

APN 601: FINANCIAL ANALYSIS OF SOCIAL SECURITY PROGRAMMES

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Preface

International Standards of Actuarial Practice (ISAPs) are models for actuarial standard-setting bodies, such as the Actuarial Society of South Africa, to consider. The International Actuarial Association ([IAA](#)) encourages actuarial standard-setting bodies to consider taking one of the following courses of action, if it has been determined that an ISAP is relevant for actuaries in their jurisdiction:

- ✓ Adopting the ISAP as a standard with appropriate modification, where items covered in the ISAP are not currently contained in existing actuarial standards;
- ✓ Endorsing the ISAP as a standard as an alternative to existing standards;
- ✓ Modifying existing standards to obtain substantial consistency with the ISAP; or
- ✓ Confirming that existing standards are already substantially consistent with the ISAP.

Such an adopted standard (rather than the original ISAP) applies to those actuaries who are subject to such body's standards, except as otherwise directed by such body (for example with respect to cross-border work).

APN 601 is not binding upon an [actuary](#) unless the [actuary](#) states that some or all of the [work](#) has been performed in compliance with this ISAP.

This ISAP was adopted by the [IAA](#) Council in October 2013 and the Council of the Actuarial Society adopted an adapted version in August 2015.

Introduction

This Actuarial Practice Note (APN) applies to [actuarial services](#) performed in the context of [social security programs \(SSPs\)](#). It is intended to:

- ✓ Promote the development of consistent actuarial practice for SSPs throughout the world; and
- ✓ Narrow the range of practice considered acceptable under ISAP 1 – General Actuarial Practice.

Where this APN defines as acceptable a practice that would not be acceptable under SAP 901, it is clearly identified.

Because of their significant expertise in preparing long-term financial projections, [actuaries](#) often play an important role in carrying out [financial analyses](#) of [SSPs](#). [Financial analyses](#) are commonly referred to as valuations. Due to the reliance placed on actuarial projections in public policy decision-making, it is important that the short- and long-term demographic and economic analyses of these [SSPs](#) provide objectively-prepared projections of their future conditions.

In this area of practice, the International Actuarial Association ([IAA](#)) previously adopted [IASP 1 – Guidelines of Actuarial Practice for Social Security Programs](#), which became effective in January 2013. This was a level 4 standard (which has the effect of a current international actuarial note) and is superseded by the adopted version of this ISAP.

Few existing professional standards and guidelines specifically apply to [SSPs](#). Most countries have no specific standards in this area. The [IAA](#) has decided to issue this ISAP to fill this gap. Its action is supported within the International Social Security Association (ISSA) and the International Labour Organization (ILO). Through APN 902, an adopted version of ISAP 2, the Actuarial Society of South Africa addresses the guidance gap for its members.

Section 1. General

1.1. Purpose – This SAP provides guidance to [actuaries](#) performing [financial analyses](#) of [SSPs](#), or reviewing, advising on, or opining on such analyses, to give [intended users](#) confidence that:

- ✓ [Actuarial services](#) are carried out professionally and with due care;
- ✓ The results are relevant to their needs, are presented clearly and understandably, and are complete; and
- ✓ The assumptions and methodology (including, but not limited to, models and modelling techniques) used are disclosed appropriately.

1.2. Scope – This APN applies to [actuaries](#) when performing or reviewing, advising on, or opining on [financial analyses](#) of [SSPs](#).

1.3. Compliance – There are situations where an [actuary](#) may deviate from the guidance of this APN but still comply with the APN:

- 1.3.1. [Law](#) may impose obligations upon an [actuary](#). Compliance with requirements of [law](#) that conflict with this APN is not a deviation from the APN.
- 1.3.2. The actuarial code of professional conduct applicable to the [work](#) may conflict with this APN. Compliance with requirements of the code that conflict with this APN is not a deviation from the APN.
- 1.3.3. The [actuary](#) may depart from the guidance in this APN while still complying with the APN if the [actuary](#) provides, in the [report](#), an appropriate statement with respect to the nature, rationale, and effect of any such departure.

Paragraphs 2.6, 2.8, and 2.9 of [SAP 901](#), as modified by paragraph 2.6 of this APN, cover the situation where the [actuary](#) is directed to use certain assumptions or methodology. The [actuary](#) who complies with these paragraphs is not deviating from this APN.

1.4. Relationship to SAP 901 – Any [actuary](#) who asserts compliance with this APN (as a model standard) must also comply with [SAP 901](#), except where [SAP 901](#) is overridden by this APN. Whenever guidance in this APN overrides the guidance in [SAP 901](#) the caption **[This paragraph replaces paragraph x.y [title of paragraph x.y] in SAP 1]** will be shown at the start of the paragraph. References in [SAP 901](#) to “this SAP” should be interpreted as applying equally to this APN, where appropriate.

In particular (as laid out in paragraph 1.6.2 of SAP 901) this document uses various expressions whose precise meaning is defined in the Glossary. These expressions are highlighted in the text in italics.

1.5. Effective Date – This APN is effective for [actuarial services](#) performed after 1 September 2015.

Section 2. Appropriate Practices

- 2.1. Consideration of all Relevant Features of the SSP and Law** – The actuary should consider all relevant SSP features, the policies and the stated intentions of the sponsoring entity, and current law, if that information exists and is reasonably available to the actuary. The actuary should also take into account established practice (if relevant) when no law exists with regard to certain benefit provisions or financial measures (for example, the basis for future indexation of retirement benefits). For a newly established or substantially changed SSP, the actuary should take into account other relevant information, including relevant experience in comparable SSPs.
- 2.2. Data** – The actuary should consider what data are required in order to perform, review, advise on, or opine on the financial analysis of the SSP. These data might include:
- a. National or regional demographic statistics on variables such as fertility, mortality (life expectancy), morbidity, and migration (if such data are not available on a national or regional basis, the actuary might consider information from a wider geographical area that might apply, or it may be necessary to rely on relevant and reliable statistics of international organisations);
 - b. Demographic status and experience of the SSP, as applicable;
 - c. Economic experience, labour market conditions, and inflation;
 - d. Financial attributes of the SSP, such as contributions, investment earnings, and liquidity of assets;
 - e. Benefits of, or claims on, the SSP;
 - f. Number and experience of classes of contributors and beneficiaries of the SSP;
 - g. Covered salaries and past service credits; and
 - h. Censuses and population surveys covering, for example, family statistics.
- 2.3. Assumptions** – If the actuary sets the assumptions, the actuary should use neutral assumptions in a financial analysis of an SSP. Neutral assumptions are such that the actuary expects that the resulting projection of the SSP experience is not a material underestimate or overestimate.
- 2.3.1. The actuary should consider performing an experience analysis to the extent that the available data permit, to analyse past experience and to set future assumptions.
- 2.3.2. The actuary should select assumptions that reflect the time horizon of the analysis (which might be 75 years or more). The actuary may select different assumptions for different time intervals in the projection (e.g., a common technique for this is to use recent experience as the basis for the model assumptions for the first “n” years of projection, with longer-term trends applied to the ultimate assumptions after the first n years (select and ultimate)).
- 2.3.3. The actuary should consider any automatic balancing mechanisms that exist in an SSP when selecting the model variables and assumptions for an SSP financial analysis. The actuary should consider to what extent the SSP is “immunised” from the volatility of some variables (e.g., life expectancy) by the automatic balancing mechanisms.
- 2.3.4. Credible experience data might not exist for a newly introduced SSP, or for new benefits to be provided by an existing SSP. To establish assumptions in such cases, the actuary may:....
- a. Investigate the risk characteristics of the potential covered population through

surveys or enquiries until credible data are available;

- b. Consider the relevant external experience, including:
 - ✓ Other [SSPs](#) (including the programme being replaced, if any), or
 - ✓ Other countries;
- c. Use reasonable proxies or default values as may be appropriate.

If credible experience data do not exist, the [actuary](#) should disclose in the [report](#) that the [financial analysis](#) has been based on incomplete data (and perhaps none relating to the [SSP](#) itself), and should consider recommending that [financial analyses](#) should be performed again as new information becomes available.

2.3.5. If the [actuary](#) uses assumptions that include margins, then the [actuary](#) should disclose in the [report](#) the basis and rationale for the margins and explain the relationship between the result using the assumptions that include margins and the result using neutral assumptions.

2.3.6. The [actuary](#) should consider including in the analysis projections based on other sets of assumptions such as those that would result in high projected costs and those that would result in low projected costs when such projections are helpful in analysing the uncertainty of the projections and communicating the financial status of an [SSP](#).

2.4. Consistency with the Financing Method – The [actuary](#) should use a methodology that is consistent with the financing method used for the [SSP](#).

2.4.1. For pay-as-you-go or partially funded [SSPs](#), the analysis should use an open group methodology, under which contributions and benefits of both current and future participants are considered.

2.4.2. For fully funded [SSPs](#) (that is, where accrued liabilities are intended to be funded over participants' working years), the analysis should use a closed group methodology, under which only current participants are considered, with or without their assumed future benefit accruals.

However, if the [actuary](#) judges an alternative approach to be more appropriate, that approach should be used with justification communicated in the [report](#). In such circumstances, the [actuary](#) may also consider reporting the results of the [financial analysis](#) under:...

- a. An open group methodology for pay-as-you-go or partially funded [SSPs](#); and
- b. A closed group methodology for fully funded [SSPs](#).

If the [law](#) specifies a methodology for measuring the actuarial assets and obligations that does not follow either section 2.4.1 or 2.4.2, as applicable, the [actuary](#) should communicate that fact. The [actuary](#) should also comply with the guidance of paragraph 2.6 of this APN.

2.5. Independent Expert Review – A [financial analysis](#) is often subject to review by an independent expert.

2.5.1. This review might address:

- a. Whether the assumptions used in the [financial analysis](#) are within a reasonable range both separately and in the aggregate;
- b. Whether the results of the [financial analysis](#) are within a reasonable range; or
- c. Other aspects of the [financial analysis](#).

- 2.5.2. “Independent expert” means a suitably experienced reviewer who:
- a. Has not been involved in preparing the [work](#) that is subject to review; and
 - b. Is not employed by the [principal](#) or its sponsoring agencies.

In this context a reviewer contracted by the [principal](#) to perform the review is not considered to be employed by the [principal](#) or its sponsoring agencies.

- 2.5.3. The [actuary](#) who prepared the [financial analysis](#) should cooperate with the reviewer by providing the reviewer with any requested material in the [actuary's](#) possession if the terms of the [actuary's](#) engagement so permit, and by being available to discuss data, methodology, assumptions, and other factors as necessary, with the reviewer.

- 2.6. Assumptions and Methodology Mandated by Law – [This paragraph replaces paragraph 2.9 “Assumptions and Methodology Mandated by Law” in SAP 901]** When an assumption or methodology is mandated by [law](#), the [actuary](#) should apply the guidance of paragraph 2.8 of [SAP 901](#) as if the assumption or methodology were prescribed by the [principal](#) or another party.

Section 3 Communication

3.1 Report on Financial Analysis –

- 3.1.1 The [actuary](#) should communicate the results of any [financial analysis](#) in a [report](#) that:

- a. Includes enough information to enable sound decisions to be made;
- b. Discloses who the [principal](#) is, what the purpose of the [financial analysis](#) is, and the instructions given to the [actuary](#);
- c. Indicates the nature and timing of future cash flows being quantified;
- d. States the nature and significance of material risks faced by the [SSP](#);
- e. Explains the approach taken to the risk in the analysis;
- f. Indicates the nature and extent of any material uncertainty in the information it contains; and
- g. Indicates the sensitivity of the results to variations in key assumptions and methodology.

- 3.1.2 There are several measures the [actuary](#) might use to present the results, including:

- a. Projected cash flows and ending positions;
- b. Discounted cash flows; and
- c. Required contribution rates for sustainability.

- 3.1.3 This section applies specifically to [reports](#) concerning the projected financial status of an [SSP](#). The [actuary](#) should include at least the following information in an [SSP financial analysis report](#). The appendix (which is educational and not part of the guidance of this APN) shows lists of possible content for most sections of a [report](#).

- a. Description of the relevant provisions of the [SSP](#);
- b. Key dates:
 - ✓ [Valuation date](#);
 - ✓ [Report date](#); and
 - ✓ Date up to which all relevant information had been taken into consideration, if it differs from the [report date](#).

- c. Methodology, data, and assumptions;
 - d. Results and findings;
 - e. Analysis of results; and
 - f. The actuarial [opinion](#).
- 3.1.4 The [actuary](#) should include a formal statement in the [report](#) that the [report](#) has been prepared, and the [actuary's opinion](#) given, in accordance with the applicable local standards of practice or this model APN.
- 3.2 Actuarial Opinion** – The [actuary](#) should provide an [opinion](#) on the [actuary's](#) assignment:
- 3.2.1. Unless paragraph 3.2.3 applies, the [opinion](#) should state the extent to which the following hold, or do not hold:
- a. The data upon which the [report](#) is based are sufficient and reliable;
 - b. The assumptions used for the [report](#) are reasonable and appropriate both in the aggregate and individually; and
 - c. The methodology employed is appropriate and consistent with [accepted actuarial practice](#).
- 3.2.2. Unless paragraph 3.2.3 applies, the [opinion](#) should include a statement with respect to the extent to which the [SSP](#) is financially sustainable over the period covered by the projections used for the [financial analysis](#). Financial sustainability of an [SSP](#) relates to its continuous capacity to support the benefits offered by the [SSP](#) when considering the applicable financing rules and the future demographic and economic environment in which it will operate.
- a. If the [SSP](#) is relatively new or benefits have recently been increased, contributions may continue to rise significantly after the end of the period covered by the projection. If this is probable, the opinion report should make reference to the ultimate level of contributions.
 - b. The [opinion](#) should provide an indication of the eroding effect of inflation on the real value of benefits for plans that do not provide full benefit protection against inflation.
- 3.2.3. The [actuary](#) may answer questions about an existing financial analysis of an [SSP](#). (For example, the [actuary](#) might be asked to estimate the effect of using a revised population projection while keeping all other assumptions the same.) In such case the [opinion's](#) scope (especially what is not included) should be clearly articulated and pertinent to the question.

APPENDIX

Possible Report Content

Note: this appendix is provided for informational purposes, and is not part of the APN. It contains lists the task force drafting the ISAP assembled to show possible items covered by the various sections of the [actuary's report](#).

1. Description of the provisions of the [SSP](#) related to:
 - a. Coverage;
 - b. Nature of the [SSP](#), e.g., defined benefit or defined contribution;
 - c. Financing approach, e.g., pay-as-you-go, partially funded, or fully funded;

- d. Source of funding, e.g., worker or employer contributions, transfers from government revenues, including legislated or contractual contribution rates; and
 - e. Benefit provisions, e.g., contingencies covered, formulae, amounts, restrictions, and eligibility conditions.
2. Methodology, data, and assumptions:
- a. Description of the methodology used;
 - b. Key demographic assumptions such as mortality (longevity), morbidity, fertility, migration, and unemployment;
 - c. Key historical demographic data, such as:
 - i. Eligible and beneficiary population by relevant demographic characteristic groupings, and how these populations compare to the total population;
 - ii. Dependency ratios;
 - iii. Employment earnings by age groups and gender, and averages;
 - iv. Contributory earnings and averages by age groups and gender;
 - v. Labour force participation rates by age groups and gender; and
 - vi. Covered payroll and workforce;
 - d. Key economic data and assumptions such as rates of inflation, economic growth, and return on investments (if any);
 - e. The extent, if any, of interdependency among assumptions;
 - f. Summaries of the data used as a basis for the [SSP financial analysis](#) assumptions, and as a starting point for the projections; and
 - g. Sources, quality, and relevance of the data used.
3. Results and findings:
- a. Projected demographic values at selected future points in time, such as:
 - i. Eligible and beneficiary population by relevant demographic characteristic groupings, and how these populations compare to the total population;
 - ii. Dependency ratios;
 - iii. Employment earnings by age groups and gender, and averages;
 - iv. Contributory earnings and averages by age groups and gender;
 - v. Labour force participation rates by age groups and gender; and
 - vi. Covered payroll and workforce.
 - b. Financial projections showing cash flows and balance sheet values for the recent past and for the future, such as:
 - i. Contributions;
 - ii. Investment earnings;
 - iii. Other income;
 - iv. Total income;
 - v. Benefits or claims;
 - vi. Administrative expenses;
 - vii. Total expenditures;
 - viii. Annual balance (income minus expenditure);
 - ix. Actuarial deficit and funded ratio as of [valuation date](#) and other representative dates (for fully-funded pension schemes);

- x. Nature of assets and/or individual accounts;
- xi. Market value of financial or tangible assets;
- xii. Fund value, if any; and
- xiii. Value of notional assets (such as value of future contributions, if that is recognized as an asset).

The results may be expressed in relation to one or more relevant volume measures, such as the size of the jurisdiction's economy.

- c. Cost rates as appropriate:
 - i. Pay-as-you-go cost rate;
 - ii. General average premium or partially funded cost rate; or
 - iii. Fully funded cost rate.
 - d. A presentation designed to provide an indication of the financial sustainability of the SSP, if appropriate.
4. Analysis of results:
- a. Reconciliation with the prior report, along with explanations of significant changes in results.
 - b. Discussion of the pattern of financial projections (e.g., as a result of the ageing of the population, maturity of the SSP, and recent changes in SSP design or financing) and the implications thereof. The actuary may include a comparison of how benefits are projected to grow or decline as a result of different levels of inflation or economic growth and during which part of the projection period, as an indicator of potential stability or instability of the system in the longer term.
 - c. Sensitivity of results to variations in one or more assumptions.
 - d. Effect of automatic balancing mechanisms (if any) under each scenario used for the projections in the report, where "effect" covers both how the automatic balancing mechanism alters the key parameters of the SSP (such as the pension age, or determination of benefits) and how the alteration of the key parameters changes the amounts paid to beneficiaries.
 - e. Findings with respect to the short-, medium-, and long-term financial sustainability of the SSP with due regard to the funding rules under the law if such funding rules exist.
 - f. Indications of possible sources of future financial instability (e.g., depreciation of future benefits either because of non-indexation or because indexation may lag behind economic growth, or inadequacy of future contributions due to non-indexation of contribution limits).
 - g. Potential recommendations on possible measures to ensure the long-term financial sustainability of the SSP.
 - h. Impact of any options or guarantees embedded in the benefits of the SSP on the cash flows shown.
 - i. The suitability of the approach for calculation of any capitalised value of liabilities used for an SSP in light of the particular funding method and the time horizon used.
