Discussion Note

Application of AS1.04, AASB 1038 & AASB 139:
Effect of Margin on Services Valuation on Friendly Societies

Discussion Note Status

This Discussion Note was prepared by the Life Insurance and Wealth Management Practice Committee (LIWMPC) of the Institute of Actuaries of Australia ("IAAust") in June 2006. This discussion note does not represent a professional standard or a guidance note of the IAAust. It has been prepared for the purpose of:

- generating discussion on aspects of liability valuation by friendly societies that may lead to divergent practices within the IAAust's membership, and
- raising issues for consideration by members practicing in this area.

Feedback from IAAust members is encouraged and should be forwarded to the LIWMPC (care of Allen Truslove).

Background

The exemption for friendly societies from life insurance financial reporting requirements via the Class Order [CO 99/1225] issued by the Australian Securities and Investments Commission (ASIC) has expired and no relief is available in respect of reporting years commencing on or after 1 January 2005.

The consequence is that, if applicable, under AASB 1038 friendly societies may have liabilities calculated under a Margin on Services (MoS) basis at 30 June 2006 and thereafter.

Under AASB 1038 a life insurance contract is a contract regulated under the Life Insurance Act 1995, or similar contracts issued by entities operating outside Australia where either:

- one party (the insurer) accepts significant insurance risk (i.e. risk, other than financial risk) from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) affects the policyholder; or
- there is a *discretionary participation feature* i.e. a contractual right to receive additional benefits as a supplement to guaranteed benefits:
    - (a) that are likely to be a significant portion of the total contractual benefits;
    - (b) whose amount or timing is contractually at the discretion of the issuer; and
    - (c) that are contractually based on:
        - (i) the performance of a specified pool of contracts or a specified type of contract;
        - (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
        - (iii) the profit or loss of the company, fund or other entity that issues the contract.

A contract governed by the Life Insurance Act, that does not meet the above definition of a life insurance contract is a life investment contract. Life investment contracts are treated under AASB 139 and AASB 118.

Friendly Society profit allocation under the Life Insurance Act .

The Life Insurance Act 1995 (the Act) sets out in Division 5 the procedure for allocation of profits and losses and capital payments for life insurance companies and in Division 6 the procedure for distribution of retained profits and shareholders' capital. For friendly societies these divisions are replaced (via substitution in Schedule 5 of the Life Insurance Regulations 1995) with a general provision on distribution of surplus which is much less restrictive. The substitution is

"Division 5 Distribution of surplus in approved benefit fund

56 Distribution of surplus

(1) If the appointed actuary of a friendly society advises the society, in writing, that there is a surplus in an approved benefit fund of the society, the society may, if the rules of the approved benefit fund so provide, do 1 or more of the following:
   (a) pay, apply or allocate all or part of the surplus to the members of the approved benefit fund;
   (b) transfer all or part of the surplus to another approved benefit fund of the society;
   (c) transfer all or part of the surplus to the management fund of the society.

(2) If the surplus includes an asset other than money, the value of the asset is the fair value of the asset determined in accordance with subsection 45(3).

(3) A distribution under subsection (1) must comply with any prudential standard."

For the purpose of this Discussion Note it is appropriate to distinguish between surplus and distributable surplus.

Surplus is the excess of assets over policy and other liabilities. Distributable surplus is the lesser of this and the excess of assets over the amount required to meet capital adequacy and solvency requirements. The amount required to meet capital adequacy and solvency requirements should be assessed after allowing for any proposed distribution to ensure these requirements are satisfied post distribution.

Following allocation of current bonus or benefit extension any surplus not distributed is implicitly undistributed surplus. There must be sufficient undistributed surplus after the current distribution, or seed capital, to ensure capital adequacy and solvency requirements are met.

It is important to consider how surplus emerges to enable it to be distributed under the Act. Following a valuation and subsequent surplus distribution, the policy liability includes that distribution and a liability for future bonuses or benefit enhancements including the bonus or benefit enhancement due at the end of the year. At this stage the bonus or benefit enhancement due at the end of the year is a liability and not surplus. At the end of the year this bonus or benefit enhancement has not eventuated and hence falls into surplus along with any experience profit. As it has now fallen into surplus it can be distributed following the valuation in accordance with Division 5 subject to the fund meeting capital adequacy and solvency requirements following the distribution.

Is the above Life Insurance Act distribution method consistent with valuation standard AS1.04?

The valuation standard AS1.04 defines Policy Liability as the:

Best Estimate Liability *plus*
Value of future Best Estimate Bonuses *plus*
Value of future Best Estimate Shareholder Profits

Current year Best Estimate Bonuses are an appropriation of profit for participating business.

In the Life Insurance Company environment, because of the valuation approach adopted, the sum of current bonus and policy liability is generally equivalent to the asset share, possible augmented by any Policy Owner Retained Profits and associated Shareholder Retained Profits. Within the policy liability, the allowance for future profits has to be split into shareholder and policyholder entitlements in accordance with section 4.1.3 of valuation standard AS1.04.

For friendly society benefit funds the situation is more diverse. Paragraph 4.1.2 of AASB 1038 explains:

"Equity in a shareholder-owned life insurer will generally comprise only shareholder equity. Although participants in the industry commonly refer to "policyholder retained profits", in relation to Australian business such amounts are unvested policyholder benefits liabilities. Under Australian legislation, "policyholder retained profits" relating to Australian life insurance business are paid to policyholders, although the timing of the payment is at the discretion of the life insurer. A life insurer may have unallocated surplus that is in the nature of "policyholder equity" if it is a friendly society or has foreign life insurance operations in a jurisdiction that permits retained profits to remain unallocated between policyholders and shareholders, and the policyholders' component has yet to be determined. A key factor in evaluating the classification as liability or equity of retained profits in a friendly society is the benefit fund rules of each particular benefit fund. If the rules of a benefit fund were such that all retained profits by default are for the benefit of policyholders, such retained profits would be classed as policyholder benefit liabilities."

There are three different scenarios that may apply for friendly societies which depend on the description of how surplus may be allocated in the fund rules. These are:

- The rules prescribe a fixed level of fees or no fees to be transferred to the Management Fund with all surplus being used to improve member benefits.
- The rules prescribe a fixed level of fees or no fees to be transferred to the Management Fund with any surplus assets belonging to the Management Fund. The surplus is released to the Management Fund under a transfer of surplus rule. There is no provision in the rules to increase benefits.
- The rules prescribe a fixed level of fees or no fees to be transferred to the Management Fund. The rules provide for surplus to be used to improve member benefits or to be transferred to the Management Fund.

It is worthwhile considering what constitutes surplus. It is clear that the amount required to cover current benefit extensions and current transfers of surplus to the Management Fund is surplus which we can call current surplus.

“Surplus” could be set equal to current surplus. In this situation the excess of net assets over Best Estimate Liabilities plus current surplus would be treated as part of the policy liability and not “surplus”.

In the future, any excess of net assets over Best Estimate Liabilities plus current surplus will eventually be released from the policy liability to “surplus” to enable its allocation as benefit enhancement or transfer to the Management Fund.
(This amount could be classified as future surplus and lead to an alternative definition of “surplus”. “Surplus” in this alternative context would refer to both current and future surplus, and hence also include any margins over Best Estimate Liabilities that are currently held within the policy liability.)

When all current and future surplus belongs to the Management Fund it will, for general purpose financial reporting, ultimately emerge as profit. It is therefore necessary to determine profit carriers and margins under MoS to ensure that the profit emerges in an orderly fashion.

When current and future surplus belongs to policyholders, or is to be shared between policyholders and the Management Fund with the exact basis for sharing being undefined, there is either no profit, or no definite expectation of profit. (Future shareholder profits are deemed to be future transfers of surplus to the management fund or another benefit fund.) Such profit as may emerge will only be identified at the point that it is transferred to the Management fund. The pattern of future bonus emergence and the distinction between value of future bonuses or profits held within the policy liability and unallocated surplus identified separate from the liability is therefore of no material significance for the purpose of financial reporting.

The solution to making AS1.04 consistent with this is to allow a degree of flexibility, depending on the nature of the fund, the practicalities of the valuation process and consistency with past reporting, such that the current and future surplus is held as:

- part of the policyholder benefit liabilities (which in this case are explicitly aligned to the value of the fund asset), or
- explicit surplus, or
- a combination of both (although this is likely to be more complex, as it requires some mechanism for the orderly release of the margins for future bonuses and transfers).

Section 15 of valuation standard AS1.04 may also be relevant when setting the opening value of the policy liability under the approach chosen, in conjunction with discussions between the actuary and the auditor.

For those funds which provide for distributions of surplus to policyholders, any explicit surplus (after allowing for any distribution in the current period) would then be classified as unallocated benefit funds for the purpose of applying valuation standard AS1.04, and as either unvested policyholder benefit liabilities or policyholder equity for general purpose financial reporting under AASB 1038, depending on whether there is any potential for future transfers to the Management Fund. Thus, whether the current and future surplus is reported as policy liability or explicit surplus it will not be recognised as shareholder equity. Equity will only arise where the benefit fund rules provide that surplus can only be transferred to the Management Fund.

Defined Contribution Funds

The question for a product is whether it is a life insurance contract or a life investment contract.

If a defined contribution fund is characterised by the absence of both insurance risk and a discretionary participation feature then the defined contribution benefit fund does not satisfy the definition in AASB 1038 of a life insurance contract. This fund would then be governed by AASB 139 and AASB 118. If the fund has a discretionary feature or is subject to insurance risk it is governed by AASB 1038.

Friendly society defined contribution funds are classified as investment linked or investment account funds.

The current investment linked funds of friendly societies have no insurance risk and no discretion as to the timing of allocation of investment earnings and hence have no discretionary feature. The appropriate reporting standard is AASB 139 to the extent that it gives rise to a financial instrument and AASB 118 to the extent that there is a management services element under the contract.

Friendly society investment account funds generally have no insurance risk. Those investment account funds that do have an insurance risk element can be unbundled for valuation purposes with the insurance risk being separately valued.

Investment account funds with or without a capital guarantee have members entitled to allocation of investment earnings (net of tax and fees). If a capital guarantee applies, some of the net investment earnings must be carried forward in order to meet capital adequacy and solvency requirements if seed capital does not meet those requirements. In general, even when there is no explicit capital guarantee there is an expectation that capital will be protected and some of the net investment earnings must be carried forward in order to meet capital adequacy and solvency requirements if seed capital does not meet those requirements.

If an investment account fund has no insurance risk and there is no discretion as to the amount or timing of bonus distributions, the appropriate reporting standard is AASB 139 to the extent that it gives rise to a financial instrument and AASB 118 to the extent that there is a management services element under the contract.

The balance of this section will cover other investment account funds. Most, if not all of these have a discretion to carry forward amounts as unallocated distributable surplus (amounts in excess of the amount required to meet capital adequacy and solvency requirements). Unallocated surplus (as distinct from unallocated distributable surplus) plus any seeding capital must, at a minimum, be sufficient to cover the reserves needed to meet statutory solvency and capital adequacy requirements and may exceed the statutory requirement. There is a discretion to hold more than the minimum and this discretion may be used to enable some averaging of bonus rates over time. Some societies may provide a non-guaranteed terminal bonus financed from the unallocated surplus to members who exit following the valuation of the fund.

One solution is to treat these investment account funds as funds having a discretionary feature and adopt the provisions of AASB 1038. This will lead to these investment account funds and those with insurance risk as being subject to AASB 1038. As previously stated the insurance risk can be unbundled. Therefore the key aspect to be addressed is the approach for a pure (no insurance risk) investment account fund.

These funds have prescribed fees for transfer to the management fund. Any undistributed surplus belongs to the members of that fund and therefore should be classified as policyholder benefit liability in accordance with paragraph 4.1.2 of AASB 1038.

These funds can be most conveniently valued using the accumulation approach. For general purpose financial reporting under AASB 1038, policyholder benefit liabilities are equal to the value of the assets of the fund net of other liabilities and any seed capital. Seed capital is capital from the management fund provided to meet solvency and capital adequacy requirements. Transfers or other funding provided to the fund to ensure that account balances plus other liabilities are at all times covered by the value of assets cannot be regarded as seed capital.

One possibility for reporting on these funds would be to set the policy liability equal to the value of the assets of the fund net of other liabilities and seed capital less the value of the current period bonus. (Note that policy liability is not the same as policyholder benefit liabilities.) Following the declaration of the bonus (or providing for the bonus) there would then be no surplus under this arrangement.

Alternatively, the policy liability might be set equal to the account balance pre bonus. The balance of the fund (excluding seeding capital) is then described as unvested policyholder benefit liabilities or surplus. The current bonus declaration simply results in a movement from unvested policyholder benefit liabilities to vested policy liability subject to the amount vesting being no more than the distributable portion of unvested policyholder benefit liabilities (or surplus).

These approaches are, in practice, equivalent to those that have been used in previous valuations.

Defined Benefit Funds

Defined benefit funds carry insurance risk. Hence these are insurance contracts within the definition in AASB 1038. A MoS valuation method then applies.

The treatment under AASB 1038 depends on how surplus is to be allocated. Each of the three scenarios described earlier are considered below.

All surplus is used for benefit enhancements

In this case there are no shareholder profits and hence there is no profit carrier needed as the profit carrier is only used for the orderly release of shareholder profits. Any excess of assets over Best Estimate Liabilities will eventually be distributed to members. The reporting options are similar to those for the investment account business.

One possibility would be to set the policy liability equal to the value of net assets less the amount required to cover any proposed distribution in the form of benefit enhancements. Surplus is equal to current surplus or the amount of net assets set aside to cover the current distribution in the form of benefit enhancements which is necessarily the same as net assets less policy liability. The future surplus would remain within the policy liability.

Alternatively, the policy liability might be set equal to the Best Estimate Liability. All current and future surplus would then be explicitly recognised as surplus and would be classified as unvested policyholder liabilities for accounting purposes.

While there is no formal requirement to address the timing of surplus release as benefit enhancements, the actuary should address this issue. This is particularly important for funds where an expectation has been created for members of uniform reversionary bonuses. In this case, the actuary should be mindful of sustainability of bonus levels when recommending benefit extensions in the form of declaration of a current year bonus. The declaration should be consistent with the level that can be sustained in the future. This will necessarily involve determination of the amount expected to be required for future bonus.

There will be situations where it is appropriate to distribute surplus for enhancement of benefits in a non uniform manner. However, even in these circumstances the actuary should consider the consequences of the current distribution (or lack thereof) on future distributions.

Where the rule provides for distributable surplus to be allocated to members the provision for a transfer to the management fund may exist only to allow transfer to the management fund of any residual assets on wind-up of a fund. In that case it is appropriate to assume that such a fund is the same as a fund with no management fund entitlement to surplus, and that there is then no profit carrier for determining transfers of surplus to the Management Fund.

All surplus belongs to the Management Fund

In this case a MoS profit carrier must be put in place to ensure profits are released in an orderly manner. Standard guidance as applies to life companies generally in respect of non-participating benefits will also apply to the valuation of these products. This Discussion Note does not address the appropriate profit carrier as it will depend on the nature of the benefit fund. It should be noted, though, that the requirement to apply MoS does not preclude the use of approximate methods where appropriate, in accordance with paragraph 3.10 of valuation standard AS1.04.

Any difference between the value of the fund and the policy liability is, in this case, Shareholder (i.e. Members') Retained Profits.

Actuaries will need to have regard to Section 15 of valuation standard AS1.04 when initially setting the level of the profit margin.

Surplus may be transferred to the Management Fund or to improve member benefits.

There is no indication of timing of the use of surplus in these cases or how the surplus is to be distributed between the Management Fund and benefit improvements. Any excess of net assets over Best Estimate Liabilities will eventually be distributed to members or transferred to the Management Fund. Any explicit surplus already identified may therefore be classified as policyholder equity for accounting purposes.

As before, there may be flexibility in setting the policy liability. One possibility would be to set the policy liability equal to the value of net assets less the amount required to cover any proposed distribution following the valuation in the form of benefit enhancements and/or management transfers. Surplus is equal to current surplus or the amount of net assets set aside to cover the current distribution in the form of benefit enhancements and/or management transfers which is necessarily the same as net assets less policy liability.

The future surplus would remain within the policy liability. As there is no clear separation of the entitlement of future profits between members and the Management Fund it is therefore appropriate to have no MoS profit carrier and as a consequence there is no need to explicitly define a profit margin (since there is no explicit expectation of transfers to the Management Fund).

Alternatively, the policy liability might be set equal to the Best Estimate Liability. All current and future surplus would then be explicitly recognised as surplus and would be classified as policyholder equity for accounting purposes.

While there is no formal requirement to address the timing of surplus release as benefit enhancements or transfers to the Management Fund, the actuary should address this issue.

This is particularly important for funds where an expectation has been created for members of uniform reversionary bonuses or there is an expectation (and possibly a need) of significant transfers of surplus to the Management Fund to support society activities. In this case, the actuary should be mindful of sustainability of bonus levels and management transfers when recommending benefit extensions in the form of declaration of a current year bonus or a transfer of funds to the Management Fund. Bonus declarations and management transfers should be consistent with the level that can be sustained in the future. This will necessarily involve determination of the amount expected to be required for future bonus and future management transfers.

There will be situations where it is appropriate to distribute surplus for enhancement of benefits in a non uniform manner. However, even in these circumstances the actuary should consider the consequences of the current distribution (or lack thereof) on future distributions.

This assessment is similar to MoS but with more flexibility in the form of surplus release. For example, a society may be unprofitable and be seeking a transfer of benefit funds or of the whole society to another society. In these circumstances it may be appropriate to allow for larger management transfers than would be sustainable over the life of the fund on a temporary basis for the anticipated period to the transfer to the other society to enable the society to operate until the transfer to the other society is completed.

Other issues

When valuing benefit fund liabilities the actuary should consider whether management fees (specified and surplus transfers) are adequate to cover the expenses incurred in operating the fund, whether they are reasonable for the benefits being provided and whether they are sustainable at current levels. The actuary should be mindful that the fund should only continue to operate if it is in the interests of members to continue.

In circumstances where continuation of the current practice is not in the interests of members the actuary should comment on this in the financial condition report together with options to rectify the problem such as, for example, a conscious decision by the society to support the fund for lower than adequate fees, transfer of the benefit fund to another society or fund wind up.