

Synergies with SAM

*Understanding the similarities
and differences between
IFRS 4 Phase II and SAM*

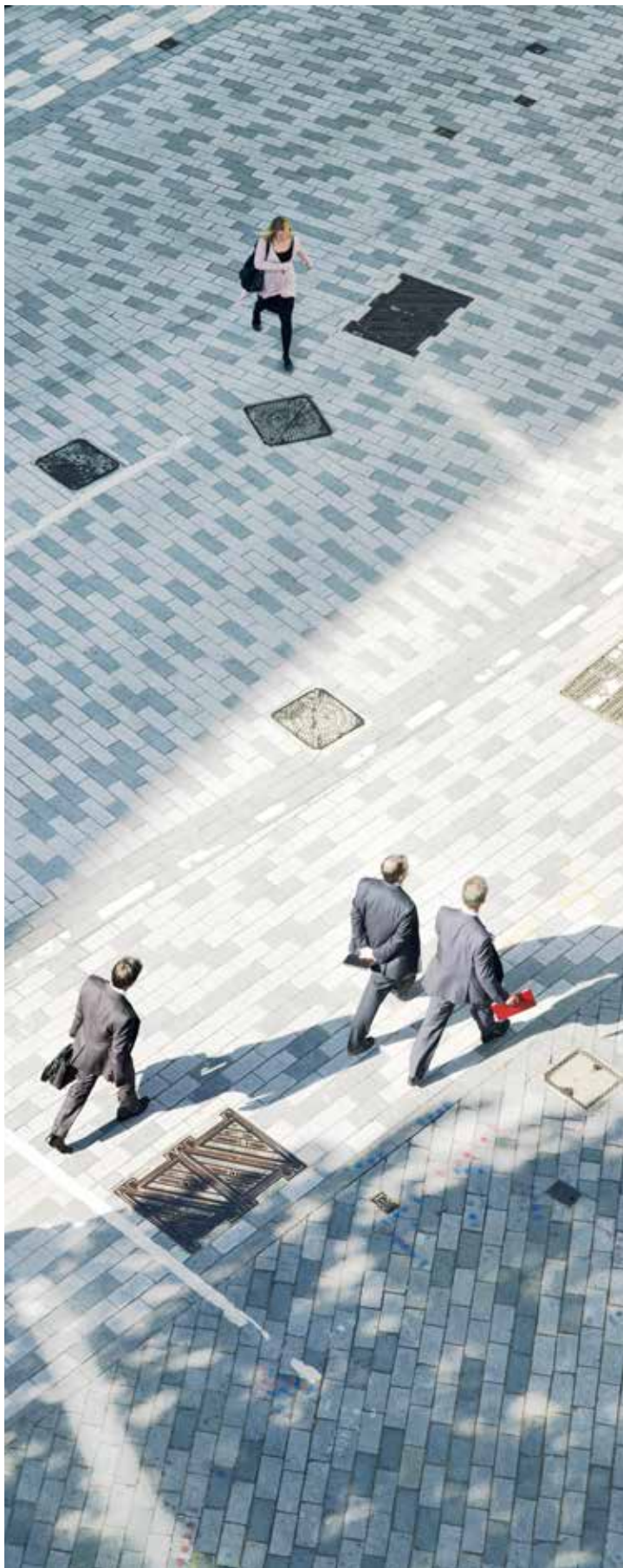


Table of contents



Introduction	4
The aim and objectives of IFRS 4 Phase II and SAM contrasted	5
An overview of the timeline for change	8
The difference in scope between IFRS 4 Phase II and SAM	10
Liability models for insurance and investment contracts	11
<i>IFRS unbundling versus SAM segmentation</i>	13
<i>Recognition</i>	14
<i>Contract boundary</i>	14
<i>Unit of account</i>	15
<i>Cash flows including acquisition costs</i>	16
<i>Discount rate</i>	19
<i>Risk adjustment/margin</i>	18
<i>Contractual service margin</i>	20
Other important differences between IFRS and SAM	21
<i>Performance reporting and analysis of change</i>	21
<i>Consolidation (IFRS) versus group supervision (SAM)</i>	22
<i>Simplified measurement approach for liability for remaining coverage</i>	23
<i>Valuation requirements for assets and other liabilities</i>	23
Contacts	25

Introduction



The regulatory and financial reporting landscape for insurers in South Africa and their global counterparts is undergoing significant change. While many question the need for change and the costs associated with it, the true competitive advantage lies in implementing the changes as efficiently as possible.

Insurers need to carefully plan how they will implement the proposed Solvency Assessment and Management (SAM) regime while at the same time dealing with proposed changes to financial reporting as part of the International Accounting Standards Board's (IASB) new IFRS standard for insurance contracts (IFRS 4 Phase II).

The insurers that are able to plan and implement an integrated approach to SAM and IFRS 4 Phase II are expected to achieve cost savings and operational benefits. The converse is true for those insurers that approach the change in a piecemeal fashion. They are likely to incur significant additional costs associated with the change and ongoing costs for operating systems which have not been built together. This publication sets out to compare and contrast the major features of the proposed SAM regime against the proposed financial reporting changes. Only once project teams are able to understand where the models are similar and where they are different can they effectively plan an integrated approach to the regulatory and financial reporting changes that are fast approaching.

Firstly, insurers need to understand what parts of their business are impacted by the proposed changes. While the changes proposed in SAM are far wider, as they cover all contracts issued by regulated insurers together with the economic value of the assets and other liabilities held by insurers and insurance groups, IFRS 4 Phase II will only impact 'insurance contracts' as defined in the accounting standards. Therefore, the reporting systems implemented by insurers need to be planned to cater for the differences that might arise from IFRS 4 Phase II changes as well as differences between other existing accounting standards and SAM.

Insurers will need to spend time to understand the differences in how technical provisions are measured under SAM as compared to IFRS 4 Phase II. While both propose the use of discounted cash-flow models, using expected cash flows adjusted for risk, significant differences exist in terms of which cash flows may be included, the time horizon over which these cash flows are measured (contract boundary), what types of risk-adjustment models may be used, and how discount rates should be determined. In particular, the proposed IFRS 4 Phase II requirement to track multiple discount rates for performance and financial position reporting will add significant complexity to insurers' systems and data requirements.

The aim and objectives of IFRS 4 Phase II and SAM contrasted

In a world of ever more change and the increasing costs associated with change, insurers need to understand the potential for taking a holistic approach to these changes.

Insurers that do not view the move to a new IFRS standard for insurance contracts in isolation from the changes occurring within the regulatory environment will in all likelihood experience:

- a decrease in costs associated with aligned projects;
- less complex and more integrated systems;
- improved overall reporting processes and a move towards integrating the proposed reporting demands into the wider financial and management reporting process; and
- improved documentation, validation and use of models.

In order to manage the changes in the current regulatory and accounting regimes optimally, organisations need to understand the similarities and differences between IFRS 4 Phase II and SAM regulations. They should also understand the similarities and differences between the current accounting and regulatory regimes and the aforementioned proposals.

IFRS

The objective of the insurance contract project is to provide a single principle-based accounting standard to account for all insurance contracts as defined in IFRS. Phase I of the project resulted in IFRS 4, 'Insurance Contracts' being issued in March 2004. However, IFRS 4 offered limited improvements in accounting for and the measurement of insurance contracts and primarily focused on enhancing risk disclosures for insurance contracts. Globally, there were still substantial differences in relation to recognition, measurement and performance reporting.

The second phase of the project focuses on enhancing the comparability of financial reporting for insurance contracts between different insurance entities, jurisdictions and capital markets. In order to achieve the desired level of comparability, the IASB decided that the project would provide an accounting model for all insurance contracts.

A proposed standard has been developed that is applicable to all insurance contracts, i.e. for the short-term and long-term insurance industries and across multiple geographies, often with different regulatory regimes.

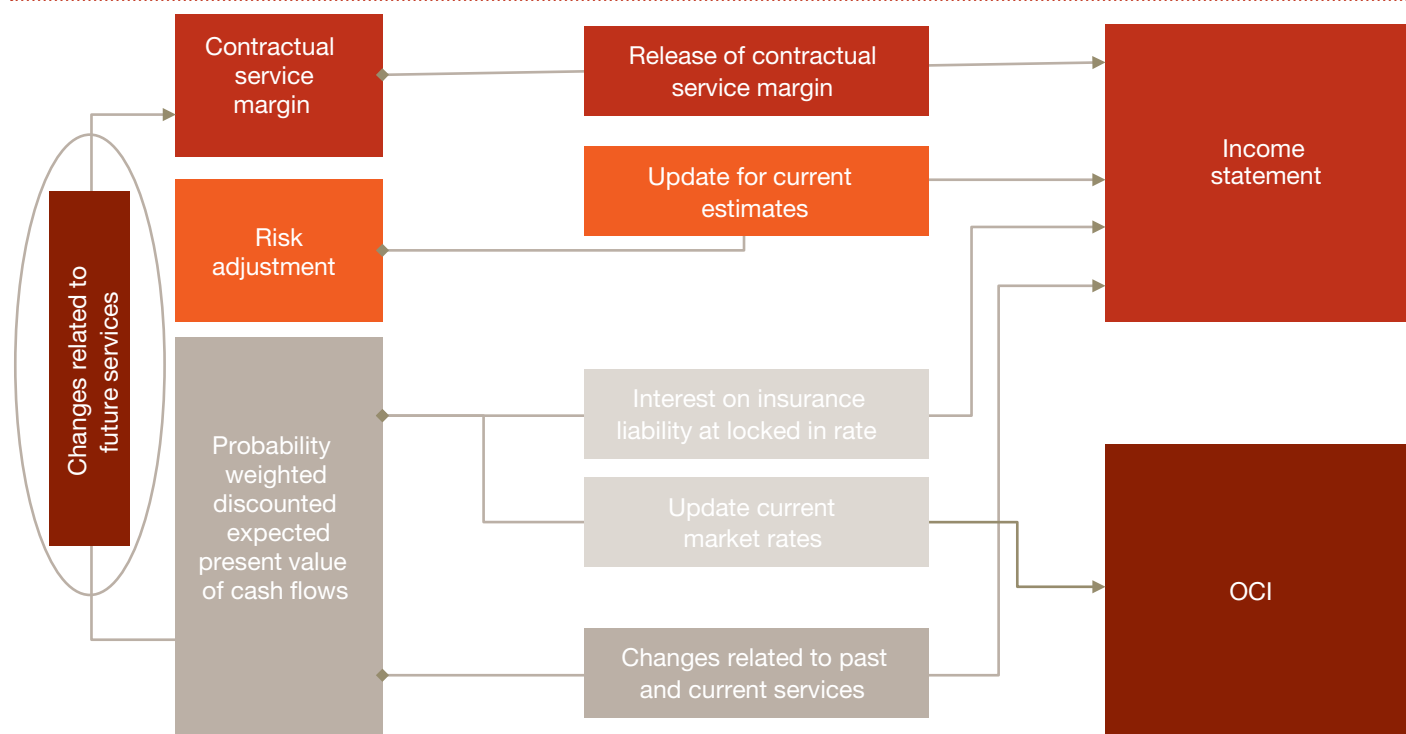
The new IFRS for insurance contracts aims to provide principles for an entity to report useful information about the nature, amount, timing and uncertainty of cash flows from insurance contracts. The IASB has determined that, for information reported about insurance contracts to be useful, that information needs to be based on a current value approach with a fulfilment objective that maximises the use of observable market information and presents the performance of the entity over time.

A current measurement model is proposed where estimates are re-measured in each reporting period. The measurement of insurance contract liability continues to be based on the building blocks of discounted, probability-weighted cash flows, a risk adjustment and a contractual service margin representing the unearned profit of the contract.

The latest proposals move away from the previous summarised margin approach for presenting performance in the income statement, in response to the request for volume information, and strives to align the presentation of revenue with that in other industries. An insurer should present as insurance contract revenue the consideration for insurance services provided under the insurance contract. As for other types of contracts with customers, the insurer would not present as revenue, amounts deposited by customers (that is, amounts repaid to policyholders even if the insured event does not occur). Insurance contract revenue is allocated to periods in proportion to the value of expected coverage and other services that the insurer provides in the period.

Figure 1 summarises how the changes in the building blocks flow into the income statement and into other comprehensive income (OCI) in shareholder's equity on the balance sheet. The changes related to future services will be recognised against the contractual service margin as long as it has a positive balance (that is, the contract is not onerous). This is explained further in the section dealing with performance reporting and analysis of change.

Figure 1 - Measurement model and link to performance reporting



Solvency assessment and management

SAM is the new risk-based solvency regime that is being developed for the South African insurance industry. The reason for this development is to align the South African insurance industry with the core principles as described by the International Association of Insurance Supervisors (IAIS) and in particular to become equivalent to the European regulatory framework and standards, known as Solvency II.

Solvency II is therefore an important reference point in terms of the determination of insurers' capital adequacy, risk governance and risk disclosure. SAM will share the main features of Solvency II. This specifically relates to the regulatory framework firstly being principles-based and secondly being based on an economic balance sheet. It also uses the same structure of three pillars:

- Pillar 1: The quantitative assessment of the assets, the liabilities and the capital requirements;
- Pillar 2: Governance and risk management framework; and
- Pillar 3: Disclosure and reporting requirements.

This document focuses on the implementation of the Pillar 1 requirements under SAM, as this addresses the measurement of assets and liabilities for regulatory purposes.

The primary purpose of the new SAM regime is the protection of policyholders and beneficiaries. However, in addition to this, the Financial Services Board (FSB) has also highlighted further objectives of SAM, being the following:

- Align more accurately the capital requirements of an insurer, given the underlying risks it is exposed to;
- Develop a risk-based regime that is proportionate, given the nature, scale and complexity of the business;
- Encourage insurers to adopt more sophisticated risk monitoring and risk management tools, such as full or partial internal capital models, and increase the use of risk mitigation tools; and
- Achieve greater overall financial stability in the South African insurance industry.

A further aim of the alignment of the South African insurance industry with Solvency II is to ultimately meet the requirements of so-called third-country equivalence, established by the European Union. However, in implementing this principle, the approach adopted by the FSB is that Solvency II must be adapted to be relevant and appropriate for the South African market context.

Since SAM will be an advanced risk-based regulatory regime that involves the deployment of significant resources and cost, the principle of proportionality will be adopted. It is envisaged that this will ensure that the compliance burden reflects the nature, scale and complexity of the risks that the insurer faces.

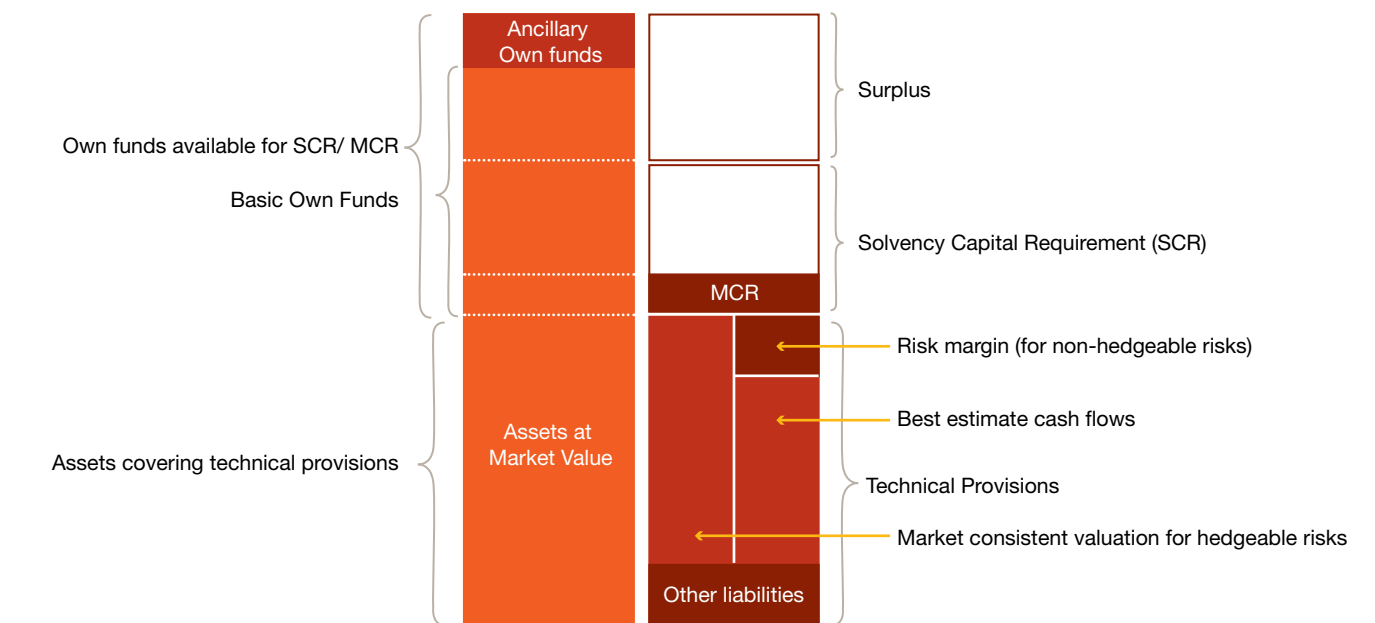
The objective of the quantitative assessment under Pillar 1 of SAM is to assess solvency. This means that the assets less the liabilities (i.e. the basic own funds) plus any further potential sources of funds are the capital resources that an insurer has at its disposal. For the insurer to be solvent, this needs to be sufficient to meet its capital requirements.

Changes in the basic own funds (similar to the net asset value/shareholders' equity of the company) provide insight into the level, trend and volatility of an insurer's solvency and also form the basis of the value-at-risk calculation used to calculate the capital requirement. As such, the calculations support the measurement of an insurer's risk exposure insofar as its solvency position is concerned.

IFRS has as its objective the requirement to provide information both about the financial position of an insurer, which is information about the insurer's economic resources and the liabilities/claims against the insurer, and about the effects of transactions and other events that change the insurer's economic resources and liabilities/claims. Both types of information provide useful input for users of the financial statements. Logically, profit reporting cannot be divorced from a solvency assessment. Profit reporting should intuitively be consistent with the drivers of net asset value for solvency assessment purposes. Nevertheless, there are aspects such as timing of profit recognition which may not be relevant to both standards.



Figure 2 – SAM pillar 1



An overview of the timeline for change

IFRS

The IASB published a second exposure draft (revised ED) setting out its near-final proposals for IFRS 4 Phase II in June 2013.

Since the first exposure draft in 2010, the IASB has made significant revisions to address the perceived 'artificial' earnings volatility reflected in the income statement under the original model. It has also attempted to achieve convergence with the US accounting standard setter (FASB), but full convergence is unlikely. The FASB recently made an important decision on the direction of the insurance contracts project, voting to narrow the scope of the project to identifying targeted improvements to US GAAP accounting for long-duration insurance contracts and considering only disclosure enhancements for short-duration contracts.

The revised ED represented what may have been the final opportunity for the industry to influence the proposed new accounting standard. It targeted five key areas, namely:

- Treatment of unearned profit in contracts ('unlocking' the contractual service margin for changes in cash flows relating to future insurance coverage);
- Contracts that have cash flows that are expected to vary directly with returns on underlying items;
- Presentation of the insurance contract revenue and expenses;
- Determining the interest expense and presentation of the effect of changes in the discount rate in other comprehensive income; and
- How to transition to the new proposals when applying the new accounting for the first time.

The IASB started its redeliberations of the five targeted areas of the revised ED in the first quarter of 2014. Currently, the timelines to complete these redeliberations and the drafting of the final IFRS 4 Phase II are unknown. It is our view that the earliest a final standard will be issued is realistically not before the first half of 2015.

Insurers also face significant changes to the classification and measurement requirements for financial instruments. The IASB is developing IFRS 9, which will replace the current IAS 39. IFRS 9 originally was effective from 1 January 2015; however, due to project delays and additional exposure of parts of the project, the finalisation of IFRS 9 is now expected to occur during the second quarter of 2014, with the standard expected to become effective 1 January 2018. The earliest possible effective date of the new insurance standard will be 1 January 2018.

SAM

Subsequent to the original announcement of the development of SAM, the FSB reviewed the original timeline for implementation in light of the changing timelines of Solvency II in Europe and consultation with the South African insurance industry. In addition, the FSB also wanted to ensure that the timetable enables insurers and the supervisor to achieve a smooth transition to the new framework.

In order to achieve a smooth transition to the new regime, two parallel runs to SAM will be held. These consist of two phases:

- The 'light' phase of the parallel run will be conducted during **the second half of 2014**. The reporting will be largely based on the third quantitative impact study (QIS 3) templates, but with simplified specifications in some areas.
- The 'comprehensive' phase will be conducted **throughout 2015**. This will consist of a full set of quarterly and annual quantitative reporting templates along with a mock ORSA exercise.

The implication of the above is that even though the full implementation of the SAM framework will only be **effective from 1 January 2016**, insurers need to be in a position to comply in essence with most of the requirements of the SAM framework by 2015 whilst complying with the current regulatory requirements.

Figure 3 - Current known timeline for SAM and IFRS

		2014 – H1	2014 – H2	2015	2016 onwards
Insurance contracts		IASB re-deliberation and issuance of final standard			Mandatory effective date 1 January 2018?
Financial instruments	Classification & measurement	IASB re-deliberation	Final standard		Effective date of 1 January 2018
	Impairment				
SAM		Compulsory SA QIS 3 Pillar II readiness follow up review	"Light" parallel run ILAB expected to be effective from mid 2014	Comprehensive parallel run	SAM effective 1 January 2016



The difference in scope between IFRS 4 Phase II and SAM

IFRS

The new IFRS on insurance contracts is only applicable to those contracts which meet the IFRS definition of an insurance contract – i.e. a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder). The definition is unchanged from the current IFRS 4; however, certain additional supporting guidance has been provided. This could have the result that some contracts no longer meet this definition and hence could potentially be accounted for under IFRS 9 in future. Therefore, entities should ensure that their policies and procedures appropriately identify all insurance contracts affected by this possible change.

The revised ED, similar to IFRS 4, scopes out contracts which meet the insurance contract definition but are issued by non-insurers, or where the accounting is specifically addressed by other IFRSs (e.g. product warranties, employee benefits, residual value guarantees in leases, etc.). An additional exclusion not currently included in IFRS 4, but which will be in the new IFRS, is 'fixed fee service contracts'. Insurers who issue these 'fixed fee service contracts' (for example, legal assistance insurance) will need to carefully consider the accounting implications of the new proposed standard for revenue recognition (expected in H1 2014) which may govern the accounting for these contracts in future.

Consistent with current IFRS, where an insurer issues a policy that does not meet the definition of an insurance contract, such a contract will continue to be accounted for as an Investment Contract, currently in accordance with IAS 39. However, once effective these contracts will be accounted for in terms of IFRS 9.

IFRS 9 will not have a significant impact on the measurement of the investment contracts, because the classification and measurement of these contracts is consistent with IAS 39. However, there may be an impact on how IFRS 9 classifies and measures the assets the insurer holds to back insurance and investment contracts. Most financial assets are expected to continue to be carried at fair value through profit or loss under IFRS 9.

SAM

The regime will apply to all licenced insurance entities that operate on a commercial basis, including government-owned insurers.

In terms of the type of business that the insurer writes, all contracts have to be considered in the SAM regime. This is irrespective of the nature of the contract being insurance, investment, a combination of these, or contracts that provide a service.

Micro-insurers will fall under the same primary legislation as insurers operating in South Africa, but will be granted very specific simplified sub-ordinate regulatory requirements.

As is the case with SAM, the micro-insurance regulations will still cover prudential and market conduct requirements, as well as governance and risk management requirements. However, the aim will be to facilitate lower underwriting and distribution costs and generally lower compliance costs.



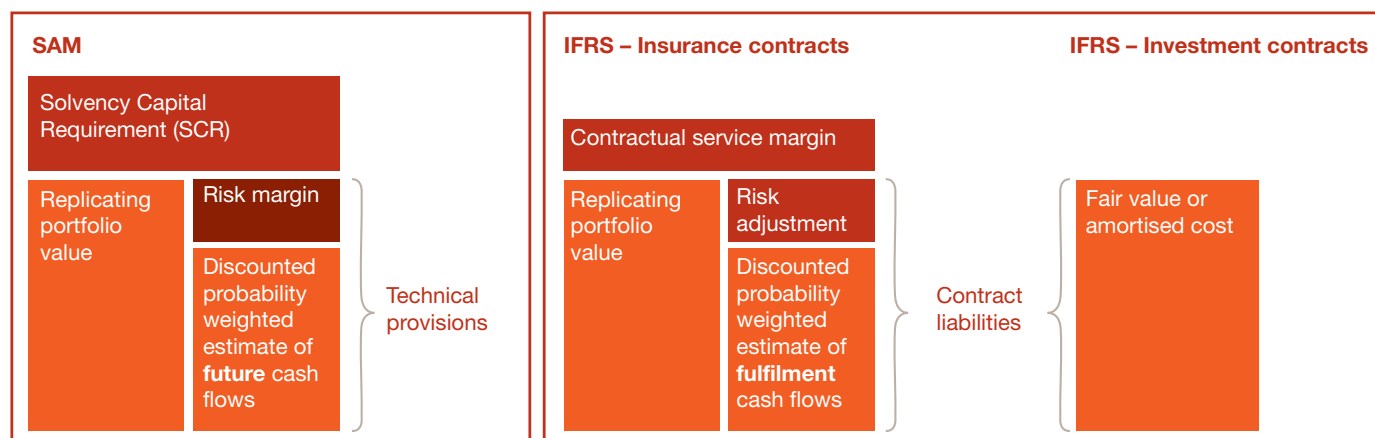
Liability models for insurance and investment contracts

The following sections deal with the differences between these frameworks insofar as it affects insurance contracts (comparing SAM technical provisions and the proposed IFRS 4 Phase II standard).

Investment contracts under IFRS can be measured either at amortised cost or at fair value, with fair value being by far the most prevalent treatment.

The model contains deferral of acquisition costs and upfront fees. Figure 4 summarises these differences.

Figure 4 – Measurement under the different liability models

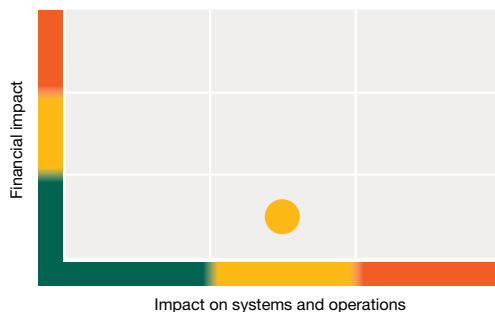


The key liability model aspects are covered in more detail in the sections that follow. A summary of the extent of differences between SAM and IFRS 4 Phase II contract liabilities is provided in the table below.

Topic	Level of differences
IFRS unbundling vs SAM segmentation	●
Which standard is applied to a contract or parts of a contract?	●
Recognition	●
At what point in time are the standards applied to an insurance contract?	●
Contract boundaries	●
Up to what point in time is the standard applied to measuring cash flows?	●
Unit of account	●
How will the definition of a portfolio affect measurement, profit recognition, etc.?	●
At what level will the various components of the liabilities be measured?	●
Cash flows including acquisition costs	●
Which cash flows are included in the measurement under each of the two standards?	●
Discount rate	●
Which discount rate will be used to discount the liabilities?	●
Risk adjustment/margin	●
What is the difference between the risk adjustment and the risk margin?	●
Contractual service margin	●
How and when is the expected profit on an insurance contract recognised?	●



IFRS unbundling versus SAM segmentation



IFRS

Once a contract has been classified as an insurance contract under IFRS 4, the standard allows insurers an accounting policy choice as to whether a deposit component was unbundled and accounted for in terms of IAS 39. Most South African insurers do not voluntarily unbundle deposit components.

Under IFRS 4 Phase II, the unbundling of investment components and other services will no longer be an accounting policy choice and insurers will have to follow the guidance provided in the revised ED.

These components will have to be unbundled where the investment component or other service component is distinct, i.e. insurance and non-insurance components are not highly interrelated.

Where the insurer determines that the investment component or the other service is distinct under IFRS 4 Phase II, they must account for the investment component in terms of IFRS 9 or the other service component in terms of the revenue recognition standard.

Where investment components are not unbundled, the exposure draft requires insurers to disaggregate the non-distinct investment components (components that are paid back to the policyholder regardless of whether the insured event happens or not – e.g. experience account balances, amounts paid on surrender, profit commissions or certain cashback bonuses) when presenting their revenue from insurance contracts. However, these components are still measured using the guidance in IFRS 4 Phase II.

The revenue presented by insurers under IFRS 4 Phase II will only represent the amount of cash received to underwrite the risk element of the contract and not the cash received for the non-distinct investment components. This will represent a significant change for many insurers whose premium revenues equalled the cash received (long-term insurers) or total expected premiums (gross written premium by short-term insurers) under a contract.

SAM

SAM categorises insurance products under different risk classes. The Financial Services Board (FSB) will authorise insurers for each class of insurance business it wishes to underwrite.

There is a link between the authorisation classes of insurance and three other elements of SAM that will depend on the category of insurance products underwritten. These are:

- the grouping of business classes for calculating technical provisions;
- the grouping of business classes for calculating capital requirements; and
- the grouping of business classes for reporting and disclosure under Pillar III.

All obligations should be allocated to one of the classes of business that the insurer is licensed to underwrite. Business should be allocated to the first segment for which it meets the requirements or that it has a material component of relating to that segment.

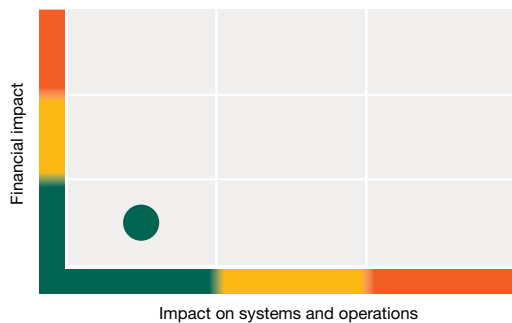
Generally, 'unbundling' may not be required where only one of the risks covered by a contract is material. In this case, the contract may be allocated according to that main risk. However, where a contract covers risks across the different classes of business, insurance obligations for these contracts should be 'unbundled' into the appropriate classes of business.

Some of the segments relating to life insurance products under SAM relate to both an investment and a risk component. There is no need under SAM for a different treatment of these products, or to split these products for the purposes of calculating the value of the technical provisions.

While certain products, e.g. financial instruments **without** discretionary participating features, will not be subject to the requirements of IFRS 4 Phase II, but rather IFRS 9, SAM is a regulatory framework for all contracts issued by the insurers operating in the South African market.

SAM is not limited to the definition and the nature of insurance and insurance-related contracts, but to the entire business as a whole, since the financial soundness of the legal entity is being considered. Therefore, to the extent that an insurer is involved in non-insurance-related businesses, these still form part of the assessment and calculation requirements under SAM.

Recognition



IFRS

Insurance contracts are recognised under the exposure draft at the earlier of the beginning of the coverage period, the date on which the first payment is due from the policyholder, or the date on which the portfolio that the contract forms part of becomes onerous.

The above requirement represents a change from the first exposure draft, which required insurance contracts to be recognised when the insurer first became a party to the contract. The IASB decided to amend the recognition point because of informational challenges insurers would face in determining when they first become party to a contract. This would be especially prevalent in an intermediary/broker model where the intermediary/broker has the authority and binds the insurer/reinsurer before the coverage period commences.

SAM

Under SAM, contracts are recognised when the insurer first became a party to the contract. That means it is consistent with the first exposure draft of IFRS 4 Phase II.

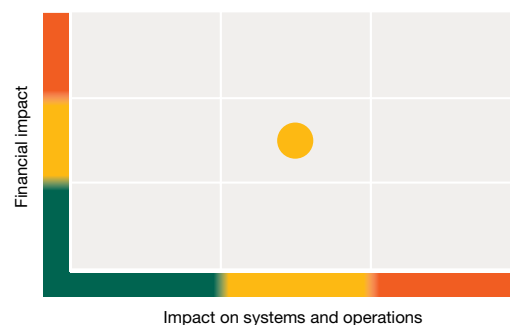
When the solvency is assessed and reported on at any point after this contract effective date, the liabilities and capital requirement pertaining to this contract have to be considered.

It may happen that a contract never becomes effective, due to non-payment of the first premium due (policies “not taken up”) or policyholders exercising their right to cancel during the “cooling-off” period. The policy is still considered in the solvency assessment with the appropriate adjustments, given the possibility of an early cancellation.

Whereas under IFRS 4 Phase II pre-paid premiums are recognised with the portfolio of liabilities to which they would apply, SAM recognises these as current liabilities.

The implication is that assumptions around policies not taken up or initial lapse rates may have an impact on SAM liabilities, but would have less of an effect on IFRS results.

Contract boundary



IFRS

An insurance contract is measured and recognised under the exposure draft over the coverage period. The coverage period is defined by the contract boundary.

The boundary of a contract represents the point beyond which any cash flows relating to the contract are no longer recognised in the measurement of the liability. Those cash flows within the contractual boundary need to be taken into account in determining the current value of the insurance contract, whereas those cash flows occurring outside the contract boundary may not be included in the contract’s measurement.

Under the revised ED, the contract boundary ends where the insurer’s substantive obligation to provide coverage ends, i.e. when the insurer has a practical ability to reassess the risk of the particular policyholder and re-price the contract to reflect the aforementioned risk, or the insurer has the practical ability or right to reassess the risk at a portfolio level and the pricing does not take into account the risks of future periods.

The ability to re-price at a portfolio level was included in the revised ED to ensure that, for example, medical schemes that utilise annual community underwriting practices have an annual contract boundary. If this amendment was not proposed it would have required such entities to model their cash flows over a much longer contract boundary where the scheme, as is the case in South Africa, does not have the ability to underwrite at the individual policyholder level.

The definition contained in the revised ED will not allow insurers to build their re-pricing expectations into the measurement. The contract boundary ignores the individual insurer’s intentions as to re-pricing; rather, the test objectively asks the insurer to determine at what point it has the right to re-underwrite individual contracts.

SAM

SAM generally adopts an economic approach to the setting of contract boundaries. In principle, this is consistent with Solvency II. However, the interpretation and application of what is deemed to constitute an economic approach differ.

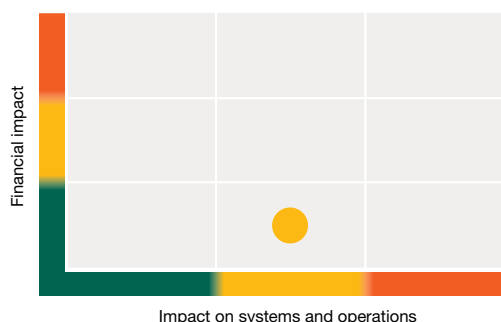
The general principle followed is that the boundary of a contract is the point at which the insurer has a unilateral contractual right to amend the premiums or the benefits payable under the contract in such a way that the premiums fully reflect the risks. The change would thus be such that the insurer can fundamentally change the risk it underwrites.

Although the boundary principles in the two frameworks are similar, there will be differences for certain contracts. QIS 3 provides further product-specific guidance on the contract boundaries for linked and reinsurance contracts. A short contract boundary will be applicable for policies that meet the following features:

- No guarantees on any benefit payments, whether on surrender, maturity or death;
- No guarantees on charges that the insurer may apply to the policyholder; and
- Where the assets held by the insurer are directly linked to the value of the benefit payable to the policyholder (linked contracts).

For reinsurance contracts, the ability for reinsurers to review the conditions of a reinsurance contract, and whether this will result in the termination of the contract, is highlighted as the determining feature of where the contract boundary ends under SAM.

Unit of account



IFRS

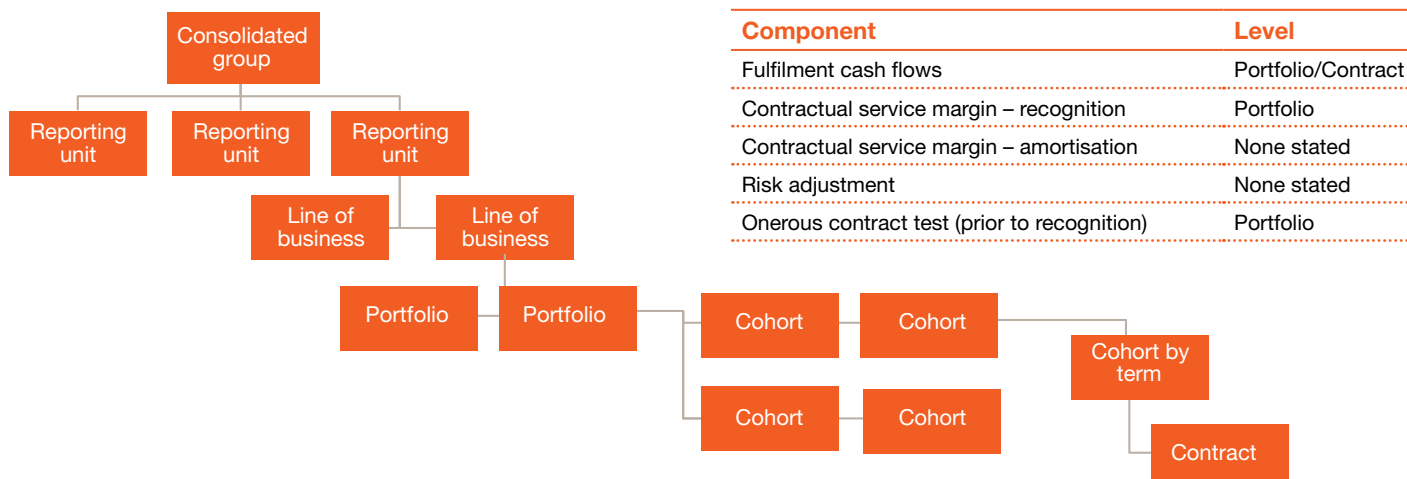
The exposure draft on insurance contracts includes more than one unit of account that preparers need to be aware of (Figure 5). The proposed IFRS standard is designed to measure and report on the performance of insurance contracts. For many of the principles contained in the revised ED, the unit of account is the individual insurance contract, e.g. recognition of an insurance contract begins when the coverage period on a contract starts.

However, many of the principles are applied at the level of a portfolio of insurance contracts. For example, the date of recognition is brought forward where the contract is included in an onerous portfolio.

The exposure draft provides a definition of a portfolio, being a group of insurance contracts that provide coverage for similar risks and that are priced similarly, relative to the risks taken on, and the insurer manages these as a single pool.

The determination of portfolios will be a significant area of accounting judgement and debate. The significance of the judgement is increased, because while the contractual service margin is set at portfolio level, the unit of account for release of the contractual service margin (and the pattern of service) is not specified. The Basis for Conclusions to the revised ED seems to suggest a lower, more granular level (i.e. by cohort).

Figure 5 – IFRS 4 Phase II unit of account



Insurers that define a portfolio very broadly could potentially cushion the impact of writing onerous business in the current year by including these contracts in a previous profitable portfolio of contracts. This may avoid or delay the recognition of onerous contracts.

Similarly, the exposure draft does not specify at what level the risk adjustment added to the mean best-estimate fulfilment cash flows should be calculated. Hence, the extent to which diversification benefits are taken into account will differ between different insurers. However, insurers need to comply with the objective of the risk adjustment.

The application of the portfolio definition is important, as it will affect the contractual service margin, day one loss recognition and the ongoing onerous contract test for contracts under the simplified approach (Premium Allocation Approach, or PAA). The ISAB has attempted to define a portfolio in a way that is clear enough so it can be applied without being overly prescriptive.

However, this remains a judgmental area that may have different interpretations in practice.

SAM

SAM stipulates that the technical provisions need to be determined per line of business, as defined under SAM's segmentation rules. Besides the definitions of classes and subclasses of business, there is no further definition of a portfolio of business.

The overhead expenses need to be allocated to each line of business that the insurer is licensed to underwrite. The way this needs to be done is not prescribed.

The risk margin is determined as a global calculation, since it is driven off the solvency capital requirement (SCR). As is the case for overhead expenses, this also needs to be allocated per line of business.

When splitting the risk margin per line of business, it must also allow for diversification between lines of business. Consequently, the sum of the risk margin per line of business should be equal to the risk margin for the whole business. The allocation of the risk margin to the lines of business should be done according to the contribution of the lines of business to the risk margin.

A simplified pragmatic approach may be adopted for this allocation process.

Cash flows including acquisition costs



IFRS

The revised ED requires each insurance contract to initially be measured at either nil value for contracts which are expected to be profitable, or the expected loss, in the case of onerous contracts. The section on the 'Contractual service margin' provides more detail on how the profit element is released to profit or loss.

The calculation of the contractual service margin and value of an insurance contract under IFRS 4 Phase II is driven by what cash flows are included versus those which are excluded.

The expected cash flows used in measuring the insurance contract will be the mean expected cash flows expected to occur up to the contract boundary.

The cash flows include the insurer's mean estimate of:

- Premiums – including premium adjustments and lapses;
- Payments to policyholders – e.g. claims;
- Acquisition costs – see below for further details;
- Claims-handling costs – costs attributable to processing and resolving claims;
- Any benefit or claim paid in kind;
- Cash flows from embedded options and guarantees;
- Policy administration and maintenance costs;
- Transaction-based taxes;
- Withholding taxes paid on behalf of policyholders;
- Potential salvage and subrogation recoveries; and
- Fixed and variable overheads where they are directly attributable to fulfilling the portfolio.

It is expected that the allocation of overhead costs will be a significant area of difference between IFRS 4 Phase II and SAM, because IFRS 4 Phase II is explicit that cash flows relating to costs that cannot be directly attributed to a portfolio of insurance contracts, such as product development and training, may not be included in the measurement of insurance contracts. It is expected that these costs would be included as part of the cash flows used for SAM technical provisions.

Acquisition costs

Another area where significant difference is expected is the treatment of acquisition costs. Under SAM, acquisition costs are expensed as incurred, whereas IFRS 4 Phase II in effect allows for the capitalisation of these costs.

The initial measurement of an insurance contract under the revised ED requires the insurer to include its directly attributable acquisition costs as part of its fulfilment cash outflows, thus effectively reducing the contractual service margin (unrecognised expected future profits).

A significant change from the earlier exposure draft is that this attribution now occurs at a portfolio level and no longer applies only to incremental costs at contract level.

Therefore, as the insurer accrues for the directly attributable acquisition costs relating to an insurance contract, it reflects these payments as an adjustment to the current value of the insurance contract, i.e. the directly attributable acquisition costs are capitalised into the insurer's overall measure of its insurance contract portfolio.

The implication is that negative liabilities will be recognised, but only to the extent that they are held in respect of directly attributable acquisition cost paid in excess of any premium received for the contract. It is important to note that this negative liability would only occur at a point following initial recognition, after the acquisition cost included in the model has been paid.

SAM

The expenses allowed for in the calculation of the technical provisions should include both overhead expenses and expenses which are directly assignable to individual claims, policies or transactions.

Overhead expenses include, for example, expenses which are related to general management and service departments which are not directly involved in new business or policy maintenance activities and which are insensitive to either the volume of new business or the level of in-force business. Overhead expenses may also include costs incurred in starting up a new insurer.

The allocation of overhead expenses to lines of business, homogeneous risk groups or any other segments of the best-estimate liabilities should be done on an economic basis, following realistic and objective principles.

Although the methodology to be applied is not prescriptive, it is clear that under SAM the acquisition costs that are not directly attributable to the portfolio must still be allocated.

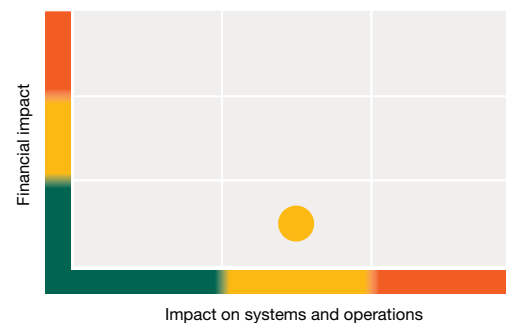
For non-life insurance obligations, the insurer should allocate expenses between premium provisions and claims provisions on an economic basis.

SAM does not capitalise any of the attributed acquisition cost, but does allow insurers to recognise negative liabilities. In this way, allowing negative provisions for contracts also reflects any loading in charges/premiums in respect of the recoupment of upfront costs.

For pure linked business, SAM would apply a short contract boundary. This implies that any recognition of expected future charges to defray upfront cost cannot be allowed for in the liability measurement, and neither would upfront costs be capitalised. Where these contracts have significant upfront acquisition costs, it would result in new business strain on a regulatory basis.

These contracts would be treated as investment contracts with investment management service (IMS) elements under IFRS 9 and the new revenue standard. IMS fees will in essence be recognised as the services are rendered, and it is expected that the new revenue standard will allow for the capitalisation of certain acquisition expenses at the contract level.

Discount rate



IFRS

The future cash flows are discounted to reflect the time value of money of the insurance liability. The discount rate reflects the characteristics of the cash flows for the insurance liability, which means that the discount rate is consistent with the cash flows (like currency and liquidity) and excludes effects that are not present in the cash flows. The discounting will usually be based on the use of interest rate curves instead of single rates.

If the extent, timing or uncertainty of cash flows from insurance contracts depends wholly or partially on returns from underlying items (like an asset portfolio), then the discount rate reflects that dependence. IFRS 4 Phase II therefore allows significantly more discretion on what discount rates are to be used, but does require additional disclosure around the adjustments.

In determining a discount rate, insurers have discretion as to whether a top-down or bottom-up approach is used. Regardless of the approach adopted, the discount rate calculated must exclude the credit risk specific to the insurer ('own credit risk').

In the top-down approach, an insurer can identify a discount rate on a replicating portfolio and deduct the elements not included in the liability, such as credit risk. The proposals do not specify restrictions to the actual portfolio of assets that the insurer holds or the reference portfolio of assets used to determine the discount rate if a top-down approach is adopted. The insurer's own credit risk is explicitly excluded from any discount rate determined to value cash flows.

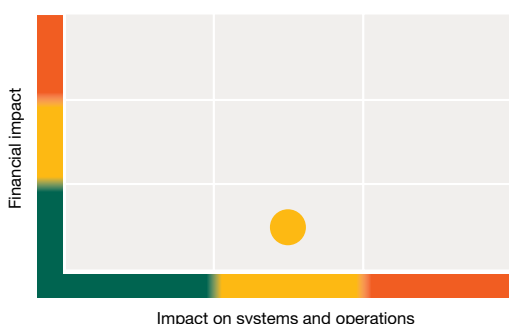
In the bottom-up approach, differences in liquidity characteristics arise when insurance liabilities do not have the same liquidity characteristics as assets that are traded in financial markets.

SAM

For QIS3, insurers were given the option to allocate a risk-free rate to a portion of liabilities. The two options available are the swap and bond yield curves. These curves are supplied by the FSB. Insurers' choice around which rate to apply to a portfolio of liabilities is restricted to an upfront choice. The approach could be seen to be similar to the bottom-up approach considered for IFRS, but without an allowance for an illiquidity premium.

For portfolios where there is a direct link to the underlying returns on assets, IFRS 4 Phase II explicitly acknowledges that the current value of the asset pool referenced is the present value of discounted cash flows, irrespective of the rate assumed. This is not stated as explicitly in SAM, but it is expected that a similar approach would be followed for these contracts under SAM.

Risk adjustment/margin



IFRS

The building blocks used for the measurement of insurance contracts require that the fulfilment cash flows are the best estimate (statistical mean) of the cash flows expected under the contract. Therefore, the fulfilment cash flows do not reflect a most-likely outcome or a more-likely-than-not outcome. Rather, the cash flows are an unbiased estimate of the expected outcome.

The outcome produced by applying the above principle provides a risk-neutral measurement of an insurance contract. However, insurers (to varying degrees) require compensation for exposure to an insurance contract with a wide range of possible outcomes compared to a liability with fixed cash flows. This adjustment is made such that the insurer is indifferent as to assuming an uncertain insurance obligation when compared to a certain obligation with the same mean cash flows. The extent of the adjustment is intended to be a reflection of the value that an individual insurer would expect as compensation for managing uncertain cash flows, specific to the risk appetite of the insurer's management.

The exposure draft does not prescribe the method that should be used to calculate the risk adjustment. However, any risk adjustment is required to have the following characteristics:

- Risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity.
- For similar risks, contracts with a longer duration will result in a higher risk adjustment than contracts with shorter durations.
- Risk with a wide probability distribution will result in higher risk adjustments than contracts with a narrower distribution.
- The less that is known about the current estimate and its trend, the higher the risk adjustment.
- To the extent that emerging experience reduces uncertainty, risk adjustments will decrease, and vice versa.

The methods that could be employed include, but are not limited to, the following:

- adding margins so as to arrive at a pre-determined confidence level, where the risk adjustment is the difference between the liabilities valued at a set percentile and at their best estimate;
- a cost-of-capital approach, where the risk adjustment is equivalent to the cost required to set up and maintain capital to support the non-hedgeable risks to which an entity is exposed;
- a conditional tail expectation (CTE), where the risk adjustment is determined as the expected loss suffered due to the occurrence of an event outside of a specified probability level;
- or even the use of a replicating portfolio, where the best-estimate liability and the risk are reflected in the observable value of replicating assets.

The exposure draft states that an entity must apply judgement when determining the risk adjustment technique used.

The merits of the methods are compared in the table below.

Method	Pros	Cons
Confidence level	Straight-forward calculation	Does not make appropriate allowance for loss distributions with fat tails
Cost-of-capital	Used for pricing and valuation, and prescribed by SAM	Actuarially complex calculation
Conditional tail expectation	Better reflection of extreme losses	Judgement required in determining confidence band
Replicating portfolio	Straight-forward calculation if replicating assets with observable market values are available	Difficulty in disaggregating the best-estimate cash flows, time value of money, and risk adjustment components

The specification of the portfolio as the unit of account for other components of the liability measurement does mean that the risk adjustment would need to be allocated to portfolios of liabilities, even if it is calculated at a more or less granular level. This specification complicates the use of the replicating portfolio approach, as the replicating portfolio does not necessarily reflect the unit of measurement which is to be applied when measuring insurance liabilities.

Regardless of the method used by management in measuring insurance contracts, insurers will have to translate (and disclose) the risk adjustment presented into a confidence level which is intended to aid the users of financial statements in benchmarking an entity's performance against that of its peers.

The additional disclosure requirements when using a confidence level (and conditional tail expectation) approach are simple and easily communicable. The cost-of-capital and replicating portfolio approaches necessitate more careful consideration when arriving at the confidence level disclosed.

Diversification benefits are implicitly allowed for within the portfolios of insurance contracts. It will therefore be crucial to inform the user of financial accounts about further diversification benefits between different portfolios of insurance contracts and the extent to which this was considered in setting the risk adjustment.

The risk adjustment will be determined separately on gross and reinsurance contract obligations.

SAM

SAM uses a similar argument to IFRS as to why an additional provision is required over and above the best-estimate liabilities. A risk margin is added to the best-estimate liabilities in calculating the technical provision. Technical provisions are equivalent to the amount a willing buyer would be expected to pay a willing seller in order to take over and meet its insurance obligations, where the willing buyer is assumed to be a reference entity with no other existing liabilities. This would mean that insurer-specific views are not incorporated in the same way as for the IFRS risk adjustment.

The risk margin should be calculated by determining the cost of providing an amount of eligible own funds equal to the SCR necessary to support the insurance and reinsurance obligations over the lifetime of the obligations. (The SCR referenced here does not allow for any market risks that can be mitigated.) The rate used in the determination of the cost of providing that amount of eligible own funds is known as the cost-of-capital rate and is set at 6%. This rate does not only allow for the opportunity cost, however, but also for the frictional and related costs of having to hold a solvency capital requirement.

Diversification benefits are allowed at an undertaking level, but not at a group level.

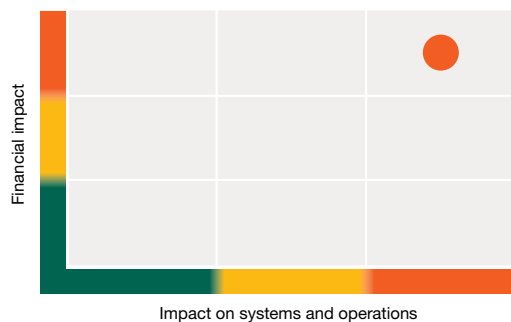
SAM does allow a number of simplifications to the prescribed approach. The range of simplifications makes for a significant difference in the unwinding of the risk margin over the term of a contract or portfolio of contracts.

Even if the cost of capital approach and rates were adopted to calculate the risk, the following aspects would result in differences:

- Different cash flows, e.g. indirect expenses
- Different discount rates
- Different capital requirements, e.g. due to diversification benefits.

It is important to note that both of these quantities are affected by variations to experience as well as assumption and methodology changes. In addition, the risk margin would also be informed by the remaining level of uncertainty around cash flows and the extent to which insurers reflect that in the reporting of liabilities.

Contractual service margin



IFRS

The objective of the proposed insurance contract standard is to reflect the recognition of insurance contract revenue over time as the insurer provides services to the policyholder. In order to achieve this objective, the IASB requires insurers to calculate a contractual service margin (CSM) which represents the insurer's best estimate of the profits it expects to earn over the contract coverage period, i.e. the excess of cash received compared to the risk-adjusted fulfilment cash flows.

The original exposure draft required the insurer to set and lock in the contractual service margin (previously referred to as the 'residual margin') on initial recognition, and amortise the margin to profit or loss on the basis of passage of time or on the basis of the expected timing of incurred claims and benefits. Changes in cash estimates would be recognised in the income statement when these occurred.

This method was rejected by many constituents of the IASB, as it introduced income statement volatility for estimation risk. For example, a negative change in expected cash flows would be recognised in the income statement, even though an unrecognised contractual service margin remained for a contract.

Under the revised ED, the IASB has proposed that the contractual service margin should be unlocked for changes in the insurer's best estimate of fulfilment cash flows relating to future coverage.

The revised ED currently allows an insurer to recognise the contractual service margin over the coverage period in a systematic way that reflects the pattern of transfer of services. This will be an area of significant judgement for insurers to ensure that the pattern of profit recognition is appropriate for products. Different judgements could result in a potential lack of comparability between insurers. However, to guard against the threat of reduced comparability, the revised ED will require disclosure of the above judgement and a full reconciliation of the opening to closing contractual service margins.

When considering the release of the contractual service margin, the unit of account used would also be relevant, as it drives the level at which the contractual service margin is applied.

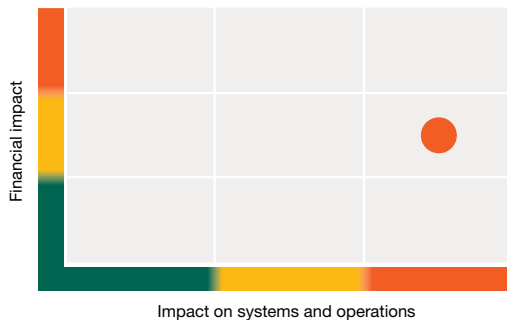
SAM

Since SAM uses an economic approach, there is no deferral of profits in the way technical provisions are calculated. Provisions are determined on a best-estimate basis with a risk margin added to obtain a market-consistent value of the provisions.

Changes to best-estimate assumptions could result in significant differences between the two bases, depending on the extent to which these can be absorbed by the contractual service margin as well as the pattern whereby these changes are introduced. The regulatory basis would always result in the full impact being reflected in changes to basic own funds.

Other important differences between IFRS and SAM

Performance reporting and analysis of change



IFRS

A primary focus of the insurance contract project is to present performance information.

Performance information will be presented through the following drivers:

- Insurance contract revenue and claims in the income statement;
- Changes in discount rates through OCI or, in certain cases, the income statement, for example:
 - Using mirroring for participation contracts,
 - Unwinding of the day-one locked-in discount rate, and
 - Accretion of interest on the CSM;
- Experience variances through the income statement; and
- Assumption changes through adjusting the CSM.

Presentation of premiums and claims information in the income statement

The original ED proposed that insurers should present the results of their insurance contracts using a summarised margin approach. This approach would summarise all cash flows associated with insurance contracts into a net result (showing separately the change in risk adjustment and the release of the contractual service margin). Under the summarised margin approach, no information about volumes of premiums and claims would be presented in the income statement.

Globally, non-life insurers indicated to the IASB that the summarised margin approach would result in key information no longer being presented to users. As a result, the IASB proposed in the revised ED an 'earned premium approach'.

One of the key challenges with the 'earned premium approach' is that it requires the insurer to exclude from insurance

contract revenue (premiums) those cash flows that have been received in respect of investment components that have not been unbundled, i.e. the investment component has been disaggregated but measured as part of the insurance contract. Therefore, while the 'earned premium approach' will provide volume information in respect of premiums and claims, this information is likely to differ significantly from premiums and claims currently reported.

In addition to the requirement to present premiums using the 'earned premium approach', the insurer is required to reconcile the opening insurance contract liability (or asset) to the closing insurance contract liability (or asset) per measurement component, i.e. changes in cash flows, contractual service margin, and the risk adjustment.

Presentation of changes in discount rates

While the discount rate applied in measuring insurance contracts on the insurer's statement of financial position is a current discount rate, the IASB has included a requirement that the release of the contractual service margin and the contractual service margin must be based on a 'locked-in' discount rate that applied on recognition of the insurance contract. In effect, two discount rates will apply, with the change in discount rates being presented outside of the income statement through 'other comprehensive income'. This use of dual discount rates is expected to create significant system challenges to track and recognise cash flows using multiple discount rates.

SAM

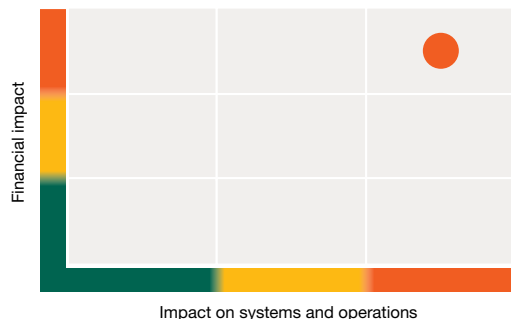
Although a key objective of SAM is to determine solvency on an economic basis, it is currently proposed that an analysis of change from one period to another be reported on and disclosed.

This will include:

- An analysis of the movement in basic own funds and the drivers for changes, in total and disaggregated, for example demographic assumption and experience changes as well as economic changes; and
- A reconciliation between basic own funds under SAM and the net assets under IFRS.

In the current IFRS 4 environment where existing accounting policies are applied, this will be challenging. Going forward with the adoption of IFRS 4 Phase II, the analysis of change and reconciliation exercises will have to be revised, given the difference between IFRS 4 Phase II and existing accounting practices.

Consolidation (IFRS) versus group supervision (SAM)



IFRS

IFRS 10, 'Consolidated financial statements', introduced new guidance on control and consolidation. The key principle in the new standard is that control exists, and consolidation is required, only if the investor has power over the investee, exposure to variable returns from its involvement with the investee and the ability to use its power over the investee to affect its returns.

IFRS requires an insurer (a parent) to prepare consolidated financial statements where it controls one or more investees (subsidiaries). The consolidated financial statements set out to present the financial position, financial performance and cash flows of the consolidated group as if the parent and its subsidiaries are one reporting entity.

The consolidation conclusion is not expected to change for most 'straightforward' entities. However, changes can result in complex cases.

The 'group' is defined in IFRS 10 to mean "a parent and its subsidiaries". The financial statements of a parent and its subsidiaries must be presented as a single economic entity. This means that the consolidated financial statements are presented as though the parent entity investors, and the other non-controlling investors in partially owned subsidiaries, have similar economic interests in a single entity. Non-controlling interests are, therefore, viewed as having an equity interest in the consolidated entity.

The income statement arrives at the profit or loss for the financial year and requires that the profit or loss be analysed between profit attributable to non-controlling interest and profit attributable to equity holders of the parent.

The share of non-controlling interest of the results for the year is shown as an allocation of group profit and not as a deduction in arriving at the profit or loss for the financial year.

The consolidation process combines the parent and its subsidiaries, using uniform accounting policies for similar transactions and adding together items of assets, liabilities, equity, income and expenses. Intra-group balances, transactions, income and expenses must be eliminated in full.

SAM

Under the current SAM proposals, an insurance 'group' exists where there are two or more entities of which at least one is an insurer and one has significant influence (broadly following IFRS guidance) on the insurer. Significance of influence is determined based on criteria such as participation, influence, and interconnectedness, risk exposure and intra-group transactions. These criteria are different to those applied under IFRS.

The deduction aggregation (DA) method must be used as the default approach under SAM. The DA method calculates the group solvency as the difference between the sum of the aggregated own funds in the group and the aggregated solvency capital requirements in the group.

The process for 'subsidiaries' is to fully combine the information of the parent and its subsidiaries. For 'associates', the insurer accounts for its rights and obligations by recognising its share of any assets, liabilities, income and expenses (proportionate consolidation).

For the assessment of group solvency, the capital adequacy on a group-wide basis should adjust for forms of intra-group transactions, including internal participation structures and intra-group transfers of capital and risks.

However, insurance groups will be allowed to use the accounting consolidation (AC) method, which is consistent with IFRS. This will require approval by the FSB, though.

Insurance groups may also be allowed to use a combination of the DA and AC methods, which allows for diversification between group entities included under the AC part. Again, this will be subject to prior approval being granted by the FSB.

It is furthermore proposed under SAM that there should only be allowance for diversification between South African insurance participations regulated under SAM where the AC method is used, and that group diversification benefits for insurance participations in non-equivalent jurisdictions should not be included.

The latter implies that all insurance participations in non-equivalent jurisdictions should be included when using the DA method.

Simplified measurement approach for liability for remaining coverage

The revised ED proposes an optional simplified approach for measuring the liability for remaining coverage for certain contracts (the ‘premium allocation approach’ or ‘PAA’). Under the PAA, the liability for incurred claims is recognised according to the building blocks approach (BBA); however, it does not have to be discounted if the cash flows are expected to occur within a year after the claim is incurred. The PAA is allowed to be used if the measurement of the liability for remaining coverage is a reasonable approximation of the BBA or if the coverage period is one year or less.

The measurement of the liability for remaining coverage would not be a reasonable approximation if, at inception, the entity expects significant variability in the fulfilment cash flows before a claim is incurred. This will be the case if the coverage is for a long period of time or the contract includes embedded options or other derivatives.

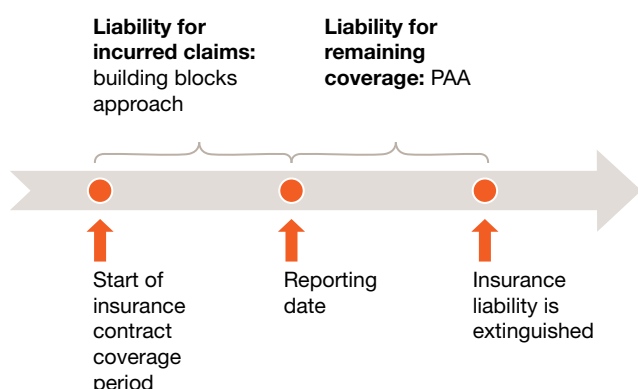
The PAA is likely to apply to non-life insurers with short-duration contracts. However, many life insurers will also be able to apply the PAA to certain contracts such as employer-provided group business.

The PAA is permitted, rather than required, which provides composite insurance groups who write both life and non-life insurance with the ability to apply one model for all insurance contracts. For those entities that do want to apply the PAA, it may be unclear in practice how an entity would go about proving that the PAA is a reasonable approximation to the BBA.

Some insurers in the non-life industry have expressed concern that the requirement in the PAA to use a locked-in interest rate at the time of inception of the policy, rather than at claim inception, may require segmenting claims data based on contract inception cohort (in addition to the more widely kept loss or accident date from which claims liabilities are usually calculated).

There is not a similar simplification under SAM.

Figure 6: Premium allocation approach



Valuation requirements for assets and other liabilities

The following section highlights some material differences between IFRS and SAM valuation requirements for certain assets and other liabilities, as well as for some of the items where fair value was not considered to be the most appropriate manner for measuring other assets and liabilities in the SAM balance sheet.

Given that the SAM proposals will require insurers to explain and be able to reconcile the differences between IFRS and SAM, it is important to understand what the proposals are, what the implications for the SAM balance sheet will be and how these proposals differ from IFRS.

General approach

The basis to valuing assets and liabilities is that of an economic, market-consistent approach under SAM. Unless otherwise stated, all assets and liabilities other than technical provisions should be valued in conformity with IFRS, as they are considered a reasonable proxy of the economic valuation principles under SAM. A relatively simple concept, but one which creates a number of issues.

There has been significant progress in creating a common framework for the calculation of fair value under IFRS. IFRS 13, ‘Fair value measurement’, is effective for periods beginning on or after 1 January 2013, and its implementation should allow preparers and users to become more comfortable with the consistent application of fair value principles.

‘Fair value’ is the price that would be received when selling an asset or paid when transferring a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price). The best test of fair value is an orderly transaction between market participants. The absence of this could lead to complex and subjective valuations.

Given the subjectivity of certain valuations, a debate has already started on IFRS 13, and additional guidance is being developed. One of these items is the IASB’s educational material to assist preparers in applying IFRS 13 when measuring the fair value of unquoted equity instruments. Another matter that has been raised is the appropriate unit of account for a significant holding in an instrument which trades in an active market.

There are, however, departures from the principle of fair or economic value under SAM. In determining these departures, concepts such as proportionality and consistency are considered.

Participations

Participations mean the ownership, directly or by way of control, of 20% or more of the voting rights or capital of an undertaking. Investments in subsidiaries, associates and joint ventures are typical examples of participations.

It is, however, proposed that investments in collective investment schemes (CISs) and asset holding intermediaries (AHI) be excluded from participations under SAM, as the investments underlying these entities will be fair valued.

IFRS currently allows a policy choice (i.e. cost or at fair value) in valuing subsidiary or associate investments. The recommendation for SAM is a mark-to-market or a mark-to-model approach to derive the economic value. Participation in insurance, financial and credit institutions or reinsurance companies is still under discussion.

Given the higher degree of judgement involved, especially when participations are marked-to-model, additional governance requirements are proposed such as independent reviews, as well as disclosure of valuation techniques and assumptions.

Deferred tax

The current recommendation is that deferred taxes should be recalculated for the SAM balance sheet values. Deferred tax would be calculated in accordance with the principles contained in IFRS (IAS 12, 'Income taxes') on the temporary difference between the carrying values of assets and liabilities in the SAM balance sheet and the related tax base.

The use of an IFRS principle for deferred tax is a departure from the fair value concept. The most obvious example of this is that deferred tax for IFRS is an undiscounted amount.

The advantages of using IFRS principles of calculation are that they are well defined and understood. Deferred tax assets are, however, subject to an extra requirement to test for recoverability, which allows for deferred tax assets only to the extent it is considered probable that taxable profits will be available against which the asset can be utilised.

The allowance of deferred tax assets would be a significant change, as they are not allowed under the current regulatory regime, but would be consistent with the Solvency II proposals.

Intangible assets and goodwill

Intangible assets such as software or customer relationships have to meet stringent requirements before they can be recognised as assets. The current recommendation is that intangible assets should be separable to be considered for SAM recognition.

IFRS on intangible assets is considered to be a good proxy if, and only if, the intangible assets can be recognised and measured at fair value as per the requirements set out in IAS 38: 'Intangible assets'. The intangibles must be separable and there should be evidence of exchange transactions for the same or similar assets, indicating that it is saleable in the market place.

If a fair value measurement of an intangible asset is not possible, or when its value is only observable in a business combination as per IFRS 3: 'Business Combinations', such assets should be valued at nil for SAM purposes.

Goodwill will have an economic value of nil for SAM purposes.

Financial liabilities

The valuation of financial liabilities raises two contentious issues: first, whether to take into account the insurer's own credit standing at inception; and second, whether to take into account any subsequent changes. IFRS applies the former for liabilities measured at amortised cost and the latter when these are fair valued. Ignoring an entity's own credit risk would not result in financial liabilities being recognised at fair value. The SAM proposal is to consider own credit standing only on initial recognition and that subsequent changes should not be taken into account.

The proposal avoids the issue that a deterioration in own credit would lead to a reduction in fair value of the liability and an increase in own funds.

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