

SAP 104: CALCULATION OF THE VALUE OF THE ASSETS, LIABILITIES AND SOLVENCY CAPITAL REQUIREMENT OF LONG-TERM INSURERS

Classification

Compliance with this Standard of Actuarial Practice (SAP) (excluding the Appendix) is mandatory for actuaries performing valuations of long-term insurers registered in South Africa for the purposes of published financial reporting, prudential supervision reporting, and tax liability calculation.

Appendix A (entitled "Advisory guidelines to assist with complying with accounting standards for producing financial statements") has an advisory status, due to the fact that the authority for published financial reporting should be taken directly from the International Financial Reporting Standards (IFRS) themselves.

Abstract

This SAP considers the valuation of a long-term insurer's assets, liabilities and solvency capital requirement.

Purpose

The purpose of this SAP is to assist fellow members of the Actuarial Society of South Africa in discharging their professional responsibility in relation to the valuation of a long-term insurer's assets, liabilities and solvency capital requirement.

Legislation or Authority

The Insurance Act, 2017 and associated Prudential Standards; IFRS 9; IAS 32; IFRS 4; IFRS 15; IFRS 13; the Companies Act, 2008 (Act 71 of 2008); and the Income Tax Act, 1962 (Act 59 of 1962).

Application

Actuaries performing or reviewing valuations of long-term insurance companies in South Africa.

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Status

Version 1	Approved in August 1986
Version 2	Approved in August 1995
Version 3	Effective for financial years starting on or after 1 January 1998, and updated in May 1998, October 1999 and May 2001
Version 4	PGN 104 Addendum version 1, effective from 30 June 2003
Version 5	PGN 104 Addendum version 2, effective from 31 December 2003
Version 6	Effective for valuations performed for financial years commencing on or after 1 January 2005
Version 7	Effective for valuations performed as from 31 December 2008
Version 8	SAP 104 effective for valuations performed as from 31 December 2012
Version 9	SAP 104 effective for valuations performed as from 30 June 2017

Version 10 SAP 104 effective for valuations performed for financial periods ending on or after 1 July 2018

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1 BACKGROUND TO STANDARD OF ACTUARIAL PRACTICE

1.1 Introduction

- 1.1.1 There are a number of different reasons for performing a valuation of a long-term insurer's assets and liabilities and, in certain instances, its solvency capital requirement.
- 1.1.2 Generally speaking, the purpose of the valuation will drive the valuation methodology and assumptions.
- 1.1.3 The Insurance Act, 2017 replaces the Statutory Valuation Method of the previous version of this standard that was based on the Financial Soundness Valuation Method. As a result the Financial Soundness Valuation method is no longer required for prudential supervision reporting. The forthcoming IFRS 17 reporting requirements will also replace the current published financial reporting standards. Until the implementation of IFRS 17 the current local recognised practice to value insurance contracts is the Financial Soundness Valuation method per section 2. This standard is therefore an interim standard between the new prudential requirements being enacted and until the IFRS 17 requirements are in force.
- 1.1.4 Due to the history of SAP 104 the content covers both mandatory and advisory material. Actuaries referring to SAP 104 should consider the sections listed below as mandatory while all other content may be considered advisory.
 - 1.1.4.1 Section 2.1 – 2.5: Financial Soundness Valuation
 - 1.1.4.2 Section 3.2 – 3.3: Published Reporting
 - 1.1.4.3 Section 4: Prudential Supervisory Reporting
 - 1.1.4.4 Section 5: Tax Liability

1.2 Three main valuations

- 1.2.1 There are three valuations of long-term insurers that are required to be performed regularly. These are:
 - 1.2.1.1 Valuation of assets and liabilities for published financial accounts.
 - 1.2.1.2 Valuation of assets, liabilities and solvency capital requirement for prudential supervision reporting.
 - 1.2.1.3 Valuation of assets and liabilities for calculation of the insurer's tax liability.
- 1.2.2 While in some instances the above three valuations may be arrived at by use of the same methodology and assumptions, they are three distinct valuations, with different purposes, and the actuary should be aware of the distinctions. Therefore the assumptions used in the above three valuations might not always be consistent.
- 1.2.3 Importantly, each of these valuations is governed by different statutes, falling under different regulatory bodies. Specifically:
 - 1.2.3.1 Published financial reporting falls under the Registrar of Companies and needs to comply with the Companies Act, 2008 (Act 71 of 2008). Published financial reporting also needs to comply with International Financial Reporting Standards (IFRS). JSE-listed companies also need to comply with the JSE rules.
 - 1.2.3.2 Prudential supervision reporting falls under the Prudential Authority and needs to comply with the Insurance Act, 2017 and associated Prudential Standards.
 - 1.2.3.3 Asset and liability valuations used for calculating a long-term insurer's tax liability falls under the South African Revenue Service and need to comply with the Income Tax Act, 1962 (Act 59 of 1962).

- 1.2.4 Changes in South African prudential supervision and financial reporting for long-term insurers, driven in part by international developments in these areas, have given rise to some differences in the valuation requirements for each purpose.

1.3 International Financial Reporting Standards

- 1.3.1 The International Accounting Standards Board has a standard for Insurance Contracts (IFRS 4) and a standard for the Recognition and Measurement of Financial Instruments (IFRS 9), both of which apply to the valuation of assets and liabilities for published financial reporting. IFRS 9 replaced IAS 39 on or after 1 January 2018. IFRS 4 is intended to be replaced by IFRS 17 in due course. The IASB is exploring alternatives for insurers to reduce accounting volatility on adoption of IFRS 9 before adoption of IFRS 17. These alternatives may be amendments to IFRS 4 (Phase 1).
- 1.3.2 In terms of the Companies Act, all companies must apply International Financial Reporting Standards as issued by the International Accounting Standards Board (IASB).
- 1.3.3 With the introduction of IAS 39 (and its replacement IFRS 9) and IFRS 4, long-term insurers in South Africa need to approach the valuation of certain parts of their business from three distinct perspectives as follows:
- (a) Published financial reporting perspective (IFRS 9, and IFRS 4 and its future replacement IFRS 17);
 - (b) Prudential supervision reporting perspective; and,
 - (c) Tax liability perspective.
- 1.3.4 The accounting standards themselves provide the authority that must be complied with when producing published financial statements. It is thus considered inappropriate to provide any additional mandatory guidance in SAP 104. Nevertheless, Appendix A contains guidance of an advisory nature to assist actuaries in complying with the accounting standards when producing financial statements.

1.4 Prudential supervision reporting

- 1.4.1 The Insurance Act, 2017 prescribes the financially sound condition for prudential supervision purposes. The requirements for the financially sound condition are different from the Financial Soundness Valuation as well as the Statutory Valuation Method as prescribed in the previous version of SAP 104.
- 1.4.2 Actuaries are advised to ensure that they have access to the latest versions of the relevant Prudential Standards under the Insurance Act, 2017.

1.5 Financial Soundness Valuation

- 1.5.1 New accounting standards introduced mean that the Financial Soundness Valuation as described in previous versions of SAP 104 may no longer always be applicable for producing published financial results.
- 1.5.2 Nonetheless, for the foreseeable future, aspects of the Financial Soundness Valuation are still likely to play an important role in published financial reporting.
- 1.5.3 The Financial Soundness Valuation methodology for determining liabilities remains a pivotal part of this SAP and is detailed in section 2 below.
- 1.5.4 Note that section 2 is limited to details around liability valuation for published financial reporting purposes.

2 FINANCIAL SOUNDNESS VALUATION OF LIABILITIES

2.1 Introduction

- 2.1.1 A Financial Soundness Valuation of a long-term insurer's liabilities is intended to be prudently realistic, allowing explicitly for actual premiums that are expected to be received in terms of the contract and future experience that may be expected in respect of interest rates, expenses, mortality, morbidity and other relevant factors.
- 2.1.2 A minimum level of financial resilience is introduced by compulsory margins added to best-estimate assumptions of all parameters. Further resilience and prudent release of profits is achieved by the inclusion of additional discretionary margins.
- 2.1.3 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.

2.2 Best-estimate assumptions

- 2.2.1 Best-estimate assumptions should be considered separately for relatively independent groups of homogeneous policies (i.e. the policies within the groups are similar, but the groups differ from each other). Examples of appropriate groupings that could be considered include splitting business by product type, by cohort, by distribution channel or by geographic region.
- 2.2.2 The best-estimate assumptions should be realistic, generally guided by immediate past experience, and modified by any knowledge of or expectations regarding the future. Best-estimate assumptions should depend on the nature of the business.
- 2.2.3 Allowance must be made for:
 - 2.2.3.1 Expenses at a realistic level, making allowances for escalation of future expenses at an inflation rate that is consistent with the rate(s) of interest used.
 - 2.2.3.2 The effect of lapses and surrenders at a level that is consistent with past experience modified by expected future trends.
 - 2.2.3.3 Mortality and morbidity, at a level consistent with past experience modified by expected future trends. This must include the best-estimate of the effect of AIDS.
- 2.2.4 When setting the interest rate(s) at which to discount the liabilities, the actuary should:
 - 2.2.4.1 Ensure that the rates used are mutually consistent and consistent with market yields to maturity of fixed interest securities;
 - 2.2.4.2 Consider the expected future investment returns on a portfolio of assets appropriate to the liabilities, bearing in mind characteristics such as term, nature and duration;
 - 2.2.4.3 Make allowance for tax, using the actuary's expectation of the effect of the tax basis on the expected future investment returns and of any expected future changes in the long-term insurer's tax position.
- 2.2.5 The actuary, in setting the 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. Where this is done, there is no requirement to report on the result of more than one valuation.

2.3 Compulsory and discretionary margins

2.3.1 Compulsory margins as per the following table must be added to all best-estimate assumptions. The value of any reserves calculated on a retrospective basis should be at least equal to the corresponding prospectively calculated reserves, where the prospectively calculated reserves must include allowance for the compulsory margins.

Assumption	Margin
Mortality	7.5% (increase for assurance, decrease for annuities)
Morbidity	10%
Medical	15%
Lapse	25% (e.g. if the best estimate is 10%, the margin is 2.5%)
Terminations for Disability Income Benefits in Payment	10%
Surrenders	10% (increase or decrease, depending on which alternative increases liabilities)
Expenses	10%
Expense inflation	10% (of estimated escalation rate)
Charge against investment return	25 basis points in the management fee or an equivalent asset-based or investment performance-based margin

2.3.2 The following should be noted when applying the compulsory margins:

2.3.2.1 The intention of the compulsory margins (to be added to the best-estimate assumptions) is to introduce a degree of prudence to allow for possible adverse deviations in experience during the expected future lifetime of the business. These compulsory margins will at the same time serve to an extent to defer profits and thus reduce the risk that profits are recognised prematurely.

2.3.2.2 When deciding on the direction in which to apply the compulsory margins, the following should be considered:

- i The margins should be applied at a policy grouping level consistent with the level at which the best-estimate assumptions have been set. This is particularly important as the direction in which a particular risk's compulsory margin is applied could differ for different groups of policies. For example, margins in respect of mortality claims applied to a book of term assurance business will lead to an increase in the best-estimate assumption, whereas for a book of annuity business, the best-estimate assumption will be decreased.
- ii Consideration should also be given to the extent to which the direction of the margin needs to be changed depending on other factors, such as the duration of the policy, or age of the policyholder. For example, an increase in the assumed level of lapses may be conservative early on in a policy's life; however it is possible that after a certain period, a decrease in the lapse assumption may be more conservative. Simply increasing (or decreasing)

the assumption over the entire life of the policy may not be appropriate and may lead to the reserve being understated. In this case, the actuary should consider, where it is practically possible to do so, increasing the best-estimate assumption for a certain period and then decreasing it thereafter, such that at the policy grouping level, the appropriate amount of prudence is built in.

2.3.3 There are a few points to note around the application of the compulsory margin on the “charge against the investment return”:

2.3.3.1 Consistent with the points raised in 2.3.2.2 above, the application of the compulsory margin on the charge against investment return needs to be considered separately at different terms and durations for different categories of policies. In the event that one or more categories of policies have negative liabilities at certain terms and/or durations, it may be more appropriate to apply the investment return margin as an addition to rather than a reduction from the best-estimate rate for that category of policies.

2.3.3.2 The margin should be applied differently depending on the type of business being valued. Examples include:

- i Linked business (Rand reserve) – assume an investment fee of 1.25% if the real investment fee is 1.5% (say).
- ii Reversionary bonus business – value the liabilities at 0.25% less than the valuation rate of the assets (adjusted for the effect of taxation, asset management charges and credit risk), without adjusting the expected future bonus rate accordingly.
- iii Non-profit business including immediate annuities - value the liabilities at a rate of 0.25% less than the rate used for valuing the assets, adjusted for credit risk. This is discussed further in 2.4.7 and 2.4.8.

2.3.4 The compulsory margins must be added throughout the lifetime of policies. The exception is for regular renewable policies where the margin should be added for a minimum period of twelve months, or up to the next renewal date, if this period is longer than twelve months. Future management actions may not be assumed to reduce the compulsory margins.

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

2.3.6 In addition to the compulsory margins, discretionary margins may be included where the actuary believes that:

2.3.6.1 The compulsory margins are insufficient in a particular case for prudent reserving; or

2.3.6.2 The discretionary margins should be used in order to defer the release of profits consistent with policy design or company practice.

2.3.7 Justification should be provided by the actuary and approved by the Board of Director for any discretionary margins used. Reserves in respect of discretionary margins may be calculated on a retrospective or prospective basis.

2.4 Specific points concerning methodology

2.4.1 The premiums and benefits to be valued must be those payable in terms of the contract.

2.4.2 The benefits to be valued must take into account the reasonable expectations of policyholders. This important issue is considered further in 2.5 below.

- 2.4.3 The liabilities (including the compulsory margins) should be calculated before taking into account any reinsurance the long-term insurer has in place. The value of reinsurance may need to be separately quantified.
- 2.4.4 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 may 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.
- 2.4.5 When valuing participating business, liabilities should include 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. However, if such expected allocations to shareholders could act as a buffer in adverse circumstances, it is not necessary to reserve for both the compulsory margins and such expected shareholders entitlements. It would be adequate to reserve for the higher of the two.
- 2.4.6 Where a policy of smoothing bonuses has been followed, the liabilities should be increased by any positive 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, for example because of a downward fluctuation in the market value of backing assets, it is acceptable to reduce the liabilities to reflect the amount that can reasonably be expected to 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.
- 2.4.7 When valuing level annuities and annuities with fixed increases, the projected expected cash flows at each duration should be discounted according to the yields of appropriate duration taken from a yield-curve of appropriate backing assets, reduced where applicable by the best-estimate allowance for credit risk, as well as by the investment return compulsory margin. Alternatively, the cash flows can be discounted at a single discount rate (reduced by the best-estimate allowance for credit risk and by the investment return compulsory margin) derived so as to give the same present value as using the yields from the yield-curve directly.
- 2.4.8 Inflation-linked annuities should be valued in real terms according to the adjusted real yield curve in the same way as described in paragraph 2.4.7.
- 2.4.9 Unbundled business consists of contracts where a designated portion of the premium is allocated or deemed to be allocated to investment in an asset accumulation fund. This will usually include the following categories: market-related, smoothed bonus, universal life and deposit administration. The following points specific to the valuation of unbundled business should be noted:
- 2.4.9.1 For this business the total reserve would consist of two parts, namely a “fund reserve” and a “Rand reserve”.
- 2.4.9.2 Subject to the provisions of 2.4.6, the fund reserve including, where applicable, the face value of any non-vested bonuses, must be taken to be not less than the value of the accumulation fund.
- 2.4.9.3 The Rand reserve (which can be positive or negative) must be derived from a discounted cash flow calculation that allows for:
- i expected future mortality and morbidity experience, including margins;
 - plus

- ii expected future commissions, expenses and expense inflation, including margins; plus
- iii the cost of any guarantees provided in terms of the contract; less
- iv expected future risk benefit premiums, contractual expense charges, contractual management fees and contractual charges for guarantees.

2.5 Policyholder reasonable expectations

- 2.5.1 The reasonable expectations of policyholders cannot be defined in watertight terms. They will depend upon, inter alia, the type of product, the insurer's historically established practices, the manner in which benefits are quoted and presented to policyholders and expectations created by marketing material.
- 2.5.2 An overriding principle is that in the calculation of the liabilities, account needs to be taken of those expectations that in the actuary's opinion should influence the long-term insurer when deciding on future distributions of surplus.
- 2.5.3 In order to encourage consistent interpretation of policyholder reasonable expectations, the following guidelines are provided:
- 2.5.3.1 Policyholders expect all contractual benefits to be paid and obligations to be met.
 - 2.5.3.2 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.
 - 2.5.3.3 Holders of smoothed bonus policies expect to participate in the smoothed investment performance of the underlying asset portfolio as described in marketing literature.
 - 2.5.3.4 In the absence of anything to the contrary, holders of with-profit and smoothed bonus policies (as described in marketing literature) expect over the medium term (three to five years) to receive an equitable share of the investment performance and, where applicable, other profits and losses that are earmarked for policyholders by the insurer.
 - 2.5.3.5 The insurer may have made specific and clear announcements or taken action to change previously created expectations.
 - i The actuary will need to consider what expectations have been created and whether the insurer has taken clear action to change any previously held expectations to determine which expectations need to be taken into account in the valuation.
 - ii The following are some of the specific ways in which expectations are frequently created:
 - (a) Where there is a history of maintaining bonus rates or strong smoothing of bonus rates over a sustained period, policyholders will expect that the same approach will apply in the future, given a continuation of past and current circumstances.
 - (b) The illustration of future values assuming the maintenance of bonus rates creates an expectation that those rates will be maintained, given a continuation of past and current circumstances.
 - 2.5.3.6 In the case of reversionary bonus policies, it is not acceptable to discount future benefits at high interest rates without allowing for the corresponding bonuses that could be supported under such conditions (see 2.5.3.4 above).

- i If the 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 actuary considers that no such expectations have been created, the full maintenance of the level of bonus rates that may reasonably be expected under conditions consistent with the investment return assumptions may be assumed.
- ii The full amount 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 need to be assumed at levels consistent with investment return assumptions (for example, where the amount of bonus depends on a scale that is related to duration).

2.6 Option of disregarding amounts representing negative liabilities

- 2.6.1 The option of disregarding the amounts representing negative liabilities was previously governed by the Long-term Insurance Act, 2017 as well as Directive 145.A.i(LT). The respective portion of the Act and the Directive has since been repealed.
- 2.6.2 For the financial soundness method negative liabilities in respect of long-term policies may be deducted from liabilities, provided that the company's liabilities (including current liabilities) after such deduction are greater than or equal to zero.
- 2.6.3 The insurer must apply its policy for the treatment of negative reserves consistently from year to year and disclose the policy in the financial statements.
- 2.6.4 The decision on the treatment of negative liabilities lies with the company (board of directors).
- 2.6.5 In order to keep the treatment consistent for published reporting, the relevant section in Directive 145.A.i(LT) has been included in Appendix B.

3 PUBLISHED REPORTING

3.1 Accounting standards

3.1.1 There are five key related accounting standards in South Africa which need to be adhered to for published reporting purposes. They are:

- 3.1.1.1 IFRS 9 Financial Instruments: This standard relates to the recognition and measurement of IFRS defined investment contracts. This standard was subject to mandatory adoption for published financial reporting periods commencing on or after 1 January 2018 replacing IAS 39.
- 3.1.1.2 IFRS 13 Fair Value Measurement. This standard relates to defining fair value, setting out a single IFRS framework for measuring fair value, and the disclosure around fair value measurement. This standard became effective 1 January 2013. Although fair value definitions and measurement were covered in IAS 39, this standard was created afterwards to replace the fair value guidance across standards. For this reason, similar guidance on fair value is not found in the newer IFRS 9 which now relies on IFRS 13.
- 3.1.1.3 IFRS 4 Insurance Contracts (Phase I). This standard relates to the recognition, measurement and disclosure of insurance contracts and became effective for published financial reporting periods commencing on or after 1 January 2005.
- 3.1.1.4 Financial Instruments IFRS 7 Disclosures. This standard relates to disclosure with respect to IFRS defined investment contracts and became effective for published financial reporting periods commencing on or after 1 January 2007.
- 3.1.1.5 IFRS 15 Revenue from Contracts with Customers. This standard deals with revenue recognition and is very relevant for investment management contracts. This standard was subject to mandatory adoption for published financial reporting periods commencing on or after 1 January 2018 replacing IAS 18.

3.2 Valuation of insurance contracts

As per the current IFRS 4 (i.e. Phase I), local recognised practice should continue to be used for the valuation of insurance contracts, unless the company adopts a more relevant and no less reliable, or more reliable and no less relevant accounting policy (for example early adoption of IFRS 17). Currently the local recognised practice is the Financial Soundness Valuation method as outlined in Section 2 of this SAP, but subject to some specific requirements included in IFRS 4.

3.3 Valuation of investment contracts with discretionary participating features

Investment contracts with participation in profits on a discretionary basis present particular difficulties of accounting treatment. These difficulties have been recognised by the IASB and the concomitant IFRS 4, which has indicated that these contracts can continue to be valued using local recognised practice, until IFRS 17 is adopted. The Financial Soundness Valuation method as outlined in Section 2 of this SAP will continue to be applicable, again subject to some specific requirements included in IFRS 4.

3.4 Financially sound condition

The ability of an insurance company to pay dividends, reduce shareholders' equity or to write new business is dependent, amongst other things, on the insurer's ability to maintain a financially sound condition at all times as required by the Insurance Act, 2017. As a result, insurers should calculate and publish the prudential financially sound condition. Details of the calculation of the solvency capital requirement and eligible own funds are contained in Prudential Standards issued by the Prudential Authority.

3.5 Disclosures

Any actuary, if requested by the board, responsible for reviewing the published reporting basis should provide an opinion to the board of directors on the disclosure contained in the financial statements. In particular relating to the published reporting liability valuation method and assumptions as well as the assets methods and assumptions. The opinion should consider if the disclosure contains sufficient information on how the liabilities have been calculated as well as the accuracy of the information.

3.6 Materiality Guidelines

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.

4 PRUDENTIAL SUPERVISION REPORTING

- 4.1 The valuation of a long-term insurer's assets, liabilities and solvency capital requirement for prudential supervision reporting purposes are governed by the Insurance Act, 2017, along with the publication of Prudential Standards made under the Act. Following the effective date of the Act, the Statutory Valuation Method as detailed in previous versions of the SAP fall away and is replaced by the financially sound condition requirements prescribed by the Prudential Authority.
- 4.2 Details on the prudential calculations are specified in the Prudential Standards. The actuary should ensure they always use the latest version from the Prudential Authority website.

5 TAX LIABILITY

- 5.1 The valuation of a long-term insurer's assets and liabilities are governed by the Income Tax Act (Act 58 of 1962) as amended; and ongoing binding general rulings issued by SARS. The actuary should ensure they always use the latest version from SARS's website.

APPENDIX A: ADVISORY GUIDELINES TO ASSIST WITH COMPLYING WITH ACCOUNTING STANDARDS FOR PRODUCING FINANCIAL STATEMENTS

1 BACKGROUND

- 1.1 This Appendix gives advisory guidance to actuaries to assist with complying with accounting standards when producing published financial statements. This Appendix is not a substitute for meeting the requirements of the relevant accounting standards that are listed in Section 3 of the main body of SAP 104. It should be borne in mind that the published financial statements must be signed off by the company's auditors. Practitioners are therefore directed to the relevant accounting standards for authoritative requirements.
- 1.2 One of the implications of the current IFRS 4 is the need to identify separately investment business from insurance business. The accounting standards that apply to each of these elements of the long-term insurer's business are different and consequently, the valuation methodology may well differ between them.
- 1.3 As a result, one of the key aspects to the liability valuation for published financial reporting revolves around the classification of business. The actuary can assist in the classifications and hence subsequent valuation standard to apply. This is detailed in section 2 below.
- 1.4 As per paragraph 2.1(e) of IFRS 9, these standards will not apply to rights and obligations under an insurance contract as defined in IFRS 4 or under a contract that is within the scope of IFRS 4 because it contains a discretionary participating feature. Furthermore, if an insurance contract is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of IFRS 9 the issuer shall apply IFRS 9 to the contract.
- 1.5 One of the key tenets of IFRS 9 is that certain assets and liabilities falling within its scope are to be valued at "fair value", where fair value is defined in IFRS 13. Under IFRS 13, the definition of fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants". The Financial Soundness Valuation method reflects current market conditions (being based on realistic, best estimate assumptions), and may thus constitute a "fair value" methodology in certain circumstances under both definitions. There are, however, certain features of IFRS 9 (including the fact that a settlement notion no longer applies in the valuation of the fair value of a financial liability), that need to be specifically catered for, which could make the Financial Soundness Valuation method as set out in Section 2 in the main body of SAP 104, inappropriate for complying with IFRS 9.

2 CLASSIFICATION OF CONTRACTS

2.1 Categorisation of liabilities

- 2.1.1 IFRS 4 requires that policy contracts must be categorised as either:
 - i insurance contracts, or
 - ii investment contracts.
- 2.1.2 The classification decision will drive the valuation approach as well as the disclosure requirements.
- 2.1.3 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 are not required to be unbundled into insurance contracts and investment contracts, unless the insurer's current accounting policies do not require it to recognise the full liability and provided that the insurer can measure

the deposit component separately from the insurance component. Unbundling is permitted if the insurer is able to measure the deposit component separately. For example, if a policy has a self-standing rider, the rider may be classified separately if desired.

- 2.1.4 Investment contracts with participation in profits on a discretionary basis present particular difficulties of treatment. These difficulties have been recognised in IFRS 4, which indicates that these discretionary participating contracts can continue to be valued according to local accounting practice but subject to 2.4 below. Because of this, it is important to identify investment contracts which can be classified as discretionary participating.
- 2.1.5 Contracts should be classified at inception or on subsequent amendment of the contractual terms. For example, if life cover is added to a policy after inception, its classification can change from investment to insurance. However, once a contract is classified as an insurance contract it would then remain so classified until all rights and obligations are extinguished or expire.
- 2.1.6 Switching of an investment contract into a smoothed bonus portfolio is covered in 2.3.4 below.

2.2 Insurance contracts

- 2.2.1 The definition of an insurance contract in IFRS 4 is "a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder".
- 2.2.2 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario (excluding events that lack commercial substance) that exceeds those that would be payable if no insured event occurred.
- 2.2.3 In order for a product to be classified as insurance, it is important for an insurer to be able to demonstrate that there is a plausible possibility of an event occurring (even if it has a small probability of occurrence) which can lead to significant insurance risk. Judgement will be required in assessing "significant" in this regard, and in practice this is something that should be resolved with the company's auditors if the position is unclear.
- 2.2.4 A key consideration in classifying a contract as insurance is whether there is a significant difference between the benefit payable on the occurrence of an insured event (such as death) and that paid on voluntary termination (surrender) at various stages and under different market conditions during the term of a contract.
- 2.2.5 Charges taken into account on surrender (for example for recovery of outstanding initial expenses or as a discontinuance charge) may not be taken into account in comparing the benefit payable on surrender and death i.e. they are not relevant in assessing how much insurance risk is transferred by the contract.
- 2.2.6 Survival risk meets the definition of insurance risk.
- 2.2.7 Examples of contracts which could be classified as insurance are given below:
 - i Whole life, endowment and term assurances;
 - ii Permanent health insurance;
 - iii Credit life insurance;
 - iv Group life insurance;

- v Universal life policies incorporating life or disability cover;
- vi Dread disease policies;
- vii Funeral insurance;
- viii Contracts with investment guarantees payable only on death (or other insured risk) or on survival to a predetermined date, but not on surrender;
- ix Contracts with investment guarantees payable on both death and maturity (i.e. of the form of premiums plus growth of x% pa) are likely to be classified as insurance, provided that one can demonstrate that the discounted value of the maturity benefit (which allows for the time value of money) is significantly different to the discounted value of the death benefit;
- x Market-related contracts with a minimum death benefit such as a return of premiums;
- xi Life annuities.

2.2.8 The above examples do not cover every type of policy sold or every variation within such policies. When categorising a contract, particular attention should be paid to the specific terms and conditions of that contract and to the requirements of IFRS 4 and the accompanying implementation guidance.

2.3 Investment contracts

2.3.1 Investment contracts are deemed to be any policy contracts not falling within the definition of insurance contracts.

2.3.2 Examples of such contracts which could be classified as investment contracts are given below:

- i Non-profit single premium guaranteed contracts;
- ii Non-profit 'structured' single premium contracts;
- iii Single or recurring premium contracts with all benefits directly linked to the performance of a specific asset portfolio;
- iv Sinking fund 'investment only' business;
- v Group smoothed bonus contracts;
- vi Annuities-certain and market-related 'living annuities'.

In some instances the examples of contracts given above may contain features that may classify them as insurance (e.g. an inclusion of a death guarantee that is deemed significant to classify as insurance).

2.3.3 The above examples do not cover every type of policy sold or every variation within such policies. When classifying a policy contract, it is important to consider the specific terms and conditions of that contract and the requirements of IFRS 4 and the accompanying implementation guidance.

2.3.4 Some investment contracts allow switching between investment funds. In particular, switching may be into or out of a smoothed bonus portfolio. The option to switch a pure investment policy into a smoothed bonus portfolio is not sufficient to classify the contract as investment with discretionary participation. One will need to review the switching history, and if a significant proportion of business has switched into a smoothed bonus portfolio at some stage, then this may be sufficient to enable all such contracts with such options to be classified as investment contracts with discretionary participation. Clearly, if and when an investment contract is switched to discretionary participation, then it can be reclassified as discretionary participating if not done so already.

2.4 With discretionary participation features – Insurance or Investment

- 2.4.1 In deciding on the classification of discretionary participation contracts between investment and insurance, one should consider the effect of any potential negative Market Value Adjuster (MVA). Although IFRS 4 applies to the valuation of contracts with discretionary participation for both insurance and investment contracts, there are disclosure requirements to separate them.
- i Where an MVA may be applied to a surrender value or a death benefit but not to a maturity benefit, such a contract is likely to be classified as insurance (i.e. provided that the MVA results in a significant difference between the benefits), because there is a survival risk.
 - ii Similarly, where an MVA may be applied to a surrender value or a maturity benefit but not to a death benefit, such a contract is likely to be classified as insurance (i.e. provided that the MVA results in a significant difference between the benefits).
 - iii However, where an MVA is applied to a surrender value but not to a death benefit nor to a maturity benefit, such a contract is likely to be classified as investment since the contract does not transfer insurance risk. It is certain that the policyholder will live or die. If it can be demonstrated that the benefits payable on death and maturity are significantly different after allowing for the time value of money, the contract is likely to be classified as insurance.

3 VALUATION OF ASSETS

As per paragraph 4.1.1 of IFRS 9 debt instruments are required to be classified into three categories, viz. amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of the business model for managing the assets and the contractual cash flow characteristics of the financial asset. As per paragraph 4.1.4 of IFRS 9 an entity can make an irrevocable election at initial recognition of an equity instrument held as an asset to be measured either at fair value through profit or loss or to present subsequent changes in fair value in other comprehensive income. Ideally, the valuation approach of the assets should be consistent with the valuation approach of the liabilities. The approach used is subject to the requirement that one remains within the confines of IFRS 9 whichever is adopted.

4 VALUATION OF LIABILITIES

- 4.1 The valuation of a contract depends on how a contract has been classified. This section considers the valuation of insurance contracts, the valuation of investment contracts without discretionary participating features (e.g. term certain annuities), the valuation of investment contracts with discretionary participation features (e.g. smoothed bonus pure savings contracts with no guarantees) and the valuation of investment management contracts (e.g. market-linked pure savings contracts with no guarantees).
- 4.2 Valuation of insurance contracts:
- 4.2.1 As per paragraph 3.2 in the main body of this SAP, local accounting practice should continue to be used for the valuation of insurance contracts, which is the Financial Soundness Valuation method as outlined in Section 2 of the main body of SAP 104, unless the company adopts a more relevant and no less reliable, or more reliable and no less relevant accounting policy (for example early adoption of IFRS 17).

- 4.2.2 In terms of IFRS 4, insurance contracts are subject to a liability adequacy test. The purpose of the test is to ensure that the liability held is sufficient to meet all expected future obligations under the contract, including guarantees and options, using current estimates of future cash flows. If the test shows that the liability is inadequate, the entire deficiency needs to be recognised in profit or loss. Because the Financial Soundness Valuation method complies with these minimum requirements as laid out in IFRS 4, no additional work is likely to be required.
- 4.3 Valuation of investment contracts without discretionary participation features:
- 4.3.1 Investment contracts (including the deposit component of investment management contracts) without discretionary participating features are to be valued in terms of IFRS 9. To ensure consistency between the value of assets and the value of liabilities, where corresponding assets are valued at fair value, these investment contracts should also be valued using fair value. However, see 4.3.9 below.
- 4.3.2 In broad terms, some may regard the Financial Soundness Valuation method as an appropriate approach to fair value accounting. There are, however, certain features of IFRS 9 that need to be specifically catered for, which could make the Financial Soundness Valuation method as set out in Section 2, inappropriate for complying with IFRS 9.
- 4.3.3 Under IFRS 9, there is a hierarchy of ways to determine the fair value of a liability. The first way is to use the market price as quoted in an active market on an arm's length basis. For contracts where no quoted markets exist, valuation techniques include a discounted cash flow valuation, an option pricing valuation, replicating portfolio techniques and the use of recent arm's length transactions. IFRS 13 requires that the valuation techniques used should maximise the use of relevant observable inputs and minimise unobservable inputs. However the standard acknowledges that, given certain circumstances, one valuation technique may be more appropriate than another. IFRS 13 described three valuation approaches: the market approach (using prices and other relevant information that have been generated by market transactions that involve identical or comparable assets); the income approach (typically being a discounted cash flow approach); and adjusted net assets method.
- 4.3.4 According to paragraph B5.1.2A(a) of IFRS 9, in the absence of any quoted price, a valuation approach must be used which can be demonstrated to provide reliable estimates of market prices. The technique should be chosen such that it includes all relevant factors, including an allowance for 'own credit', that market participants would consider in setting a price as covered in IFRS 13. Assumptions should be consistent with market observable data wherever possible. Economic assumptions such as interest rates will typically have observable market data to use. A discount rate should be used equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument.
- 4.3.5 There is unlikely to be observable market data for assumptions such as persistency and mortality. One will need to estimate what these assumptions are likely to be in an arm's length transaction to transfer the liability to another entity. These assumptions should be based on best estimates of future experience with a margin to cover the risk that actual experience may differ. The compulsory margins may not be contrary to these requirements. Discretionary margins, unless they are covering specific identified risks not covered by compulsory margins, are not likely to be appropriate. However, it should be noted that, as per 4.3.6 below, additional margins may be required to be set up to eliminate gains at inception.

- 4.3.6 For investment contracts with a quoted price, no profit is recognised at point of sale since the fair value is equal to the price quoted in the market. According to paragraph B5.1.2A(a) of IFRS 9, a gain or loss may only be recognised at inception if fair value is evidenced by comparison with other observable current market transactions in the same instrument, or is based on a valuation technique incorporating only market observable data. For investment contracts written by life offices, the valuation technique frequently uses assumptions other than market observable data. Given this, it will be difficult to demonstrate that any profit may be recognised at inception. This is recognised in paragraph B5.1.2A(b) of IFRS9, which states that the application of paragraph 5.1.1 may result in no gain or loss being recognised at inception. Furthermore, a gain or loss shall be recognised after inception only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price. Any gain at inception should be recognised over the life of the contracts.
- 4.3.7 In terms of the requirements of paragraph B5.1.2A(b), the account balance is an appropriate reserve for a unit-linked type contract. Any Rand reserves which are currently held in the current Financial Soundness Valuation method should be eliminated under IFRS 9. Where actuarial funding may have been used and the funded value of units held, either the unfunded (i.e. total) liability should be held, or the difference between the unfunded and funded liability should be treated as a DRL (Deferred Revenue Liability) and released as the service is provided in accordance with IFRS15.
- 4.3.8 A company issuing an investment contract needs to recognise a minimum liability equal to the demand deposit. The demand deposit is the amount payable on demand, which is in effect the surrender value. Any DAC (Deferred Acquisition Cost) set up in respect of the attaching investment management contract should not be netted off against the liability held when comparing against the demand deposit floor.
- 4.3.9 For purposes of deriving fair value, where embedded derivatives (e.g. financial guarantees) exist within a product line and are classified as investment contracts, these must be fair valued. It is likely that the market consistent stochastic approaches as described in APN110 (whether risk neutral or real world) would be an acceptable method. IFRS 9 does allow an amortised cost approach to be used to value liabilities. Whilst this is inconsistent with valuing assets at fair value and is contrary to the Financial Soundness Valuation method, some life offices in South Africa may still prefer to adopt this approach for valuing investment contracts without discretionary participation.
- 4.4 Valuation of investment contracts with discretionary participation features:
- 4.4.1 As per paragraph 3.3 in the main body of SAP 104, investment contracts with participation in profits on a discretionary basis present particular difficulties of accounting treatment. These difficulties have been recognised by the IASB and the concomitant IFRS 4, which has indicated that these contracts can continue to be valued under local accounting practice. The Financial Soundness Valuation method as outlined in Section 2 of the SAP will continue to be applicable.
- 4.4.2 According to IFRS 4, a company issuing such a contract needs to recognise a liability of not less than the measurement that would be required for the guaranteed element of the contract. In the South African context, the guaranteed element includes vested bonuses that have been declared to date. If, however, the full bonus stabilisation reserve is held as a liability, as is the practice in South Africa, then IFRS 4 states that this requirement does not apply. In calculating the value of the guaranteed element (if applicable) it is appropriate

to use a prospective discounted cash flow approach rather than the face value of the current guaranteed portion.

- 4.4.3 It should be noted that IFRS 4 permits premiums, claims and other cash flows on such contracts to be recognised as revenue.
- 4.5 Valuation of investment management contracts (where the host contract is an investment contract without discretionary participating features):
- 4.5.1 An investment management contract is an investment contract as part of which investment management services are provided. IFRS 15 requires the deposit (or financial liability) component to be separated from the investment management services component.
- 4.5.2 The deposit component is valued in terms of IFRS 9 and is covered in 4.3 above.
- 4.5.3 The investment management services component is subject to IFRS 15 dealing with revenue recognition. Excess initial fees (i.e. the excess of initial fees over recurring fees) are not to be recognised up-front but are required to be recognised as revenue as the services are provided. In the same way, incremental costs are to be deferred and amortised as the entity recognises the related revenue. Incremental costs are those that are directly attributable to securing an additional investment management contract. It is likely that commission (including VAT) and additional incentives paid on the attainment of a specific sales target are the only type of costs that meet the definition of an incremental cost.
- 4.5.4 Although one may feel that there is some discretion in attributing initial fees and incremental costs between the financial liability and investment management services components, the accounting firms have concluded that the full amount of the initial fees and incremental costs relates to the investment management service component (since any amounts relating to origination of the financial liability are likely to be immaterial), and thus requires deferral. The Actuarial Society of South Africa supports this approach, since it will ensure consistency between life offices, both locally and internationally.
- 4.5.5 One can perform the amortisation calculations on a policy-per-policy basis or on a portfolio basis. If a policy-per-policy approach is followed, then the DAC (Deferred Acquisition Cost) and/or DRL (Deferred Revenue Liability) will be amortised over the actual term of the policy, and will be released when the policy goes off books. On the other hand, if a portfolio approach is followed, then allowance should be made for expected decrements in selecting the expected term over which to amortise the DAC and DRL. The expected term should be amended over time in line with significant changes in the decrement experience.
- 4.5.6 In choosing the amortisation pattern, one can adopt any recognised approach (e.g. straight line approach, or amortise the amounts via a carrier such as the expected profits or fees of the contracts in question).
- 4.5.7 The amortisation pattern of the DAC must be consistent with the amortisation pattern of the DRL.
- 4.5.8 A DAC can only be held to the extent that it is likely to be recovered in future. Recoverability can be assessed on a portfolio basis.

5 DISCLOSURE REQUIREMENTS

- 5.1 Whilst this SAP is not intended to cover disclosure requirements, it is important to note that IFRS 7 requires certain disclosures for investment contracts. Discretionary participating investment contracts are not exempt from these disclosure requirements, although it

should be noted that all flows on such contracts may be recognised as revenue. IFRS 4 requires certain disclosures for insurance contracts.

- 5.2 IFRS 4 requires revenues (in the profit and loss account) and insurance liabilities (in the balance sheet) to be shown gross and net of reinsurance.

APPENDIX B: EXTRACT FROM PREVIOUS DIRECTIVE 145.A.i(LT)

Previously the amounts to be disregarded for the Published and Statutory Valuation method was prescribed by the now repealed Directive 145.A.i(LT). This is only provided for information as it is no longer in force.

“For the purposes of the calculation of the value of assets-

There shall be disregarded-

- i An amount representing a negative liability in respect of a long-term policy in terms of which the long-term insurer concerned provides or undertakes to provide a policy benefit, provided that this provision shall not be construed as precluding the deduction of a negative liability in respect of a long-term policy from liabilities”

A negative liability in respect of a long-term policy will generally arise when, at any stage in a policy’s lifetime, the expected present value of future premiums exceeds the expected present value of future benefits and expenses.

These negative liabilities may be offset at the discretion of the statutory actuary against liabilities of the long-term insurer. Liabilities comprise of contingent liabilities for policy benefits which have not become claimable (called “policyholder liabilities” in this directive) and current liabilities. Since the Act is silent on who, within the insurer, may exercise this power, this Office is of the opinion that the discretionary power lies with the statutory actuary. Provided that the statutory actuary and the Board of the insurer agree on the timing and the circumstances under which the Board must be informed of negative liabilities.

Negative liabilities must be calculated per policy but may then be offset in aggregate against liabilities i.e. a negative liability on (say) a term policy may be used to offset the positive liability on (say) an endowment policy.

If the statutory actuary decides not to offset the negative liabilities those liabilities may not be reflected as an insurance asset either.”