall account for at least 90% of this financial effect.
- 4.20. For assumed off-setting management actions, the Statutory Actuary shall certify that these actions have been approved by specific resolution by the board of directors, and that he/she expects that these actions would be taken if the corresponding risks were to materialise.
- 4.21. A statement shall be made as to whether the ordinary capital adequacy requirements (OCAR) or termination capital adequacy requirement (TCAR) applied.

### ***Other***

- 4.22. If the Statutory Actuary is unable to reconcile major differences between the valuation data and the accounting data, or major differences in the build-up of the valuation data, the problem shall be discussed with the company and with the auditor. If the differences cannot be reconciled and are material, it will be necessary to disclose this fact and to give an opinion of the extent and effect of the discrepancy, and to state what allowance has been made in the valuation for the discrepancy.
- 4.23. Any other descriptions or explanations considered necessary to enable a reader to gain a meaningful appreciation of the figures presented.

## **5. NOTES**

- 5.1. The requirements detailed above, and any other information included in the report, shall be presented in a way that minimises the possibility of misinterpretation. The format detailed in the annexure hereto is suggested in this context, but variations thereof may be appropriate in individual circumstances. The statement reflecting the actuarial values of assets and liabilities may, for example, be incorporated into the balance sheet.
- 5.2. The annexure includes recommendations regarding the content and format of the report.

## ANNEXURE

### SUGGESTED CONTENT AND FORMAT FOR THE STATUTORY ACTUARY'S REPORT

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#### Statement Of Assets, Liabilities, Excess Assets And Capital Requirements

R'm	31.12.2002	31.12.2001
Total value of assets as per balance sheet	115 600	103 750
<i>Reconciliation of and explanation for any difference between balance sheet value and PGN 104 value</i>		
<b>Value of assets as per PGN 104</b>	<b>115 600</b>	<b>103 750</b>
Actuarial value of policy liabilities	100 000	90 000
Current and other liabilities as per balance sheet	3 000	2 700
<b>Total value of liabilities</b>	<b>103 000</b>	<b>92 700</b>
<b>Excess Assets</b>	12 600	11 050
<b>Capital Adequacy Requirements</b>	6 000	5 400
<b>Ratio of Excess Assets to Capital Adequacy Requirements</b>	2.1 x	2.0 x

#### Certification of Financial Position

I hereby certify that:

- the valuation of the ABC Life Assurance company as at 31 December 2002, the results of which are summarised above, has been conducted in accordance with, and this Statutory Actuary's Report has been produced in accordance with, applicable Actuarial Society of South Africa Professional Guidance Notes;
- my Statutory Actuary's report, read together with the annual financial statements, fairly presents the financial position of the company; and
- the company was financially sound as at the valuation date, and in my opinion is likely to remain financially sound for the foreseeable future.

*Signed*

.....

*Name*

Statutory Actuary

*Date*

### Analysis of Change in Excess Assets

The excess of the value of assets over the value of liabilities has changed as follows over the reporting period:

	Year to 31.12.2002	Year to 31.12.2001
Excess Assets as at end of reporting period	12 600	11 050
Excess Assets as at beginning of reporting period	11 050	10 000
<b>Change in Excess Assets over the reporting period</b>	<b>1 550</b>	<b>1 050</b>

This change in the excess assets is due to the following factors:

Investment return generated by excess assets over liabilities:		
Investment income	600	550
Capital appreciation	<u>900</u>	<u>450</u>
Total investment return	1 500	1 000
Operating profit	1 400	1 250
Changes in valuation methods or assumptions	100	- 150
Tax	- 450	- 350
<b>Total earnings</b>	<b>2 550</b>	<b>1 750</b>
Capital raised	-	-
Dividends paid	- 1 000	- 700
<b>Total change in excess assets</b>	<b>1 550</b>	<b>1 050</b>

### Reconciliation to Reported Earnings

Total earnings as per the above table	2 550	1 750
Reported earnings in annual financial statements	2 600	1 750
Difference	- 50	-

The reasons for this difference are as follows ....

## **Changes in Valuation Methods or Assumptions**

The value of liabilities as at 31.12.2002 decreased by R 100 million as a result of changes to valuation assumptions.

The main assumption changes causing this decrease were as follows .....

## **Valuation Methods and Assumptions**

The valuation was performed using the Financial Soundness Valuation method and was conducted in accordance with PGN 104. Assets and policy liabilities have been valued on methods and assumptions that are consistent with each other.

The result of the valuation methods and assumptions is that profits are released appropriately over the term of each policy, to avoid the premature recognition of profits that may give rise to losses in later years.

## **Liability Valuation Methods and Assumptions**

In the calculation of liabilities, provision has been made for:

- the best-estimate of the future experience, plus
- the margins prescribed by PGN 104, plus
- second-tier margins as follows to release profits consistent with policy design:
  - reduce the valuation rate for liabilities by 0,25 percentage points to release profits consistent with the amount of assets managed from year to year.
  - increase the mortality and morbidity assumptions by 10% to release expected risk profits consistent with the amount of cover provided from year to year.
  - An allowance for the shareholders 10% participation of the expected reversionary and terminal bonus payable each year in respect of conventional with profit business.
  - An allowance for the shareholders 10% participation of the bonus expected to be declared each year in respect of smoothed bonus business.

The following are the main assumptions used to calculate the value of the liabilities:

- The assumptions (before adding margins) with regard to future surrender, lapse, disability payment termination, mortality, medical claims and morbidity rates were consistent with the company's recent experience and provision has been made for the expected increase in the occurrence of AIDS-related claims. The most recent main experience investigations were ...
- Provision for expenses (before adding margins) starts at a level consistent with the company's current experience and allows for a 8% escalation per annum thereafter (previous year: 10%).

- Where relevant, liabilities include provisions to meet maturity, mortality and disability guarantees and for losses in respect of potential lapses and surrenders.
- The discount rates quoted below are before the allowance for first and second tier margins and tax.
- For non-profit annuities, liabilities have been calculated by discounting expected future annuity instalments and expenses at interest rates based on the bond yield curve at the valuation date.
- A discount rate of 12% (previous year: 14%) has been used to value other non-profit business.
- Profit-sharing life and term annuity instalments and future expenses in respect of these instalments have been discounted at 12% per annum (previous year: 14%). Future growth is provided for at the latest declared growth rate.
- For reversionary bonus policies, a gross premium valuation was done. Future bonuses were provided for at the latest declared reversionary bonus rates and at final bonus rates supported by the assumed investment return of 12% p.a. A discount rate of 12% per annum (previous year: 14%) was used. Bonus stabilisation reserves were held to equate the liabilities to the market/fair value of the corresponding assets.
- For individual unbundled policies of which the bonuses are stabilised/smoothed, a gross premium valuation was done. Future bonuses were provided for at bonus rates that would be declared should an investment return of 12% per annum be earned. A discount rate of 12% per annum (previous year: 14%) was used to place a present value on assumed future cash flows. A negative Rand reserve has been allowed for, equal to the present value of future charges not required for risk benefits and renewal expenses. Bonus stabilisation reserves were held to equate the liabilities to the market value of the corresponding assets.
- For market-related unbundled business (e.g. those where a portion of the premium is allocated to an accumulation account) the liability was taken as the market value of the units notionally credited to the policies, less the present value of future charges not required for risk benefits and renewal expenses. For the purpose of calculating the Rand reserves, the same discount rates as applied to individual investment series policies above, were used.
- In the case of group policies for which the bonuses are stabilised, the liabilities are equal to the balances of the investment accounts plus corresponding bonus stabilisation reserves. Group linked business was valued at the market value of the underlying assets.
- Policyholders' reasonable benefit expectations have been allowed for as follows ...
- Bonus stabilisation reserves have been determined as follows ...
- No bonus stabilisation reserve for any class of business was more negative than – 7.5% of corresponding liabilities at the valuation date. *Where the bonus stabilisation reserve for any class of business is more negative than –7.5% of corresponding liabilities at the valuation date, this fact must be disclosed. It is recommended that an*

*explanation of what caused this to occur be provided. If the bonus stabilisation reserve is more negative than –7.5% of corresponding liabilities at the valuation date, the Statutory Actuary must also state why he/she believes that this can be recovered through under-declaration of bonuses during the ensuing three years.*

### **Asset Valuation Methods and Assumptions**

All assets (including the excess of assets over liabilities) have been valued at market value/fair value. *This paragraph should refer to the "normal" accounting notes, where more information would be provided about what is meant by market value/fair value: for example, how properties and unlisted subsidiaries were valued.*

### **Capital Adequacy Requirements**

The capital adequacy requirements have been calculated in accordance with PGN 104. The following main assumptions have been used to calculate the investment resilience capital adequacy requirement:

- That a decline of 30% in equity asset values, 15% in property values, and 16% in fixed interest asset values (as a result of a 3% increase in fixed-interest yields) will occur, in accordance with PGN 104.
- That 50% of accumulated non-vested bonuses would be removed should asset values decline to this extent and not subsequently recover within a few months. This assumption reduced the capital adequacy requirements by R5bn.

I certify that the off-setting management actions assumed above have been approved by specific resolution by the board of directors, and that I am satisfied that these actions would be taken if the corresponding risks were to materialise.

For the purpose of grossing up the intermediate ordinary capital adequacy requirements (IOCAR) to determine the ordinary capital adequacy requirements (OCAR), it has been assumed that assets backing the capital adequacy requirements are invested 80% in equities and 20% in fixed interest assets.

The OCAR exceeded the termination capital adequacy requirement (TCAR), and thus the capital adequacy requirements have been based on the OCAR.

### **Other**

Comment on any material unreconciled differences between the valuation data and the accounting data, or in the build-up of the valuation data, on the extent and effect of any such discrepancies, and on what allowance has been made in the valuation for any such discrepancies.

*Provide any other descriptions or explanations considered necessary to enable a reader to gain a meaningful appreciation of the figures presented.*

## **APPENDIX C**

### **PGN 104: LIFE OFFICES – FINANCIAL SOUNDNESS VALUATION**

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#### **1. INTRODUCTION**

- 1.1 The objective of this guidance note is to assist fellow members of the ASSA in discharging their professional responsibility in relation to the valuation of a long-term insurer's assets, liabilities and capital adequacy requirements on the financial soundness method.
- 1.2 Compliance with PGN104 is mandatory for financial soundness valuations of long-term insurers registered in South Africa.
- 1.3 A financial soundness valuation is intended to give a prudently realistic picture of the overall financial position of the long-term insurer, allowing explicitly for actual premiums that will be received and future experience that may be expected in respect of interest rates, expenses, mortality, morbidity and other relevant factors.
- 1.4 A minimum level of financial resilience is introduced by way of
  - best estimate assumptions of all parameters increased by prescribed as well as second-tier margins for profit-reporting purposes, and in addition,
  - compliance with capital adequacy requirements for financial soundness purposes.

Profits should be recognised prudently over the term of each contract to avoid the premature recognition of profits that may give rise to losses in future years.

#### **2. GENERAL GUIDELINES**

- 2.1 The liabilities must be calculated on
  - realistic (i.e. best-estimate) assumptions of the future experience (as further described in the balance of par. 2)
  - plus prescribed margins added to the best-estimate parameters (par. 2.15)
  - plus second-tier margins where the statutory actuary believes it appropriate (par. 2.16).
- 2.2 The realistic assumptions should be guided by immediate past experience, and be modified by any knowledge of or expectations regarding the future. Realistic assumptions should depend on the nature of the business.
- 2.3 Assets and liabilities must be valued on bases that are mutually consistent.



- 2.4 Where future amounts are discounted, the gross interest rate used must be realistic in terms of actual past yields modified by any knowledge or specific expectations with regard to the future.
- 2.5 Allowance must be made for tax, using the statutory actuary's expectation of the effect of the tax basis on the particular long-term insurer in the future.
- 2.6 The premiums to be valued must be those payable in terms of the contract.
- 2.7 The liabilities should include provision for expected allocations of profit to shareholders, in particular where there is a specified relationship between profits attributable to shareholders and the bonus rates declared for policyholders. If such expected allocations to shareholders could act as a buffer in adverse circumstances, it is not necessary to reserve for both the relevant prescribed margins and such expected shareholders entitlements. It would be adequate to reserve for the higher of the two. The reserving basis used should, however, be disclosed.
- 2.8 Allowance must be made for expenses at a realistic level, making allowance for escalation of future expenses at an inflation rate that is consistent with the rate of interest that is to be used.
- 2.9 Mortality and morbidity must be allowed for at a level that is consistent with past experience modified by expected future trends. This must include the best-estimate of the effect of Aids.
- 2.10 The benefits to be valued must take into account the reasonable expectations of policyholders.
- 2.11 Statutory actuaries, in setting their assumptions, must take cognisance of the sensitivity of valuation results to changes in the various parameters, and may need to undertake valuations on more than one basis. If this is done, there is no requirement to report on the result of more than one valuation.
- 2.12 Allowance must be made for the effect of lapses and surrenders at a level that is consistent with past experience modified by expected future trends. (Approximate methods are allowed.)
- 2.13 Where a policy of smoothing bonuses has been followed, the liabilities should be increased by any bonus stabilisation reserve that exists - i.e. any undistributed surplus that is considered to be earmarked for future distribution to policyholders. If the smoothing process has resulted in a negative bonus stabilisation reserve because of a downward fluctuation in the market value of matching assets, it is acceptable to reduce the liabilities to reflect the amount that will be recovered through under-distribution of bonuses during the ensuing three years, provided that the actuary is satisfied that if market values of assets do not recover, future bonuses will be reduced to the extent necessary. A negative bonus stabilisation reserve impacts on capital adequacy requirements as set out in paragraph 6. Where reference is made to liabilities in paragraph 6, these liabilities are after taking into account the effect of any bonus stabilisation reserves, unless otherwise stated.

2.14 Expected profits should not be recognised in respect of future options expected to be taken up (e.g. automatic premium increases), but expected losses in respect of such options should be recognised. Business must be grouped into broad categories with similar expected take-up rates of the options. Only the net loss in any category (if any) needs to be recognised.

2.15 The intention of the prescribed margins (to be added to the best-estimate assumptions) is to introduce a degree of prudence to allow for possible adverse deviations in the rendering of services and the exposure to risks during the expected future "lifetime" of the business. These prescribed margins will at the same time serve to defer profits to avoid the premature recognition of profits that may give rise to losses in future years.

The prescribed margins are as follows:

<u>Risk or service</u>	<u>Prescribed margin as % of the base assumption</u>
Mortality	7,5% (increase for assurance, decrease for annuities)
Morbidity	10%
Medical	15%
Lapses	25% (i.e. if the best-estimate assumption is x%, the margin is 0,25x%)
Disability Income Benefits in payment terminations	10% of claims reserves
Surrenders	10% (increase or decrease in surrender rate depending on which alternative gives rise to an increase in liabilities)
Expenses	10%
Expense inflation	10% (of estimated escalation rate)
Charge against investment return	A reduction of 0,25 percentage points per annum in the management fee or an equivalent asset-based or investment performance-based margin

Examples of the "charge against investment return" margin are as follows:

- Linked business (rand reserve) - assume an investment fee of 1,25% if the real investment fee is 1,5% (say).
- Reversionary bonus business - value the liabilities at 0,25% less than the valuation rate of the assets (adjusted for the effect of taxation and asset management charges), without adjusting the expected future bonus rate accordingly.
- Non-profit business including immediate annuities value the liabilities at a rate of 0,25% less than the rate used for valuing the assets.

The prescribed margins must apply throughout the life-time of the policies, i.e. no future management actions may be assumed to reduce the margins.

Where business is expected to be profitable based on best-estimate assumptions, but not after allowing for the prescribed margins, the margins may be reduced to the extent necessary not to show a loss on new business. The fact that the prescribed margins were not fully allowed for and the monetary effect thereof as applied to all in-force business must then be disclosed in the financial statements. Furthermore the capital adequacy requirement before management action must be increased by the capitalised value of the shortfall, as applied to all in-force business.

To the extent that business is not expected to be profitable based on best-estimate assumptions, a loss will have to be reported.

2.16 In addition to the margins in par. 2.15, second-tier margins should be included where the statutory actuary believes that the prescribed margins are insufficient in a particular case for the prudent release of profits. Second-tier margins may also be added to defer the release of profits consistent with policy design or company practice. These second-tier margins must be defined and the reason for their existence as well as their broad financial effect on earnings must be disclosed in the accompanying actuarial report.

2.17 Any profits remaining after allowance for the liabilities (including all the margins) as referred to in par. 2.1 will then be recognised.

As a large portion of the work in respect of a policy is frequently done at issue and to the extent that a portion of the future profit flowing therefrom may be recognised with a high confidence level, it is not necessary to eliminate all initial profits as a matter of principle. The emergence of such capitalised future profits is controlled by the level of second-tier margins used.

2.18 Where materiality guidelines are applied to the liability side of the balance sheet, they should be the same as those decided on by management and approved by the auditors for use on the asset side and should preferably be stated as a percentage of earnings. Materiality guidelines refer to acceptable margins for errors and approximate valuation methods and not the effect of different valuation assumptions.

### 3. REASONABLE EXPECTATIONS OF POLICYHOLDERS

3.1 The reasonable expectations of policyholders cannot be defined in watertight terms. They will depend upon the type of product, the long-term insurer's practice, the manner in which benefits are quoted and presented to policyholders and expectations created by marketing material.

An overriding principle is that the expectations that need to be taken into account are those that in the statutory actuary's opinion may influence the long-term insurer when deciding on future distributions of surplus. In effect, the statutory actuary is required to set up reserves for what he considers the long-term insurer will probably do or might have to do in future, if the investment yield assumptions used in the valuation are realised, in the light of any expectations that he considers have been created.

In any case where the maintenance of last-declared bonus rates (other than in the case of market-related policies) is not assumed for all future years this must be disclosed with details of the reductions in bonus rates assumed.

3.2 In order to encourage consistent interpretation of policyholder expectations, the following guidelines are provided:

- a) Policyholders expect all contractual benefits to be paid and obligations to be met.
- b) Holders of market-related policies expect to participate in the unsmoothed investment performance of the underlying asset portfolio. For this purpose market-related policies are defined as those where the end benefits are held out as being linked to the value of an asset portfolio, either explicitly or implicitly.
- c) Holders of smoothed bonus policies expect to participate in the smoothed investment performance of the underlying asset portfolio as described in marketing literature.
- d) In the absence of anything to the contrary, holders of with-profit policies (as described in marketing literature) expect to receive a share of the investment performance and other profits that are generated by the assurer over time and also to share in losses.
- e) Other factors sometimes create additional policyholder expectations. These may include the manner in which the long-term insurer's products, bonus policy and benefit illustrations are presented to the insuring public. On the other hand, the long-term insurer may have made specific and clear announcements or taken action to change previously created expectations.

The statutory actuary will need to consider what expectations have been created and whether the long-term insurer has taken clear action to change any previously held expectations to determine which expectations need to be taken into account in the valuation.

The following are some of the specific ways in which expectations are frequently created:

- (i) Where there is a history of maintaining bonus rates or strong smoothing of bonus rates over a sustained period, policyholders probably expect that the same approach will apply in the future, given a continuation of current circumstances.
- (ii) The illustration of future values assuming the maintenance of bonus rates creates an expectation that those rates will be maintained, given a continuation of current circumstances.
- f) The current LOA Benefit Illustration Agreement allows for benefits in respect of policies other than reversionary bonus products, to be projected at two standard rates and for standard expenses to be used.

The principle underlying the Agreement is that policyholders are given two alternative figures which are merely illustrations of benefits that may possibly accrue, and do not represent any estimate of actual benefits. These illustrative values do not in themselves create a benefit expectation. However, other actions, in particular how benefit illustrations are presented, may well create expectations, as indicated above.

- g) In case of reversionary bonus policies, it is not reasonable to discount future benefits at high interest rates without allowing for the corresponding bonuses one would expect to declare under such conditions (see 3.2(d) above).

If the statutory actuary considers that policyholder expectations have been created in respect of projected values or bonus rate maintenance, to the extent that the long-term insurer would need to take cognisance thereof in future surplus distributions, the full maintenance of the implied bonus rate must be assumed. If the statutory actuary considers that no such expectations have been created, the full maintenance of the level of bonus rates that the long-term insurer expects to be declared, or that may reasonably be expected under conditions compatible with the interest rate assumptions being made, must be assumed.

- h) The full value of non-vested bonuses that have already accumulated or would be paid out on death, must always be valued. In addition, depending upon circumstances, future additions to such bonuses may need to be assumed (for example, where the amount of bonus depends on a scale that is related to duration).

#### **4. VALUATION OF UNBUNDLED CONTRACTS**

4.1 Unbundled contracts include any business where a designated portion of the premium is allocated or deemed to be allocated to an accumulation fund. This may include the following categories of business : market-related, smoothed bonus, universal life and deposit administration.

4.2 For this business, the total reserve would consist of two parts, i.e. a "fund reserve" and a "rand reserve".

4.3 Subject to the provisions of paragraph 2.13, the liability arising from the fund reserve must be taken to be not less than the value of the accumulation fund, including, where applicable, any non-vested bonuses.

Subject to the provisions of paragraph 2.1., the value of the fund may be reduced by the discounted value of cashflows of management fees or other charges on the fund to the extent that they are not absorbed by prescribed (or second-tier) margins.

4.4 The rand reserve must in principle be derived from a discounted cash flow calculation that allows for

- expected future mortality and morbidity experience, including margins;
- expected future commissions, expenses and expense inflation, including margins, less
- expected future expense deductions, risk benefit premiums to be charged, and management fees recovered to the extent not included in 4.3 above and to the extent that they are not absorbed by prescribed (or second-tier) margins.

In addition it may be necessary to set up rand reserves for

- any guarantees that have been given under the contract; and the reasonable expectations of policyholders.

4.5 The complexity and detail of the calculations will depend on the level of guarantees provided. For example, for a linked contract that guarantees the level of future allocation amounts, it may be necessary to calculate rand reserves policy by policy and year by year in order to ensure that future cash flows are covered without recourse to additional finance. For business with less onerous guarantees, alternative approaches may be appropriate, subject to testing that demonstrates the adequacy of the liabilities.

4.6 To promote a prudent release of earnings an appropriate mismatching reserve (calculated like the resilience reserve in par. 6h(i)) will be required in aggregate for a category of business where the deemed accumulation fund is not matched by appropriate investment assets.

## **5. VALUATION OF ASSETS**

5.1 In the case of assets backing market-related business, the assets should be valued on a basis consistent with that used for the calculation of liabilities.

5.2 In the case of all other business, it is possible to use either a fairvalue approach or a discounted cash flow (DCF) approach.

5.3 If fair value is used as the basis for valuing the assets mentioned in 5.2, it would be necessary to determine the rate of discounting implicit in such fair values, and to value liabilities on a consistent interest basis. In such cases, consideration should be given to setting aside an investment reserve.

- 5.4 If a DCF approach is used, the underlying asset value basis should be the discounting of expected cash flows at an interest rate consistent with that used in the valuation of liabilities. Where relevant, appropriate adjustments must be made to reflect any increased level of risk with regard to expected cash flows.

When valuing property and equity investments, any growth that is assumed in respect of future income must be compatible with assumptions in respect of the valuation interest rate and of the level of expense inflation, but may need to be adjusted for specific investments if the statutory actuary believes the prospects for those investments differ significantly from the normal assumptions.

The value placed on equity and property investments in total should generally not exceed the fair value, on a willing buyer/willing seller basis. However departures from this principle might be acceptable in situations where the excess of valuation over fair value is held to cover non-vested liabilities.

## **6. CAPITAL ADEQUACY REQUIREMENTS**

The use of best-estimate valuation assumptions adjusted by the prescribed margins and second-tier margins ensures that the long-term insurer should be able to weather some deviations from best-estimate assumptions. Additional amounts are however needed to ensure that the long-term insurer has sufficient capital to meet fairly substantial deviations in the main parameters affecting long-term insurers' business. These will be referred to as capital adequacy requirements and follow a risk-based capital approach in determining the minimum amount of capital required by a long-term insurer. The capital adequacy requirements equal the larger of the "termination capital adequacy requirements" (TCAR) and the "ordinary capital adequacy requirements" (OCAR), as defined below.

### **6.1 "Termination Capital Adequacy Requirements" (TCAR)**

TCAR = Lapse capital adequacy requirement + surrender capital adequacy requirement, as set out below:

#### **a) Lapse capital adequacy requirement (for policies with no surrender values)**

The lapse capital adequacy requirement equals the amount required to ensure that no policy has a negative liability, where liability refers to the financial soundness liability before taking any other capital adequacy requirements into account.

#### **b) Surrender capital adequacy requirement**

The surrender capital adequacy requirement equals the amount required to ensure that no policy's liability is less than its current surrender value. For policies which cannot be surrendered or transferred from the long-term insurer, e.g. certain retirement annuities of people younger than 55, the amount is 0.

## 6.2 Ordinary capital adequacy requirements (OCAR)

$$\text{IOCAR} = \sqrt{(a^2 + b^2 + ci^2 + cii^2 + ciii^2 + d^2 + e^2 + f^2 + g^2 + h^2 + i^2)} + j$$

where a refers to the capital adequacy requirement set out in item 6.2(a), b to the one in item 6.2(b), etc.

The sum of all groups must be taken in respect of an item before squaring. If in respect of lapses (item a), there are 2 subgroups namely x and y, then  $a^2 = (a_x + a_y)^2$ , where  $a_x$  and  $a_y$  are the lapse c.a.r. for groups x and y respectively. The capital adequacy requirement should generally be higher where groups are used instead of bundling all policies, since expected profits in one group may not be used to reduce expected losses in another group (i.e. the capital adequacy requirement for a group i.r.o. an element e.g.  $a_x$  must be greater to or equal to 0.)

IOCAR is the intermediate ordinary capital adequacy requirement before taking into account the effect of the assumed falls in fair value (according to the resilience scenario) of the assets covering it.

OCAR ? the ordinary capital adequacy requirement is then calculated by grossing up IOCAR for the effect of the assumed fall in fair value of the assets backing it, as described in paragraph 6.2h(i). For example should only equities be used to back the OCAR and the assumed fall for equities be 30% then

$$\text{OCAR} = \frac{\text{IOCAR}}{0,7}$$

Should OCAR be backed by cash then  $\text{OCAR} = \text{IOCAR}$

Should a balanced portfolio be available to back OCAR then OCAR will be built up starting with the less volatile assets.

Example:

Cash, fixed interest and equities are available as free assets. For purpose of this example assume falls in fair values of 0%, 10% and 30% respectively and the IOCAR is more than the sum of the value of the cash and 90% of the fixed interest assets.

Then  $\text{OCAR} =$

Cash amount (c) + Value of fixed interest assets (fi) + Value of equities(e)

Where e is derived from the following formula:

$$\text{IOCAR} = c + 0,9fi + 0,7e$$

*It is not necessary to take into account the fall in the fair value of the free assets which are not needed to cover OCAR.*

**a) Lapse risk (for policies with no surrender values)**



The lapse risk capital adequacy requirement equals 40% of the amount required to ensure that no policy has a negative liability before taking into account the effect of any negative bonus stabilisation reserve.

Additions to the above amount must be considered where

- the office's lapse experience fluctuates significantly from year to year or the trend in lapses has been worsening over time;
- the typical level of lapses is in excess of 20% of policies that could lapse per annum.

**b) Surrender risk**

The surrender risk capital adequacy requirement equals 20% of the amount required to ensure that no policy's liability before taking into account the effect of any negative bonus stabilisation reserve is less than its current surrender value. For policies which cannot be surrendered or transferred from the assurer, e.g. certain retirement annuities of people younger than 55, the amount is 0.

Additions to the above amount must be considered where

- surrender values are guaranteed (say 40% instead of 20% if guarantees apply at all durations);
- the office has created expectations of stabilised future surrender values at the point of sale or in regular correspondence with policyholders;
- the typical level of surrenders is in excess of 10% of in- force policies per annum.

**c) Mortality, morbidity and medical fluctuation capital adequacy requirements**

The requirements are as follows:

- |       |           |                           |
|-------|-----------|---------------------------|
| (i)   | Mortality | $\frac{45p}{\sqrt{n}}$ ;  |
| (ii)  | Morbidity | $\frac{65p}{\sqrt{n}}$ ;  |
| (iii) | Medical   | $\frac{135p}{\sqrt{n}}$ ; |

where

n = number of lives assured in the category (net of lives fully reinsured) and

p = Annual risk premium on the valuation basis or expected strain (net of reinsurance).

**Notes:**

- The above formulae are based on typical spreads of risks. The fluctuation risk can be decreased to a large extent by suitable reinsurance. Whilst it is not practical to prescribe formulae which depend on reinsurance arrangements, the valuator may make an adjustment for reinsurance where he can justify it.
- Mortality includes funeral benefits and accident benefits.
- Morbidity includes lump sum disability benefits, dread disease benefits and income protection benefits.
- Medical includes hospital cash plans and major medical benefits.
- p should include any relevant option premiums

**d) Annuitant mortality fluctuation capital adequacy requirement**

The annuitant mortality fluctuation capital adequacy requirement equals

$$\frac{r}{\sqrt{n}}$$

where

r = financial soundness reserves for the relevant (i.e. where mortality plays a role) annuity portfolios on the valuation date and

n = number of annuitants in the relevant category.

**e) Mortality, morbidity and medical assumption capital adequacy requirement**

The Aids assumption capital adequacy requirement is equal to one-third of the best-estimate Aids liability.

The mortality, morbidity and medical assumption capital adequacy requirement for business with liabilities not valued on a discounted cash flow basis, is equal to the sum of the following requirements:

- (i) Mortality: the effect of a 5% heavier mortality experience than the statutory actuary's best-estimate on the financial soundness method.
- (ii) Morbidity: the effect of a 10% heavier morbidity experience than the statutory actuary's best-estimate on the financial soundness method.
- (iii) Medical: the effect of a 15% heavier medical experience than the statutory actuary's best-estimate on the financial soundness method.

**Notes:**

- Mortality, morbidity and medical include the same benefits as described in the notes to 6.2(c).
- Additions to the above amounts must be considered for new types of benefits, new distribution channels, insufficient experience data being available, or experience worsening over time.
- Where the mortality risk is eliminated by the use of back to back policies there are no mortality capital adequacy requirements.
- The divergent experience as set out above must be assumed to last for the expected time that it would take to react to a divergence of experience by adjusting risk premiums. In cases where risk premiums cannot be adjusted, the divergent experience must be taken into account for the outstanding term of each policy.

**f) Expense fluctuation capital adequacy requirement**

The expense fluctuation capital adequacy requirement equals 10% of all renewal expenses in the previous year (excluding commission and commission-related and other acquisition costs).

An addition to the above amount must be considered where the long term insurer is growing rapidly.

**g) Expense assumption capital adequacy requirement**

The expense assumption capital adequacy requirement, for business with liabilities not valued on a discounted cash flow basis, equals the increase in liabilities should allowance be made for a 2% worse inflation rate for renewal expenses (i.e. maintenance, investment and claims expenses) lasting for the duration of the expected reaction time, or for the outstanding term of each policy if expense loadings cannot be reviewed. (The effect of discontinuances must be taken into account.)

**h) Investment capital adequacy requirement**

The investment capital adequacy requirement is equal to the greater of (i) and (ii).

**(i) Resilience capital adequacy requirement**

The purpose of the resilience capital adequacy requirement is to test the robustness of the financial position of a long-term insurer in the face of volatile market conditions. The statutory actuary must reconsider the financial soundness valuation assuming the following fall in the fair values of the assets backing the liabilities on the valuation date:

Type of asset	Fall in fair value
---------------	--------------------

Equities:

Index* up to 4%	30%
-----------------	-----

Index* 5% and over	20%
Index* between 4% and 5%	Interpolate
Properties	15%
Fixed interest assets	Fall equivalent to a 3% increase in fixed-interest yields
Cash and fluctuating interest rate assets	0%
Other assets	35%

\* The Index refers to the JSE Actuaries All Share Dividend Yield Index.

Calculation of the resilience capital adequacy requirement:

Assume  $L_0$  = Financial soundness liabilities (including any bonus stabilisation reserves) at the valuation date

$A_0$  =  $L_0$  i.e. the assets necessary to back the liabilities at the valuation date

$L_1$  = Financial soundness liabilities after the assumed fall in fair value (*before deduction of the absolute value of any negative bonus stabilisation reserve*), reduced by the effect of any proposed management actions.

$A_1$  = The value of the assets ( $A_0$ ) after the assumed fall in fair value

Then the resilience capital adequacy requirement equals:

$$(A_0 - L_0) - (A_1 - L_1)$$

$$= L_1 - A_1$$

#### Notes:

- Assume that fair values will not recover (within a short period).
- The effect of a 3% fall in fixed-interest yields must be provided for (if it leads to a higher capital adequacy requirement than the 3% increase in fixed-interest yields).
- For options and futures the long-term insurer's exposure to the relevant assets (e.g. equities) must be taken into account when calculating this requirement. A long-term insurer might, for example, hedge an equity portfolio by selling futures. Should the composition of the portfolio and the futures index sold be identical, a fall in fair value of say 30% would make a resilience capital adequacy requirement unnecessary for the hedged portion of the portfolio. As

the composition will normally not be identical, the statutory actuary would have to consider what off-set to allow. In an extreme case, the fair value of the equity portfolio may even fall while the index rises.

- Although the statutory actuary must consider liquidity when valuing and reporting on a long-term insurer, there is generally no particular capital adequacy requirement for lack of liquidity.

(ii) **Worse investment return capital adequacy requirement**

The worse investment return scenario assumes that future real investment returns would be 2% per annum lower than assumed in the valuation. This implies that the valuation interest rate used in valuing both assets and liabilities and the assumed growth rates for future dividends and rentals where applicable must all be reduced by 2% per annum.

Calculation of the worse investment return capital adequacy requirement:

Assume  $L_0$  = Financial soundness liabilities (including any bonus stabilisation reserves) at the valuation date

$A_0 = L_0$  i.e. the assets necessary to back the liabilities at the valuation date

$L_1$  = Financial soundness liabilities assuming the worse investment return scenario (before deduction of the absolute value of any negative bonus stabilisation reserve), reduced by the effect of any proposed management actions e.g, lower bonus rates.

$A_1$  = The value of the assets ( $A_0$ ) taking into account the worse investment return scenario. (It is expected that fixed interest assets will be revalued.)

Then the worse investment return capital adequacy requirement equals:

$$(A_0 - L_0) - (A_1 - L_1)$$

$$= L_1 - A_1$$

Fixed interest assets need to be revalued.

i) **Foreign exchange risk capital adequacy requirement**

The foreign exchange risk capital adequacy requirement is equal to the decrease in the excess of assets over liabilities resulting from a 20% change up or down, whichever results in the greater decrease, in foreign exchange rates for all assets and liabilities held in foreign currencies.

- j) Any understatement of the liabilities resulting from not allowing for the full prescribed margins.

### 6.3 General guidance on capital adequacy requirements

- a) The guidelines consider only the more general contingencies. Should there be any other factor which could place the long-term insurer at risk, the statutory actuary must consider additional capital adequacy requirements.
- b) Wherever applicable, allowance for off-setting factors may be made in calculating capital adequacy requirements, e.g. reducing non-vested liabilities, declaring lower bonus rates, increasing mortality charges, increasing expense charges and adjusting surrender values. The level of capital adequacy requirements is a function of the expected management action resulting in off-sets. Credit for off-sets may be taken only where management action had been resolved by the Board and where the statutory actuary is satisfied that the relevant actions will be taken as resolved.

*In the case of the **investment capital adequacy requirement** it should be taken into account that certain management actions have already been assumed to justify the use of any negative bonus stabilisation reserve. It is therefore recommended that the Board should separately resolve these management actions and any further management actions necessitated by the occurrence of the resilience **or worse investment return** scenario.*

- c) Approximate methods may be used to calculate the capital adequacy requirements.
- d) It was decided to ignore the effect of new business when calculating capital adequacy requirements, as is the case with the financial soundness method in general. In considering the future financial position of the office, the actuary will of course take expected new business into account.
- e) Separate calculations must be made for business written in different countries should exchange controls apply.
- f) The total capital adequacy requirement as set out above is the minimum amount that must be available. Where the statutory actuary perceives that this minimum is inadequate for a particular long-term insurer, he must set aside such higher amount as he regards as prudent. Examples of cases for which higher amounts must be kept, are given in 6.2. In the particular case of a long-term insurer that runs only non-profit business with stringent guarantees, capital adequacy requirements that will leave a 5% chance of insolvency is too low, i.e. the total capital adequacy requirement as set out above will have to be increased.

- g) In the case of financial groups the statutory actuary must heed the risk of using the same capital repeatedly to cover the capital adequacy requirements of different companies in the group.

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## **CAPITAL ADEQUACY REQUIREMENTS**

### **Explanatory Notes**

#### **1. Purpose of capital adequacy requirements**

The purpose of capital adequacy requirements is to provide a cushion in addition to the liabilities in order that random fluctuations in experience and adverse fluctuations or trends in any of the variables about which assumptions are made in the financial soundness valuation, would in the large majority of cases lead to a reduced cushion and not to a deficit under the financial soundness valuation. The existence of capital adequacy requirements cannot provide a guarantee against future financial difficulty - it can only help to make it less likely.

Inability to meet the capital adequacy requirements according to the ASSA guidelines would not necessarily mean that the long-term insurer was financially unsound, but rather that it was under financial strain.

#### **2. Use of capital adequacy requirements**

The same guidance note on inter alia capital adequacy requirements will be used for the annual financial statements and for regulatory purposes.

#### **3. Conditional nature of capital adequacy requirements**

As a large portion of life assurance policies in South Africa allow the long-term insurer to adjust

- charges for risk benefits
- expense charges
- policy value bases; and
- bonus rates

the capital adequacy requirement should be conditional on the expected management action resulting from adverse experience. As such the size of the capital adequacy requirement can be interpreted only in the light of the management actions assumed in the calculation.

#### **4. Action in case of shortfall**

The action to be taken in the case of a long-term insurer not having enough assets to cover liabilities as well as capital adequacy requirements is an FSB matter. One would however expect a more lenient approach directly after some adverse contingencies occurred. It is reasonable to use assets set aside to cover capital adequacy requirements when the adverse contingencies are experienced, but then it would be necessary to rebuild them within a reasonable period.

#### **5. Level of aggregate capital adequacy requirements**

A balance is needed: between aggregate capital adequacy requirements should be large enough to provide a significant cushion against adverse experience, but not of such a size to endanger the viability of the long-term insurance industry. Since it



would be too conservative to assume that all adverse events occur together, the following approach is adopted:

- a) The size of a number of cushions to cover specific events is assessed assuming only that event is to be covered. Statistically, where practical, the "target" confidence interval for the size of the cushion is 95%, i.e. owing to random fluctuations alone the cushion is expected to be inadequate one year in twenty.
- b) The overall cushion is not merely the sum of the individual cushions, but rather a lower amount as it is not expected that all unfavourable conditions will occur at the same time. Instead some simplifying assumptions are made as to the correlation between events, and these assumptions result in the adding together of the cushions in a hierarchical structure where the total is less than the sum of the parts.
- c) The simplifying assumptions made with respect to correlations are as follows:  
Two events may be strongly negatively correlated, e.g. the occurrence of A precludes the occurrence of B. In this case the higher of the two cushions is required.

Two events are strongly correlated e.g. the occurrence of A will lead to the simultaneous occurrence of B. In this case the sum of the cushions is required.

The two events are uncorrelated. In this case the square root of the sums of the squared cushions is required.

## 6. **Level of capital adequacy requirements for individual risks**

### 6.1 **Termination capital adequacy requirements (TCAR)**

#### **a) and b) Lapse and surrender capital adequacy requirements**

It is regarded as prudent that a long-term insurer should be in a position to survive a "run on the bank" scenario. The required TCAR is sufficient to survive a very selective detrimental run on the bank.

A case could well be made for taking the effect of a fall in asset values into account in calculating these capital adequacy requirements. Nevertheless it was felt that the lapse and surrender assumptions are so conservative that additions are unnecessary.

### 6.2 **Ordinary capital adequacy requirements (OCAR)**

#### **a) and b) Lapse and surrender risks**

The OCAR were chosen to provide for roughly a doubling of relevant lapse/surrender rates.

#### **c) and d) Mortality, morbidity and medical fluctuation capital adequacy requirements**

The required OCAR provide for fluctuations in experience over the year up to the next valuation. In the case of mortality, Monte Carlo simulations were done for the business spread of two large long-term insurers, taking into account a 95% confidence level to derive the requirements.

A similar calculation was done for morbidity, ignoring the dependency between morbidity and mortality lump sum benefits. The offset was ignored to make some provision for the moral and economic risks, which also influence morbidity claims.

As a result of the scarcity of experience on medical benefits it was arbitrarily decided to pitch the medical fluctuation risk OCAR at 3 times the mortality fluctuation risk OCAR.

For annuitant lives a Monte Carlo simulation was done on the same basis as for mortality.

**e) Mortality, morbidity and medical assumption capital adequacy requirement**

The aim of these requirements is to allow for errors in assumptions and for long-term experience deviating from that expected in the valuation. Taking into account that mortality experience is more credible than morbidity experience and that medical experience is largely absent, the figures of 5%, 10% and 15% were chosen rather arbitrarily to reflect the ascending order of uncertainty.

The one-third Aids assumption c.a.r. was chosen arbitrarily.

**f) Expense fluctuation capital adequacy requirement**

The expense overrun of 10% was chosen arbitrarily.

**g) Expense assumption capital adequacy requirement**

The 2% was chosen arbitrarily.

**h) Investment capital adequacy requirement**

**(i) Resilience capital adequacy requirement**

The requirement for equity values was deduced from studying 12 months' price movements of the JSE Actuaries All Share Index. The levels of 30% and 20% were chosen to roughly correspond with a probability of less than 5% that these limits would be exceeded in any 12-month period. (It should however be noted that the present dividend yield levels are very low, with the result that the probability of exceeding the limits is probably higher in current circumstances.)

The limits for the other asset categories were chosen to reflect the fact that in general terms the other assets are less volatile than equities.

An alternative approach would have been to calculate the resilience capital adequacy requirement for equities as the effect of an increase in dividend yields. This approach has the advantage that it adjusts automatically as investment conditions change. This adjustment is however so small that the less flexible, but simpler approach was chosen.

(ii) **Worse investment return capital adequacy requirement.**

The 2% was chosen arbitrarily.

(i) **Foreign exchange risk capital adequacy requirement**

The 20% foreign exchange risk c.a.r. was chosen arbitrarily.

7. **Schematic illustration of the place of capital adequacy requirements in the overall financial position of a long-term insurer**

Value of total assets	Free assets	Balance of free reserves for published financial reports ..... .. Shareholders' funds
	Capital adequacy requirements	
	Policy liabilities on financial soundness method	Financial soundness liabilities
	Other liabilities	

## PGN104: Addendum to incorporate requirements of AC133 (Similar to IAS 39)

### 1. BACKGROUND

- 1.1 Generally Accepted Accounting Standard AC133, which relates to the measurement and recognition of financial instruments, became effective for published financial statements for accounting periods commencing on, or after, 1 July 2002. As per paragraph .02(d) of AC133, AC133 will not apply to rights and obligations under insurance contracts as defined in paragraph .05 of AC125 (covering Financial Instruments: Disclosure and Presentation). However, certain policies of insurance (hereinafter referred to as ‘**investment contracts**’) may fall under the definition of financial instruments, because they do not meet insurance risk transfer requirements as defined under AC125, or the definition of insurance under international standards (see 1.2 and 2.2.2 below). This will affect components of a long-term insurer’s financial statements.
- 1.2 Application of ~~the~~ requirements of AC133 to investment contracts pre-empt much of the work that is currently being undertaken on fair value accounting at an international level by the International Accounting Standards Board (“IASB”). The Accounting Practices Committee (“APC”) has recognised the importance of ensuring that the local accounting standards remain in line with these international developments, and therefore acknowledge that implementation of AC133 from a practical perspective may be subject to change until the international standards have been finalised. The APC has invited the long-term insurance industry to make proposals regarding practical interim arrangements, pending finalisation of the international standard. This Addendum to PGN104 has been produced ~~driven~~ by the Actuarial Society of South Africa (“ASSA”) to provide guidance for valuers as part of these interim arrangements.
- 1.3 One of the key tenets of AC133 is that certain assets and liabilities falling within its scope are to be valued at “fair value”, where fair value is defined in paragraph .09 as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. A financial soundness valuation reflects current market conditions (being based on realistic, best estimate assumptions), and therefore constitutes a “fair value” methodology. Thus, in broad terms, the a-financial soundness valuation method is regarded as an appropriate approach to fair value accounting. Moreover, to the extent a financial soundness valuation is used for purposes of the published accounts the professional guidance of PGN104 is then applicable to valuation under AC133. There are, however, certain features of AC133 that need to be specifically catered for. This addendum to PGN104 is being issued to ensure that fellow-members allow consistently for properly bring-these features in the to a-financial soundness valuation being performed for purposes of the published accounts, ~~and therefore properly~~

~~discharge their professional responsibilities specifically with regard to AC133.~~

- 1.4 Ultimately, the published accounts must also be signed off by the company's auditors. ~~also.~~ This addendum to PGN104 has been reviewed by the South African Institute of Chartered Accountants ("SAICA"), who have agreed that as an interim measure in advance of finalisation of the international accounting standards on insurance contracts and investment contracts the approach ~~to valuation under AC133~~ envisioned by this addendum to PGN104 is appropriate. However, it is recognised that in practice specific points of detail may still emerge which will need both audit and actuarial input and agreement before finalisation of the published accounts.
- 1.5 This addendum will, as indicated ~~by 1.2 above~~, be subject to change as decisions are made at an international level as to how fair value accounting will be applied. Subject to future change this addendum will be applicable for all valuations performed on or after 30 June 2003 and in any event will apply to valuations performed at 30 June 2003 and 30 September 2003 and at any dates between these dates.

This addendum to PGN104 is mandatory for fellow members performing valuations under AC133 where a financial soundness valuation approach is used. Other fair value approaches are however possible, and where these are used, will require acceptance by the insurer's auditors. This addendum does not apply where AC133 allows valuation methods other than fair value.

## 2. PRINCIPLES OF THE VALUATION

### 2.1 General

- 2.1.1 The assets of a long-term insurer must, in all cases, be valued at fair value.
- 2.1.2 Assets and liabilities should be valued on a consistent basis.
- 2.1.3 AC133 applies to certain aspects of financial reporting. As in the past, PGN104 continues to apply to the valuation of liabilities for insurance contracts and for investment contracts with participation in profits on a discretionary basis, and to the determination of capital adequacy requirements. This addendum to PGN104 modifies its application to the valuation of liabilities for investment contracts in order to ensure treatment compliant with AC133.

### 2.2 Categorisation of liabilities

- 2.2.1 As a first step in valuing the liabilities, the policy contracts must be categorised as either:
- Insurance contracts, or
  - Investment contracts

2.2.2 **Insurance contracts** are deemed to be any policy contracts not falling within the definition of investment contracts. A list of such contracts is -described below, and will include for example:

- Whole life, endowment and term assurances
- Permanent health insurance
- Credit life insurance
- Group life insurance
- Universal life policies incorporating life or disability cover
- Dread disease policies
- Funeral insurance
- Contracts with investment guarantees payable only on death (or other insured risk) or survival to a predetermined date, but not on surrender
- Contracts participating in profits on a discretionary basis, including policies with reversionary bonuses and policies with smooth bonuses
- Market related recurring premium paying—contracts with a minimum death benefit of return of premiums
- Pension fund business with smooth bonuses
- Life annuities

**Investment contracts** —are effectively defined as ~~deemed to be~~ any contracts where the benefits on death (or other insured risk, such as disability or morbidity) occurring within a predetermined period or on survival to a predetermined date (or series of dates, as in the case of an annuity) are not more than the corresponding amount payable on surrender, or where the additional such benefit is insignificant. This definition follows guidance under the draft international standard, which is more detailed than that in AC125 referred to above. Judgement will be required in assessing “insignificant” in this regard, and in practice this is something that should be resolved with the company’s auditors, if the position is unclear.

Investment contracts with participation in profits on a discretionary basis present particular difficulties of treatment. These difficulties have been recognised by the IASB, which has indicated that these contracts can continue to be treated as in the past. Consistent with the international position, these contracts are not affected by this addendum to PGN104 and will continue to be valued in accordance with PGN104.

Investment contracts affected by AC133 and this addendum to PGN104 will include, for example:

- Non profit single premium guaranteed contracts
- Non profit ‘structured’ single premium contracts
- Single premium contracts with benefits linked to the performance of a specific asset portfolio (unless with profits on a discretionary basis)
- Pension fund or sinking fund ‘investment only’ business (unless with profits on a discretionary basis)
- Annuities-certain and ‘living annuities’ (unless with profits on a discretionary basis)

The above examples are based on recommended guidance of the [ASSA](#) Life Assurance Committee to SAICA, and while comprehensive, may not cover every type of insurance policy sold. Particular attention should be paid to the definition of an investment contract, as given earlier in this paragraph, when categorising a contract not included in the examples given above.

2.2.3 In theory, for purposes of establishing —how contracts are categorised a policy--by--policy approach is required. In practice it would be acceptable to base the classification on classes of policies with similar characteristics. Moreover, contracts need not be unbundled into insurance contracts and investment contracts, unless the cash flows from the insurance component do not affect the cash flows from the investment component. [For example](#)However, if a policy has a self-standing rider, the rider may be classified separately.

2.2.4 Liabilities should be classified at inception and once classified as either an insurance contract or investment contract —would then remain so.

## 2.3 Valuation of insurance contracts

2.3.1 The valuation of insurance contracts [and investment contracts with participation in profits on a discretionary basis](#) is not subject to AC133.

2.3.2 Therefore, for [these insurance](#)—contracts, the financial soundness valuation, as required ~~in the past~~ by PGN104 continues to be applicable.

## 2.4 Valuation of investment contracts

2.4.1. Investment contracts are specifically covered by AC133 and to comply with this Professional Guidance Note must be valued using fair value, notwithstanding that certain alternative approaches may be permissible under AC133.

2.4.2. The fair value approach described in the ensuing paragraphs will be called for practical purposes the financial soundness valuation method (“FSV method”). ~~AC133 permits of the use of generally accepted fair value methods, and it is the opinion of ASSA that the FSV method is a generally accepted method, and will produce a value of liabilities that is consistent with the value of assets that are valued at fair value also. The FSV method assumes that the insurer is a going concern, an assumption underlying the determination of fair values. Additionally because no deep and liquid market exists for investment contracts, reliable market information for purposes of fair valuation may not be available. In this case AC133 allows the use of reasonable fair value estimation techniques. In the opinion of ASSA, the FSV method constitutes a sufficiently reliable estimation technique. ASSA believes that the FSV method is an appropriate fair value method, because it satisfies the following AC133 requirements.~~

- It is a generally accepted method.
- It produces a value of liabilities consistent with assets valued at fair value.
- It assumes the insurer is a going concern.
- It constitutes a sufficiently reliable estimation technique, given that no deep and liquid market exists for these investment contracts, so that reliable market information is not available.

2.4.3. If the liability would, under a financial soundness valuation, be valued using a prospective approach, the fair value should be calculated in terms of PGN104, the financial soundness valuation but excluding any second tier margins.

2.4.4. In general, the prescribed margins, which are additional to best estimate, will for current practical purposes be regarded as “market value margins”. For purposes of interim guidance, these “market value margins” should be retained for purposes of deriving fair value under the financial soundness method. This is because these margins approximate to the market value margins ~~that which~~ a willing buyer would require in order to compensate for the inherent risks in the block of business being acquired. These margins may be eliminated or reduced for purposes of deriving fair value under the financial soundness method, only where objective evidence acceptable to the external auditor demonstrates ~~suggests~~ that such an approach is reasonable.

2.4.5. If the liability for a particular investment ~~If the liability for a particular investment~~ contract would, under a financial soundness valuation, be valued using only a retrospective approach, the



liability should be set equal to the fair value of the corresponding backing portfolio of assets, but the second paragraph of section 4.3 of PGN104 will not apply (i.e., the value of the fund may *not* be reduced by the discounted value of cash flows of management fees or other charges on the fund<sup>d</sup>).

d).

2.4.6. For purposes of deriving fair value using the financial soundness method, where embedded derivatives (e.g., financial guarantees) exist within a product line, these must be valued as required by PGN104. The method envisaged by the draft guidance note on reserving for maturity guarantees would be an acceptable method to use.

~~2.4.72.4.7. For purposes of determining the liability at inception of investment contracts, fair value will be taken as the consideration received, less transaction costs. Although AC133 implies that the liability of an investment contract at inception should be the consideration received less transaction costs, ASSA believes that it would be more consistent with subsequent measurement to instead use the same method at inception as required above.~~

## **APPENDIX D**

### **PGN 107: EMBEDDED VALUES AND VALUE OF NEW BUSINESS**

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#### **1. SCOPE**

Compliance with this guidance note is best practice for all embedded value statements published together with interim and annual financial statements on or after 31 December 2001, both in respect of long-term insurers registered in South Africa and in respect of holding companies of such insurers.

The guidance is intended primarily for routine financial reporting but for other situations the basic principles should still apply. These guidelines are applicable to Embedded Values and the Value of New Business written for all South African life insurance business. The guidance only applies if such values are published and in itself does not require the publication of such values.

Although the guidance does not apply to business other than life business, it does not preclude the use of similar techniques and principles in the calculation of such values.

#### **2. INTRODUCTION**

Most life insurance policies are issued on the expectation on the part of both the purchaser and the seller that the contract will remain in force for a number of years.

Both parties have expectations as regards future payments to each other. While the purchaser's obligations to make future payments are voluntary, those of the Life Company are not. In addition the Life Company expects to incur costs in administering its Existing Business in the future. Accordingly, reserves must be established in order for a company to be able to fulfil its obligations.

As these reserves include both prescribed and discretionary margins, which can be expected to emerge as profits in future, the Existing Business of a life company contains an element of shareholder value.

Actuarial techniques have been developed regarding the determination of the value of assets and liabilities. However, there is a need for guidance in relation to the issues in determining the Value of New Business written and Embedded Value of a Life Insurance company.

#### **3. DEFINITION OF EMBEDDED VALUE**

The embedded value equals:

- the net worth

- plus the value of in-force business
- less the cost of capital at risk

The embedded value does not place a value on future new business, and usually does not place any value on future profits from sources other than the in-force insurance-related business.

### 3.1 Net worth

The net worth should generally be taken as the excess of assets at fair value over liabilities on the Financial Soundness Valuation. Assets shown at fair value in the financial statements would normally be included in the net worth at the same value, but the actuary should be in agreement with the values placed on unquoted assets. Where a listed subsidiary (other than a life insurance subsidiary) is consolidated in a holding company's accounts, the net worth should include the holding in the listed subsidiary at fair value. Unlisted life insurance subsidiaries should be included at their embedded value, with their net assets forming part of the net worth, their value of in-force forming part of the total value of in-force and their cost of capital forming part of the total cost of capital, less respective allowances for minorities. Where the life insurance subsidiary is listed, it should either be included as above, or the holding should be shown at fair value.

### 3.2 Value of in-force business

An existing block of in-force business has a value because there are margins (both first and second tier) in the value of published liabilities on the Financial Soundness Valuation basis. On a best estimate basis these margins will be released in the future as profit. The **value of the in-force** block is therefore the value placed on these future expected after tax distributable profits in respect of life business (including in-force life business of life insurance subsidiaries. If the subsidiaries are not wholly-owned, the proportionate share thereof should be shown as mentioned above.)

### 3.3 Cost of capital at risk

Capital is required to be retained within a life insurance company over and above the financial soundness reserves to ensure ongoing solvency. The cost of capital at risk reflects the discount to fair value of this capital. It is calculated as the difference between the discounted value (at the risk discount rate) of the sum of projected release of the capital at risk and the investment return projected to be earned on it and the fair value of the capital at risk at the valuation date. The capital at risk should be taken as equal to the Capital Adequacy Requirements.

## **4. PROJECTIONS OF FUTURE PROFITS – METHODOLOGY**

### **4.1 General**

Essentially the existing life insurance business assets, FSV liabilities and capital at risk should be projected until the business is expected to be no longer in force.

In calculating the projected value of assets at later time periods, profits assumed to be released at earlier time periods should be excluded. The profits at the end of each time period then represent the excess of projected assets over projected liabilities. From these profits all taxes (including STC) that would be payable in respect of these profits, if distributed to shareholders, should be deducted. A present value is then placed on the projected future net profits, by discounting them to the calculation date at a risk discount rate. The assumptions to be used for these projections, including the risk discount rate, are discussed in section 0 below.

### **4.2 Group Business**

Whereas cash flow projections are often not undertaken for group business in the FSV, it is appropriate to make such projections for embedded values and for the value of new business. The same comments will apply in cases where other benefits are valued on a retrospective basis for FSV purposes.

The actuary must take due care when setting the assumptions for the cash flow projections. In particular the actuary should consider whether the modelled run-off of the business is appropriate. The assumptions with a particular influence on this are the inflation increases assumed as well as the discontinuance rate of members.

### **4.3 Cost of Capital at Risk**

The assumed composition of the assets backing the CAR should be consistent with the company's practice and with the asset distribution assumed when calculating the CAR.

### **4.4 New Business**

The value of new business should in general be taken as the value of all increases in business with date of entry in the year to the calculation date. The value is calculated as at the date of entry with all associated costs being included in the cash flows.

A policy may only be taken into account if at least one premium that was not subsequently refunded was recognised in the financial statements. Premium increases that have been allowed for in the value of in-force may not be counted again as new business when they actually incept.

In particular:

- Future “automatic” premium increases (both contractual and those which incept unless the policyholder specifically cancels them) on new and existing business should be included in the value of new and existing business respectively despite the fact that they are not included in the FSV calculations in terms of PGN104.
- For group business, increases in business from new schemes or new benefits on existing schemes should form part of the new business value. New member/salary related increases under existing schemes should form part of the in-force value.
- The renewable recurring premiums under Group Assurance contracts such as PHI and GLA should be treated as In-Force business.
- Renewable single premium receipts should be treated as single premium new business and therefore any such future receipts should be excluded from the Value of In-Force to avoid double counting.
- For open-ended contracts, i.e. those with no specific end date, the rates of continuation beyond the minimum term should be based on a best estimate and included in the Value of New Business at inception of the original contract. Such continuations may not be included as New Business when they occur, as they are already included in the Value of In-Force.
- Continuations of individual policies and deferrals of retirement annuity policies after the fixed maturity date stated in the contract should be treated as new business once they occur, if they have been included in the exits at their respective maturity dates.

The definitions given above are the preferred approach. If a company wishes to depart from these, such departures must be explicitly disclosed and the effect of the departure on in-force and new business quantified.

#### **4.5 Taxation**

The embedded value and the value of new business are concerned with projected after-tax shareholder profits out of which distributions may be made. (Whereas the FSV is concerned with tax only in the policyholders’ funds.)

The after tax profits to be valued should therefore take into account all tax liabilities of the life office, including any allowance for four funds tax and Secondary Tax on Companies. The tax liability of the distributed profits in the hands of the particular shareholder is therefore ignored.

The future taxes in respect of in-force (including new business written in the most recent accounting period) should be projected on a going concern basis. The allowable expenses in respect of the new business written are taken into account in projecting future tax rates for in-force business.

#### **4.6 Approximations and Materiality**

This guideline does not preclude the use of approximate methods. The basic principle that should be applied at all times (including half-year results) is that the actuary is satisfied that the method and calculation is sufficiently accurate to satisfy materiality concerns.

#### **4.7 Sensitivity analysis**

An important part of any calculation is an analysis of the sensitivity of the results to changes in assumptions. Sensitivity testing is particularly recommended if assumptions have been based on very limited data, when deviations from expected values may be very large, or if an assumption is considered to be particularly critical.

The in-force values may be particularly sensitive to:

- the Risk Discount Rate
- the rates of investment return
- expense levels and the effect of cost inflation thereon
- persistency levels
- mortality/morbidity rates
- take-up rates of premium indexation
- management action

In addition to the above the value of new business may be sensitive to:

- the number of new business policies sold

The actuary should try to ensure that the users of the information understand the uncertainty inherent in any one result.

For all business where it is the practice to vary bonuses based on the investment return, the bonus rates should be adjusted consistently when varying the rates of investment return.

#### **4.8 Checks**

The reasonableness of the models and the inputs used should be checked. Sufficient checks should be performed to ensure that assumptions have been derived and input correctly and that the system is projecting profits correctly in accordance with the assumptions.

An example of suitable checks to be performed is the comparison of items such as opening liabilities, premiums, claims and expenses in the first year of the profit projection with the numbers in the financial statements. Another is that the actuary should ensure that expenses assumed for the purposes of the Embedded Value reconcile to actual expenses.

#### **4.9 Outsourced services**

Some associated companies or subsidiaries may provide services to the insurance company e.g. asset management, administration, distribution. The treatment of fees paid by the insurer should be determined by the actual accounting treatment of the fee paid for the outsourced service and the valuation placed on the insurer's (or holding company's) shareholding in such associated company or subsidiary should be consistent with the accounting treatment.

### **5. PROJECTIONS OF FUTURE PROFITS – ASSUMPTIONS**

As this guidance note assumes a best estimate approach, the assumptions should be the same as for the FSV – excluding all planned margins.

#### **5.1 Experience assumptions**

Assumptions should represent best estimates of future experience. The assumption should avoid both under-estimates and over-estimates.

The best estimate assumptions should equal those used for the prospective FSV valuation as at the same date, excluding all first and second tier margins. However, some actuaries use a smoothed approach in setting FSV investment assumptions – this is inappropriate for embedded value and for value of new business calculations. For classes of business where a retrospective valuation is used for FSV purposes, future assumptions should be set in line with those that would have been used if a prospective FSV valuation were to be performed. In particular for group business, assumptions will be required in respect of the future growth of the business (e.g. rate of increase/decrease in membership of schemes, scheme termination, benefit increases due to salary inflation, etc.) These assumptions should be based on recent experience where available, and in the case of benefit increases related to salary inflation, should be consistent with the other economic assumptions. Due to the open-ended nature of some group business, assumptions based on recent experience may give rise to a projection where the book of business continues to grow at unrealistic levels for a prolonged number of years. This should be avoided, and assumptions (such as scheme terminations) may need to be adjusted in the later years. For group business, claims should be projected using claims ratios that are based on recent experience.

Despite the explicit exclusion of future premium increases, which may decrease the prospective valuation in the FSV, they should be included for Embedded Value purposes. The allowance should be based on the best estimate take up rate expected in respect of such future premium increases.

#### **5.2 Economic assumptions**

The economic assumptions should be consistent with the asset valuation. In addition they should be self-consistent and consistent with the assumed expense inflation rate.

### 5.3 Risk discount rate

The Risk Discount Rate is a risk-adjusted rate of return comprising:

- a risk-free rate of return
- a risk premium above the risk-free rate to compensate the investor for the risk that actual profits will deviate from those projected. The size of the risk premium reflects the perceived degree of risk associated with those profits.

The rate chosen should take into account the assumed long term investment returns, and the risks associated with the projected profits being valued. Since all of these factors are subject to a certain amount of judgement, opinions on appropriate discount rates will vary and there is inevitably a range of discount rates that might be considered appropriate. Values should be quoted at different rates to indicate the sensitivity of the results to the level of the discount rate.

In his recommendation, the actuary should therefore take account of items such as:

- rates of investment return assumed in the embedded value calculations. These rates will be based on those currently available or expected in investment markets (i.e. the gross equity return)
- the uncertainty associated with the other assumptions
- the uncertainty related to the projected profits being realised (i.e. taking into account the risk profile of the company itself.) This addresses inter alia any mismatching between policyholder liabilities and assets, since any such mismatching will imply greater uncertainty of the expected profits.
- the actual investment policy of the company as reflected in the current composition of its shareholder assets. This inter alia addresses the fact that the more conservative the assets backing the CAR, the less “risky” the total return stream from the company. In principle switching to riskier assets to reduce the Cost of CAR should result in a higher risk discount rate.

The risk discount rate does not allow for the particular tax position of a potential investor, since the tax positions of different investors will not all be similar.

### 5.4 Expenses

The split between acquisition and maintenance expenses should be consistent with the FSV assumptions and actual expense experience.

Non-recurring expenses may be excluded from unit costs provided they are separately quantified in the analysis of embedded value earnings as a non-recurring item, and their nature is explained. Future expected non-recurring expenses however, should be allowed for in the value of in-force business. The definition of non-recurring expenses should ensure that only really exceptional expenses are excluded.

Corporate overhead expenses relating to life business should be included in the acquisition and/or in the projected maintenance expenses unless such corporate



expenses are specifically covered by charges on the corporate assets and the assets have been written down correspondingly.

For group business, where assumptions are not usually required for the FSV, projected expenses should be based on recent expense experience. The projection of these expenses should allow for both expense inflation and also future real growth/decline in the business.

The value of New Business should reflect actual acquisition expenses for the period.

## **5.5 Management Action**

Attention is particularly drawn to the guidance in PGN103 and PGN 104 regarding assumed future management actions. Assumptions regarding future increases in expense recovery charges or risk charge rates and resulting action regarding premium increases or reductions in sums assured will generally be based on less objective supporting evidence than assumptions regarding experience. The actuary's assumptions should therefore be substantiated as rigorously as possible with formally minuted Board agreement as a minimum requirement.

## **6. DISCLOSURE**

The following are the minimum disclosure requirements.

- A table showing the embedded value at current calculation date and at previous calculation date, split between net worth, value of in-force business and cost of capital at risk.
- The net worth should be reconciled to the published value of shareholder funds with explanations of all reconciling adjustments.
- A reconciliation should be provided of the movement in the embedded value from the previous calculation date to current calculation date. The reconciliation should show the effect of any capital raised, dividends declared, value added by new business, expected unwinding of risk discount rate and cost of capital, experience variances (relative to the previous assumptions), investment variances (relative to the previous assumptions), experience assumptions changes (as at the period end), exchange rate movements and economic assumptions changes (as at the period end).
- The central risk discount rate and a summary of the basic economic assumptions used.
- The methodology used to place a value on In-Force and new business should be disclosed, as well as any material changes in the methodology used.
- A reconciliation between the premium volume of new business quoted in the published accounts and that forming the basis of the embedded value report should be provided, split into recurring and single premium. This includes explicitly showing the new business premiums (single and recurring separately) valued for embedded value purposes.

- Material changes in the definition of new business should be disclosed.
- The value of new business should be shown both gross and net of the cost of any associated capital at risk.
- If business other than Long Term Insurance business is included in the Embedded Value, this should be shown separately, both in respect of New Business and Value of In-Force.
- Explanation of significant items in experience variance
- The impact of any significant post financial period-end events.
- Any other assumption, event or management action which has had or may have a material impact on the disclosed value.
- A company may not claim compliance with PGN107, unless the report complies in all respects or all specific points of material departure have been disclosed and explained.
- Where a company publishes value of new business other than that as at the date of entry, this should be disclosed, as well as a reconciliation to the date of entry value.
- The effect of sensitivities should be shown separately for net worth, value of in-force business and cost of capital at risk. Where the sensitivities were only performed on the value of in-force business and cost of capital at risk, this should be disclosed.
- The STC calculation basis should be disclosed (e.g. calculated on cash dividends assumed to be distributed according to the dividend policy.)

Given the purpose and nature of these calculations, maximum disclosure is desirable.

## SECTION 2

### SUGGESTED ANALYSIS OF EMBEDDED VALUE TEMPLATE

Embedded value earnings for the period ccyy mm dd to CCYY MM DD

	Embedded value at end of financial period	
Less	Capital Raised	
Plus	Dividend declared	
Less	Embedded value at start of financial period	_____
	Embedded value earnings	

Components of Embedded value earnings

	Value of New Business	
	Expected Return	
	Operating Experience Variances	
	Experience Assumption changes	
		_____
	Investment Return on net worth	
	Investment Variances	
	Economic Assumptions changes	
	Exchange Rate movements	
		_____
	Total Embedded value earnings	

Notes

1. The rationale for the above split is that the first four items show experience that is largely stable or under the control of management. The other items are potentially volatile and changes in these are more market driven.
2. The investment return on the net worth should be on the same basis as for the FSV and published Financial Statements. It represents the investment return on the full net worth rather than on any part thereof.
3. The Value of New Business is as defined in paragraph 0. The expected return should include unwinding of New Business from the date of entry to the valuation date, but no allowance for experience variations over this period.

## SECTION 3

### PURPOSE AND SCOPE OF THE DRAFT GUIDANCE NOTE ON EMBEDDED VALUES

The attached draft guidance note has been prepared by a sub-committee of the Life Insurance Committee of the Actuarial Society of South Africa. It is intended to:

- provide assistance to actuaries
- encourage a consistent approach to facilitate comparisons between companies

The sub-committee accepts that financial reporting methodologies are in a state of flux internationally and expects that these guidelines may need to be updated periodically until an international consensus emerges.

Embedded value calculations are performed in varying circumstances and for varying purposes, e.g. for routine financial reporting or in connection with a proposed corporate transaction. An actuary associated with a statement of embedded value or a value of new business must be acutely aware of the fact that buying and selling decisions are likely to be based on these values. All the normal rules of professional conduct will apply. If the actuary's name is associated with the published value, professional liability issues may arise.

Whilst the guidelines can be consulted in any relevant situation, it is intended that they will **constitute best practice only for the specific situation of publication in the financial statements of life insurers, their parent companies or their group**. A background note is also attached. It will not form part of the final guidance note and highlights the philosophy as well as some of the shortcomings of the current accepted best practice.

## SECTION 4

### BACKGROUND

#### 1. Definition

The valuation basis for liabilities on the Financial Soundness basis contains margins for prudence. This is necessary from a security of benefits point of view and to ensure a high probability that the earnings (taken as increase in the excess of assets over liabilities) will not be overstated. It means that over time, experience should be more favourable than assumed in the valuation basis, and profits should emerge. These future profits are valuable to shareholders; together with net asset value and a deduction for cost of capital at risk, they comprise the embedded value of the business.

Some offices also seek to investigate the value of future business, that is the goodwill of their business. The total of embedded value plus goodwill, that is the appraisal value, is an estimate of the total value of the business to shareholders. To facilitate the investigation into the value of future business as well as analyse the change in embedded value, the value of the most recent year's new business is usually calculated. The guidance note does not consider the methodology for, nor indeed the appropriateness of, using the value of the most recent year's new business in an attempt to evaluate a life insurer's goodwill.

#### 2. A straightforward interpretation

Embedded value and the value of new business are calculated by performing a projection of future profits. This projection is usually deterministic, that is, only one possible future "best estimate" outcome is considered. A risk discount rate is then assumed and used to discount the projected profit stream, resulting in a present value measure. Alternatively a risk free discount rate plus specific market value margins may be used to discount the projected profit stream.

The most straightforward interpretation of embedded value is to interpret the projected cash flows as expected cash flows under some suitable probability model. If investors buy a share at the embedded value, and all statutory profits are distributed, then the investors' return is simply the risk discount rate on the value of in-force business plus the return on the net worth assets. This enables us to interpret the risk discount rate as a shareholder's required return, which might be compared to the expected return on other competing projects or investments. It allows for the risk that the profit levels might not be achieved due to fluctuations in the results.

#### 3. Purpose of publishing embedded values

The current profit reporting practice based on the FSV guidelines, does not necessarily represent the increase in shareholder value by a life company in a

particular period. This is due inter alia, to changes in economic conditions and to the fact that a part of the profit being reported relates to the release of margins set up at the end of the previous financial period. Increases in margins through the addition of new business during the period may also not be reflected in the profits reported. The change in the embedded value can aid as a further guide to show the true addition to shareholder value of a life office over a particular financial period.

#### **4. General commentary**

The embedded value is sensitive to the assumptions used. The effect of over-optimistic assumptions will emerge in future years as negative experience and investment variances. Also, if over-pessimistic, the effect will emerge in future years as positive experience and investment variances. The objective is to find an appropriate balance, and to avoid over-optimistic or over-pessimistic assumptions.

#### **5. Other approaches**

Attempts have been made to overcome the theoretical shortcomings of the common approach to embedded values by using quasi-deterministic short-cuts to arbitrage pricing theory or its special case, the capital asset pricing model. Risk neutral stochastic models and deflators have also been used.

These ASSA guidance notes only consider the deterministic profit projection approach interpreted as projecting best estimate cash flows. This approach may not be applicable in all circumstances and the use of other interpretations in other circumstances is entirely at the discretion of individual companies / groups.

#### **6. Accounting Influences**

Accounting standards vary from one country to another. Often, the standards have been carefully crafted to take account of product features that are popular in that country. The actuary must be aware of resulting difficulties in cross-border work. The actuary should also bear in mind that these guidelines have been drawn up in a South African context.

There is a powerful trend in international accounting towards fair value accounting. Under these rules, assets are taken at market value, and liabilities are valued using a discounted cash flow approach, but on a basis which includes market value margins, rather than prudential margins, in order to be consistent with the market valuation of assets.

In addition to the newer fair value reporting methods, a number of more traditional techniques are competing to achieve international dominance. These include the UK accruals method, US GAAP, the Australian margin on services, and various intermediate compromises such as the achieved profits measure proposed by the ABI in the UK.