Institute of Actuaries of Australia

LIFE INSURANCE AND WEALTH MANAGEMENT PRACTICE COMMITTEE

Information Note: Application of LPS 1.04, AASB 1038 and AASB 139 to Friendly Societies

August 2009

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1 Information Note Status

This Information Note – which was originally issued in June 2006 as a Discussion Note – was updated by the Life Insurance and Wealth Management Practice Committee ("LIWMPC") of the Institute of Actuaries of Australia ("Institute") in July 2009. It does not represent a Professional Standard or a Practice Guideline of the Institute and has been prepared for the purpose of encouraging greater consistency between members in their approach to the issues discussed.

Feedback from Institute members is encouraged and should be forwarded to the LIWMPC (care of Mr Anthony Asher).

2 Background

The provisions of the Life Insurance Act 1995 (Cth) ("Act") and associated regulations apply differently to friendly societies than to other life companies.

Friendly societies differ from other life companies in terms of their corporate and financial structures and products. In particular, there are different rules regarding the distribution of surplus. This is recognised in the Act via Schedule 5 of the Life Insurance Regulations 1995 (Cth).

These differences mean that actuaries working with friendly societies consider how the Act, Life Prudential Standards and accounting standards should apply in those circumstances.

That is the subject of this Information Note.

3 Friendly Society profit allocation under the Act

Division 5 of the Act sets out 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 (Cth)) 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 one 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 Information 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 is assessed after allowing for any proposed distribution to ensure these requirements are satisfied post distribution.

4 Policyholder retained profits and policyholder equity

APRA's valuation standard, Prudential Standard LPS 1.04, 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 the value of current bonus and policy liability is generally equivalent to the asset share, possibly 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 LPS 1.04.

For friendly society benefit funds, the situation is more flexible. 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 or 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:

(a) 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;

(b) 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;

(c) 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.

While the rules may offer flexibility in the manner that surplus is allocated to policyholders or the Management Fund, the actuary should consider whether the policyholders have reasonable expectations that surplus will be allocated in a particular manner. These benefit expectations can be created by advertising material or past practice.

Where the entire surplus is to be transferred to the Management Fund or where policyholder surplus is smoothed in some way, it is necessary to determine profit carriers and margins under Margin on Services ("MoS") to ensure that the surplus emerges in an orderly fashion for distribution according to the rules and policyholder benefit expectations.

When current and future surplus belongs to policyholders, or is to be shared between policyholders and the Management Fund and the exact basis for sharing is undefined, bonuses and profit will only be identified as such at the point when they are declared or transferred to the Management Fund respectively. The pattern of future bonus emergence and the distinction between the value of future bonuses or profits held within the policy liability and unallocated surplus identified separate from the policy liability is therefore of no meaning for the purpose of financial reporting.

Thus, depending on the nature of the fund, the practicalities of the valuation process and consistency with past reporting, current and future surplus can be 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 LPS 1.04 may also be relevant when setting the opening value of the policy liability.

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 LPS 1.04, 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 unless there is a reasonable expectation that shareholders will obtain a share of the distributed surplus. Equity will also arise where the benefit fund rules provide that surplus can only be transferred to the Management Fund.

5 Defined contribution funds

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

5.1 Life investment contracts

If a defined contribution fund is characterised by the absence of both insurance risk and a discretionary participation feature, and there is no discretion as to the amount or timing of bonus distributions, then the defined contribution benefit fund does not satisfy the definition in AASB 1038 of a life insurance contract. 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.

Investment account funds that do have an insurance risk element can be unbundled for valuation purposes with the insurance risk being separately valued.

5.2 Capital guarantees

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.

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.

5.3 Other investment account funds

The balance of this section will cover other investment account funds. Most, if not all, of these have 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 discretion to hold more than the minimum and this discretion may be used to enable some averaging of bonus rates over time. Some friendly 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. These funds generally have prescribed fees for transfer to the Management Fund. Any undistributed surplus belongs to the members of that fund and therefore would 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.

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 where the Value of future Best Estimate Shareholder Profits is included in the Policy Liability.) 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).

6 Defined benefit funds

Defined benefit funds carry investment or 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.

6.1 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 released as benefit enhancements, the actuary should consider 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 will be mindful of sustainability of bonus levels when recommending benefit extensions in the form of declaration of a current year bonus. The declaration will 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 will consider the consequences of the current distribution (or lack thereof) on future distributions.

Where the benefit fund rules provide 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.

6.2 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 Information 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 LPS 1.04.

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

Actuaries will need to have regard to section 15 of valuation standard LPS 1.04 when initially setting the level of the profit margin.

6.3 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.

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 surpluses would then be explicitly recognised as surplus and would be classified as policyholder equity for accounting purposes.

7 Board discretions and policyholder expectations

While there is no formal requirement to address the timing of surplus release as benefit enhancements or transfers to the Management Fund, the actuary will consider 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 will 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 Fund transfers will be consistent with the level that can be sustained in the future given appropriate future experience assumptions. This will necessarily involve determination of the amount expected to be required for future bonus and future Management Fund 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.

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 will 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 consider commenting 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.

END OF INFORMATION NOTE