IFRS 17 – Insurance Contracts Transition Report as at 1 March **2023**

CAPITEC

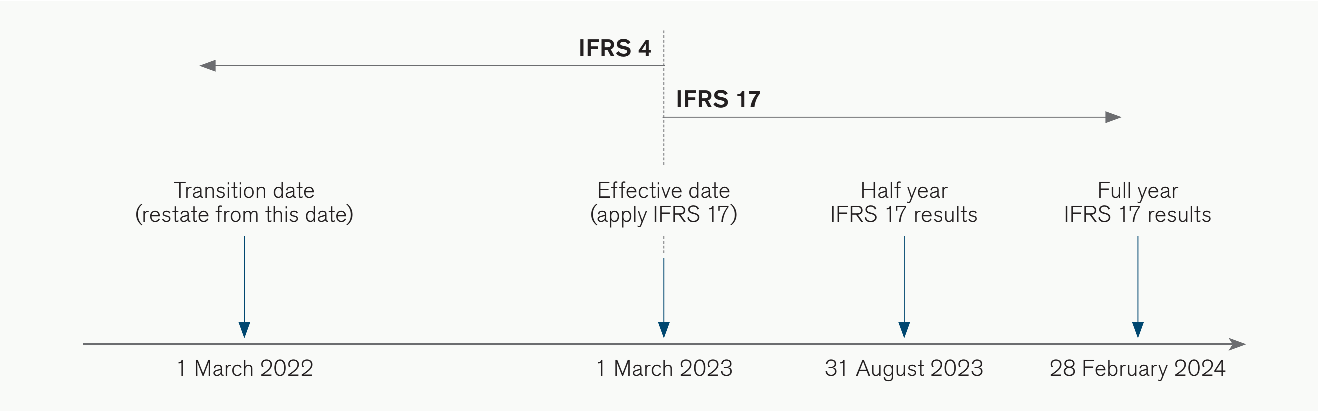
Capitec Bank Holdings Limited
(Capitec or the group or the company)

IFRS 17 Transition Report

Introduction

The group offers the Capitec funeral plan (funeral) through a contractual cell captive arrangement with Centriq Life Insurance Company Limited, and (until May 2023) credit life insurance through a contractual cell captive arrangement with Guardrisk Life Limited (Guardrisk) (the cell captive insurers). Commencing May 2023, credit life insurance is now underwritten on the Capitec Life Limited (Capitec Life) licence, with the in-force book in run-off on the Guardrisk licence. Capitec is planning to transfer the policies currently underwritten on the Guardrisk licence to the Capitec Life licence.

IFRS 17 *Insurance Contracts* replaces IFRS 4 *Insurance Contracts* for annual periods beginning on or after 1 January 2023. Capitec Bank Holdings Limited and its subsidiaries (the group) commenced with the application of the standard on 1 March 2023 (effective date). The group applies IFRS 17 to insurance contracts issued, reinsurance contracts held and in-substance reinsurance contracts issued through the cell captive arrangements in place.



IFRS 4 versus IFRS 17

IFRS 4 did not prescribe how insurance contracts should be measured or how revenue and profit from such contracts should be recognised. This meant that IFRS 4 reporters often had non-uniform accounting policies, which made comparability between insurers difficult. IFRS 4 allowed insurers to defer the release of profits by using discretionary reserves. The level of discretionary reserves applied by different insurers varied. This resulted in:

- different measurement of the insurance contract liability on the statement of financial position;
- different timing of profit or loss recognition; and
- different types of presentation and disclosure.

For many cell captive arrangements in South Africa, the level of discretionary reserves applied resulted in recognition of profit or loss on a cash basis, as long as the cell maintained sufficient capital for regulatory purposes. The accounting policies adopted by the cell captives were chosen by the cell captive insurers and not by the cell owner. As a result, Capitec had to apply the accounting policy adopted by the underlying cell. These audited results were correctly reported in the past under IFRS 4.

The use of discretionary reserves will no longer be allowed under IFRS 17, which prescribes how insurance contracts should be measured. This includes recognising prescribed reserves which defer revenue (and profit) over the life of the insurance contracts as the insurer stands ready to pay claims. In some cases, the newly prescribed reserves are greater than the historical reserves held under IFRS 4, which results in an increase. In other cases, the prescribed reserves are less than the historical reserves, in which case there is a decrease. Insurers with many different types of insurance contracts might have a combination of the above, and the increase or decrease is offset in such cases. For insurers with fewer products (or only products of a similar nature), such an offset will be less likely. Funeral insurance, in particular, is likely to result in an increase in the reserves to be recognised under IFRS 17 versus IFRS 4.

The impact on the group's financial position and financial results from the cell captive arrangements will now be recognised in terms of IFRS 17. The group will now recognise the insurance results in the cell arrangements as if it is the reinsurer to the cells, with direct exposure to the underlying cash flows (such as premiums, claims and attributable expenses).

Summary of the IFRS 17 impact on Capitec

IFRS 17 does not change the group's insurance strategy, product features or insurance operations. It requires new measurement and reporting capabilities across the actuarial and finance teams, which have been successfully implemented. IFRS 17 does not affect regulatory solvency or capital adequacy for the insurance operations (both cell captive arrangements and Capitec Life), as this is governed by the Financial Soundness Standards for Insurers.

Unchanged	Changed
• Insurance strategy • Products and product features • Insurance operations • Solvency, liquidity and capital adequacy	• New valuation models • New reporting systems • New measures for the financial position and results for insurance contracts

IFRS 4 allowed insurers to adopt generally accepted accounting practice. For the cell captive arrangements, through which Capitec conducted its insurance business, this meant recognising profit or loss as premiums were received and claims and expenses were paid. IFRS 17 requires a best estimate valuation of the lifetime cash flows expected from a group of insurance contracts and prescribes how revenue and expenses should be recognised over time.

Capitec typically charges level premiums which do not increase with the policyholder's age. The probability of a claim occurring does, however, increase with the policyholder's age, and IFRS 17 requires reporters to defer a portion of the premium (and therefore profit) to future periods as cover is provided. The same total revenue is recognised over the lifetime of a group of policies under IFRS 4 and IFRS 17, although the timing of the recognition differs.

Put differently, the total future expected profit at initial recognition is the same under IFRS 4 and IFRS 17, however, IFRS 17 defers the recognition of profit. For a group of insurance contracts, it means lower revenue and profit will be recognised in the earlier years, and more revenue and profit will be recognised in the future. It also means a more predictable and stable earnings pattern can be expected over time.

IFRS 17 requires reporters to apply the standard retrospectively. This requires a restatement of the opening retained earnings for the earliest comparative period (i.e. as at 1 March 2022) and at the effective date (i.e. as at 1 March 2023). This adjustment is required to recognise the insurance contract liabilities that would have existed had IFRS 17 been applied in the past, to defer revenue and profit to future periods. The comparative period profit is also required to be restated (for the year ended 28 February 2023).

The estimated net impact on the annual financial statements of the group for the year ended 28 February 2023 is as follows:

The impact on the statement of financial position

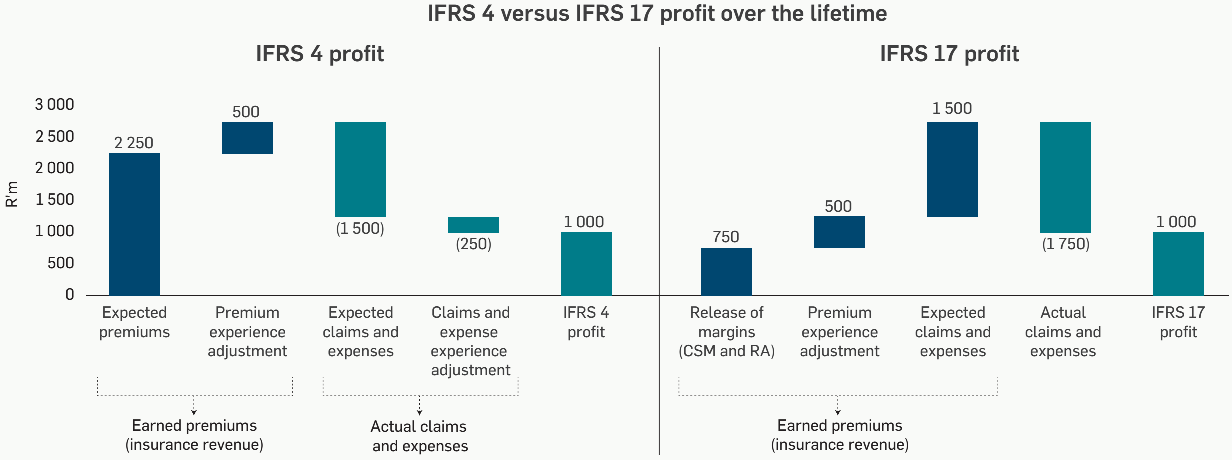
	28 February 2023 R'm
Retained earnings (reduction)	**(1 250)**

The impact on profit or loss (after tax) for the year

	FY2023 R'm	Restated FY2023 R'm	Restatement R'm	% Change
Funeral	1 431	1 020	(411)	(29%)
Credit insurance	1 888	1 588	(300)	(16%)
Total	**3 319**	**2 608**	**(711)**	**(21%)**

Illustrative example of profit under IFRS 4 versus IFRS 17

The graph below illustrates the components making up the profit under IFRS 4 and IFRS 17, respectively, over the full lifetime of a group of insurance contracts. The example ignores the impact of the time value of money for illustrative purposes. **The figures are illustrative**.



- IFRS 4 profit consists of earned premiums, less actual claims and expenses. Earned premiums can also be expressed as the total of expected premiums and an adjustment for the difference between expected and actual premiums (premium experience adjustment).
- IFRS 17 insurance revenue consists of the release of profit margins included in the earned premiums through the contractual service margin (CSM) and risk adjustment (RA), plus expected claims and expenses, plus the premium experience adjustment. IFRS 17 profit consists of insurance revenue less actual claims and expenses.
- Earned premiums under IFRS 4 is the same as insurance revenue under IFRS 17 over the full lifetime of the group of insurance contracts. However, the timing of the recognition of profit differs.

Insurance performance update

Although IFRS 17 introduces new measures which will be used in evaluating the financial performance of insurance contracts, there are existing metrics which continue to be important. IFRS 17 measures will become increasingly valuable as future financial periods are reported, allowing for comparison between periods as well as across the industry. An operational update on the insurance business for the quarter ended 31 May 2023 is provided below.

Capitec's insurance business achieved strong growth in the first quarter of the 2024 financial year, despite challenging economic conditions.

Funeral showed sustained growth, even at a time when various economic pressures are weighing heavily on the average client. This is testimony to the affordability and overall comprehensive offering of this product.

The total funeral book of business grew from 1.7 million policies at the end of the 2022 financial year to 2.2 million policies at the end of the 2023 financial year. This growth in the overall book is a combination of continued growth in new business volumes and strong persistency in the in-force business. A strong indication of the overall quality of sales is the monthly premium collection success. Premium collections are consistently in the region of 88% per month with no signs of deterioration.

The total credit life book of business grew from 1.78 million policies at the end of the 2022 financial year to 1.92 million policies at the end of the 2023 financial year, driven by the impact of the growth in net loans and advances.

The table below sets out key financial performance indicators for the quarter ended 31 May 2023.

Funeral plan

Indicator	FY2022	FY2023	FY2024: Q1
Premium earned*	R3 748 339 941	R5 289 057 103	R5 948 588 152
Number of lives covered	7 811 473	9 912 125	10 468 143

Credit life

Indicator	FY2022	FY2023	FY2024: Q1
Premium earned*	R3 077 894 587	R3 336 846 851	R3 383 354 350
Number of policies	1 781 089	1 921 565	1 949 783

** Annualised equivalent calculated for FY2024: Q1.*

Glossary of terms

Term description

	Capitec	Capitec Bank Holdings Limited
	Capitec Life	Capitec Life Limited
	Cell captive insurers	Underwriters of the contractual cell captive arrangements
CSM	Contractual service margin	The unearned profit component of the insurance contract liability presented in the balance sheet and recognised in the income statement as a company provides services under insurance contracts.
	Fulfilment cash flows	Estimates of amounts that the insurer expects to collect from premiums and pay out for claims, benefits and expenses, including an adjustment for the timing and risk of those amounts.
	Funeral	Capitec funeral plan
	Guardrisk	Guardrisk Life Limited
	Group	The level of granularity at which contracts are recognised and measured.
	Insurance contract	An agreement under which a customer (the policyholder) transfers significant insurance risk to an insurer.
	Insurance contract liabilities	Insurance contract liabilities is the sum of the fulfilment cash flows and the CSM.
	Insurance risk	Risk, other than financial risk, transferred from the policyholder to the insurer (for example, risk of death).
RA	Risk adjustment	The compensation an insurer requires for bearing the insurance risk.