

LIFE INSURANCE AND WEALTH MANAGEMENT PRACTICE COMMITTEE

Information Note:

Product Advice regarding Policies and Reinsurance to a Life Insurer or Friendly Society under LPS 320

January 2012

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A. Status of Information Note

1. This Information Note was first published in January 2012 and was prepared by the Life Insurance Product Advice Taskforce of the Life Insurance and Wealth Management Practice Committee ("LIWPMC) of the Institute of Actuaries of Australia ("Institute").
2. This Information Note does not represent a Professional Standard or Practice Guideline of the Institute. It has been prepared to assist Appointed Actuaries in their role in providing actuarial advice regarding policies and reinsurance under Life Prudential Standard 320 (Actuarial and Related Matters) issued by the Australian Prudential Regulation Authority ("APRA") ("LPS 320"). It aims to achieve a degree of consensus on the requirements of LPS 320 and, in so doing, avoid interpretations that may lead to divergent practices within the Institute's membership. This Information Note does not constitute legal advice.
3. Feedback from Institute Members is encouraged and should be forwarded to the LIWPMC.

B. Background

4. This Information Note concentrates on the requirement for life insurers and friendly societies to obtain and consider written advice from their Appointed Actuary prior to issuing or modifying a policy, or entering, terminating or modifying a reinsurance arrangement.
5. The requirements which were formerly contained in s116 of the Life Insurance Act 1995 (Cth) have been removed, and were replaced by similar requirements in APRA's Life Prudential Standard 310 (Audit & Actuarial Requirements) ("LPS 310"). APRA has now separated LPS 310 into Audit and Related Matters (remaining as LPS 310) and Actuarial and Related Matters (Life Prudential Standard 320 ("LPS 320")), and has taken the opportunity to extend and modify these requirements. The relevant extract from LPS 320 is contained in Appendix A.
6. Whilst the requirements of LPS 320 have been in place for a lengthy period of time in relation to the issuing of policies, a wide variety of practices have emerged in relation to the circumstances when advice is sought and provided, to whom the advice is provided, and the breadth of coverage of the advice.
7. In the interests of consistency of market practice formed from a common understanding, and to avoid a need for more prescriptive regulation, the LIWPMC has issued this Information Note.
8. Conclusions (and influencing arguments) are presented first with relevant references being outlined in section D.

C. Summary of conclusions

9. The Institute's Code of Professional Conduct establishes the framework for formal reporting, including the requirement to adhere to Professional Standards. Professional Standard 200 (Actuarial Advice to a Life Insurance Company or Friendly Society) ("PS 200") contains the minimum requirements for product advice required by LPS 320.
10. The requirements of PS 200 include establishment by the actuary as to whom the advice will be directed. In determining the recipient, the actuary will have regard to the company's Board-approved policy as required under LPS 320 (paragraph 20). There may be occasions where the actuary forms the view that his/her advice will be considered by the life insurer's Board regardless of the policy, although these situations would be expected to be rare.
11. The onus remains on the company to obtain and consider the written advice under LPS 320, however the Appointed Actuary may also be mindful of the requirements of PS 200 (clause 6.1.3) in relation to changing circumstances relating to a group of policies that has material financial implications.
12. The Board policy required by LPS 320 enables the life company to determine whether it believes a change to a life insurance policy is material. If the company decides a change is immaterial, paragraph 17 of LPS 320 also requires that the Appointed Actuary advise the life company that he/she agrees with the company's decision before it is accepted that no product advice is to be required. The Appointed Actuary will consider the Board policy in forming a view as to whether a proposed change is material, but will not be constrained by the wording of the Board policy in making his/her judgment. The Appointed Actuary will independently use his/her judgment as to the materiality of the change and advise the company accordingly.
13. LPS 320 (paragraph 17) requires advice on all policies prior to issue but allows the written advice to relate to a number of policies of a similar kind. Where individual policies or policies sold as part of an alliance or campaign are tailored on an individual or group basis, accepted industry practice is for the Appointed Actuary to have provided formal advice covering a range of parameters (for example, commission rates, loss ratios, acquisition expense loadings, automatic acceptance levels, etc). This advice may include a pricing framework (including pricing criteria) and the range of other terms and conditions to which the advice relates. Product advice can then be prepared on an exceptions basis when the specific terms and conditions fall outside the scope of the parameters covered by the original advice.
14. This approach may generally be appropriate for group risk tenders, incentive campaigns, direct marketing campaigns and advice from Appointed Actuaries to reinsurers on treaty terms. In each case, a base or standard set of terms and conditions can be defined, along with parameters within which the advice can apply. Generally

this kind of advice may incorporate the implications of a base scenario, but also the boundaries of any scenarios covered by the advice.

15. Paragraph 17 of LPS 320 requires the advice to be received prior to issuing policies. APRA's expectation is that written advice must be provided prior to a binding quote being issued. APRA requires the advice to include all key assumptions, commentary on the loss ratio selection and period of investigation, trends in the experience, sensitivities, risks, volatility, automatic acceptance limits ("AALs") and any other matters the Appointed Actuary believes are material.
16. In certain situations, such as group risk tenders, it is not always practical to provide detailed, tender-specific, formal (written) advice prior to the company making a binding offer for each tender in which it participates. In these circumstances, accepted industry practice is for the Appointed Actuary to have provided formal advice on a pricing framework (refer to sections D.5 and D.5.1) covering a range of parameters, including clearly defined pricing criteria, delegated authorities and risk management strategy. Detailed documentation on each proposal confirming compliance with the framework and specific financials and terms and conditions would be completed by consolidating existing file notes or other documentation.
17. An analysis of any individual policy will enable a determination to be made as to whether the particular policy is covered by a particular piece of advice. In preparing product advice, the Appointed Actuary is required to ensure that the advice states clearly the extent of coverage of the advice being given.

D. Considerations

18. The following strongly influenced the Taskforce's considerations.

D.1 Mandatory requirements for the provision of Prescribed Actuarial Advice

19. These are provided in the Code of Professional Conduct and Professional Standard 200 (PS 200).

D.1.1 Code of Professional Conduct

20. Section 7 of the Code addresses "Reporting":

"A Member must ensure that his or her reporting (whether oral or written) in respect of Professional Services provided:

- (a) is appropriate, having regard to:
 - (i) the intended audience;

- (ii) its fitness for the purposes for which such reporting may be required or relevant;
- (iii) the likely significance of the reporting to its intended audience;
- (iv) the capacity in which the Member is acting; and
- (v) any inherent uncertainty and risks in relation to the subject of the report;

(b) complies with any relevant Professional Standards.”

21. Section 8 of the Code of Professional Conduct covers Prescribed Actuarial Advice, with clauses on the “Provision of Prescribed Actuarial Advice” and the “Transmission of Prescribed Actuarial Advice to third parties”.

“‘Prescribed Actuarial Advice’ means:

- (a) any conclusion, result, opinion or recommendation required to be performed, under Legislation, by either an actuary or a person with actuarial qualifications and experience; or
- (b) any thing deemed to be prescribed actuarial advice by being:
 - (i) specified as such in a Professional Standard; or
 - (ii) declared to be such by the Council of the Institute.”

D.1.2 Professional Standard 200

22. Section 6 of PS 200 covers product and reinsurance advice.

23. Clause 6.1.3 provides that:

“Written advice from the Appointed Actuary is also required when there are proposed modifications in terms and conditions, or when the Member recognises that **there is a change in circumstances relating to a group of policies that has Material financial implications**. When the Member considers that a proposed change in terms and conditions is not Material, the Appointed Actuary must advise the Entity of this view.” [emphasis added]

24. Section 4 covers “Materiality”. “Material” is defined in clause 3.1 as:

“‘Material’ means relevant to the Entity’s circumstances and either important or essential in the opinion of the Member. For this purpose, ‘Material’ does not have the same meaning as in Australian accounting standards. ‘Materiality’ and ‘Materially’ have meanings consistent with ‘Material’”.

25. This definition provides some guidance to the Appointed Actuary in addition to the life company’s Board policy.

26. Clause 6.1.4 provides that:

“Where existing policies have terms and conditions which are subject to variation, then when providing advice on proposed new terms and conditions or changes to terms and conditions of similar policies, the Member must comment on the impact of those proposals on the business already issued.”

27. The Taskforce noted that this particular clause is consistent with the requirements of LPS 320 to include changes to terms and conditions of existing policies in the requirement for the company to obtain and consider written product advice.

28. Clause 6.1.5 of Professional Standard 200 provides that:

“With respect to the reference to ‘company’ in paragraphs 17 and 19 of LPS 320, the Member, by reference to the Board-approved policy required by paragraph 20, must clearly establish to whom in practice the advice must be directed.”

29. The Appointed Actuary, when preparing a financial condition report, considers and reports on product profitability of both existing and future new business, and this may be an adequate forum for addressing a change in circumstances. However the Appointed Actuary should at all times ensure advice is provided in an appropriate timeframe and received by the relevant people.

D.2 Responsibility to obtain and consider advice

30. The onus remains on the company to obtain and consider, and not on the Appointed Actuary to provide, advice. The Appointed Actuary cannot practically be aware of all activities in a company that could require advice and must rely on the company seeking such advice. This is particularly the case where the Appointed Actuary position is held externally and the Member is not involved in the day-to-day affairs of the company (although it can also occur within organisations, particularly those which are larger and more complex, where a variety of products are written (through both a life insurance entity and other non-life entities)). In these circumstances, the Appointed

Actuary should ensure the company has appropriate controls and mechanisms in place to keep the Appointed Actuary up to date with product and reinsurance developments and initiatives.

31. All companies are required by LPS 320 to have a clearly documented Board-approved policy setting out who must consider the advice regarding policies and reinsurance. The Board may delegate the authority to accept LPS 320 advice to a committee or an appropriate person, such as the CEO/PEO or CFO, under certain circumstances. PS 200 already requires the Appointed Actuary to establish to whom the advice is to be directed.
32. LPS 320 also requires the Board-approved policy to enable the life company to decide whether any proposed modification to a policy is material, taking into account the likely impact of the modification on policy owners and the financial position of the life company. The Appointed Actuary is to be advised of the modification and, if the company believes the modification to be immaterial, then product advice is not required provided that the Appointed Actuary advises the life company that, in his/her opinion, the modification is not material. In determining whether the product advice is to be prepared, the Appointed Actuary will have regard to the company's Board-approved policy along with consideration of materiality based on factors such as business covered, volumes, sales channels, how actual experience has compared with assumed experience, and so on.
33. Paragraph 17 of LPS 320 requires the advice to be received prior to issuing policies. APRA's expectation is that written advice must be provided prior to a binding quote being issued. APRA requires the advice to include all key assumptions, commentary on the loss ratio selection and period of investigation, trends in the experience, sensitivities, risks, volatility, AALs and any other matters the Appointed Actuary believes are material.
34. In certain situations, such as group risk tenders, it is not always practical to provide detailed, tender-specific, formal (written) advice prior to the company making a binding offer for each tender in which it participates. In these circumstances, accepted industry practice is for the Appointed Actuary to have provided formal advice on a pricing framework (refer to sections D.5 and D.5.1) covering a range of parameters, including clearly defined pricing criteria, delegated authorities and risk management strategy. Detailed documentation on each proposal confirming compliance with the framework and specific financials and terms and conditions would be completed by consolidating existing file notes or other documentation.
35. Detailed documentation for a particular tender that is outside the framework is often prepared for the Appointed Actuary by the pricing actuary responsible for the tender. The Appointed Actuary would review this documentation and use it to assist him/her in providing formal advice to the company.

36. This approach may also be appropriate for incentive campaigns, direct marketing campaigns and advice from Appointed Actuaries to reinsurers on treaty terms.
37. Where the approach outlined above is adopted, the advice will normally make it clear that, for any circumstance that is not within the scope of the advice, the company is obligated to obtain and consider specific advice prior to entering into or modifying an existing contract.

D.3 Materiality

38. As noted above, the assessment of materiality is a matter for the life company under the Board-approved policy and the Actuary's professional judgment. The consequence of a 'minor change' that is not well understood by a company can have a significant impact on a company's financial condition due to the complexity and long term nature of life insurance policies. This principle applies regardless of the age, size or number of policies to be modified.
39. The Appointed Actuary will usually adopt a practical approach to the provision of product and reinsurance advice, encouraging management focus to be given to those matters of greater importance and implications. Whilst all proposals need to be reviewed by the Appointed Actuary, it is appropriate for materiality to be applied when considering the type of formal reporting to the company.
40. Clause 5.1.4 of PS 200 provides that:

"In providing written advice required by the regulatory regime, the Member will, except for financial condition investigations, not necessarily need to prepare a full formal Report, but must, at a minimum, prepare a statement which includes references to relevant supporting documents or files. The Member must make and keep sufficient and appropriate documentation about relevant matters to enable a formal Report to be prepared later if required."
41. The Taskforce regards the cumulative impact of changes as the benchmark on which to consider materiality, rather than the impact of each proposal separately. The Appointed Actuary should include the cumulative impact of any such proposals not yet formally reported on materiality grounds when next reporting to the company.
42. A full formal report is required by PS 200 if the changes made (for example, to terms and conditions) introduce new risks or exacerbate existing risks in a manner which could have material adverse consequences for the company's financial condition (for example, material accounting losses, or significant capital strains).

D.4 Retention of records

43. The Appointed Actuary will note the requirement for retention of records for seven years included in LPS 320 (paragraph 29). This adds clarity to the statement made in clause 5.1.4 of PS 200 mentioned above.

D.5 Specific examples

44. Paragraph 18 of LPS 320 notes that the "Appointed Actuary's written advice may relate to a number of policies of a similar kind". It is common for Appointed Actuaries to establish a framework document for the pricing of policies of a similar kind. This is described in detail for group risk business in section D.5.1.
45. In this section, some examples in relation to specific areas have been set out, including use of a pricing framework. The information provided below reflects one way of complying with LPS 320, but variations may well be suitable (and practical) depending upon the individual circumstances of each life insurer.

D.5.1 Group risk

46. It is common for Appointed Actuaries to establish a framework document for the pricing of group business which describes the standard pricing process for group schemes (including experience rating) and contains other details like:
- ▶ the full range of pricing assumptions and adjustment factors;
 - ▶ standard premium rate table, standard occupation loadings;
 - ▶ methods for calculating IBNR (incurred but not reported) and disabled life claims reserves;
 - ▶ policy terms and conditions (definitions, premium rate guarantees, exclusions, automatic acceptance limits, eligibility criteria, profit sharing arrangements etc);
 - ▶ reinsurance arrangements;
 - ▶ delegated authorities; and
 - ▶ risk management strategy.
47. In practice, there are occasions in a competitive and innovative market where variation from standard product terms and conditions are required. This might occur for any number of reasons including company strategy, fund design or circumstance, etc. Such variation, unless considered immaterial by the company and the Appointed Actuary, will be the subject of product advice. The advice on these variations is

required to be provided prior to the company making a binding offer (for example, submitting a binding tender response).

48. Adoption of the approach outlined above assists in ensuring that the Appointed Actuary can deliver timely advice, consistent with the LPS 320 requirements.

D.5.2 Outwards reinsurance

49. Reinsurance terms and conditions can materially impact the profitability and capital requirements of some life insurers. Given the nature of reinsurance arrangements, it is more common that each arrangement requires specific product/reinsurance advice that is tailored to the specifics of the arrangement. In some cases, the Appointed Actuary will establish a pricing framework that covers a range of similar reinsurance structures.
50. Facultative placements covered by a broader treaty would generally not require separate product/reinsurance advice, unless the Appointed Actuary considers the particular situation to be material to the life insurer. This might, for example, be the case for reinsurance of particular group life policies.
51. Facultative placements not covered under an existing reinsurance treaty are new arrangements and product advice in relation to the arrangement is required by LPS 320.

D.5.3 Retail products

52. It is common for companies to provide individual term insurance and income protection products for the adviser market. These products regularly undergo changes to their terms and conditions for either just new policies or both new and existing policies. Over a period of 5 or more years, the company will have a range of product series in force. The Appointed Actuary will need to consider clauses 6.1.3 and 6.1.4 of PS 200:
 - ▶ clause 6.1.3 relates to the need to provide product advice where there are changes to terms and conditions for the product; and
 - ▶ clause 6.1.4 relates to the need to provide product advice where there are changes to terms and conditions for existing policies.

D.5.4 Campaigns (direct marketing or incentive)

53. Often campaigns will tailor a base product by way of adding a special feature to generate attention or enhance the attractiveness of the overall offer. This might be a temporary increase in commission, increase in points for a sales convention or a

training facility, or a product enhancement such as additional benefits or coverage or an investment guarantee. As with group life, this is to be expected in a competitive and innovative life insurance industry.

54. However, as with group life business, these changes are captured by the LPS 320 requirements for product advice and require advice from the Appointed Actuary unless they fall into the immaterial category outlined in the company's Board-approved policy.
55. To the extent that the Appointed Actuary can foresee the types of product variation (for example, adjusted commission and premium rates for a particular direct marketing campaign with a particular alliance partner), the original product advice can be broad enough to cover the arrangements (that is, a pricing framework approach). This requires the original product advice to set out the range of circumstances to which it applies.

D.5.5 Policy alterations

56. LPS 320 also applies to modification of existing policies. Such modifications take many forms – sum insured or premium increases or decreases, unit fund switches, product type changes (for example, whole of life to endowment assurance), process changes (for example, underwriting and medical limits) and surrender value basis changes. Many such changes are contractual rights under the policy terms and conditions (for example, unit fund switches) and consequently will be covered by the product advice covering the issuance of the policy. A number of other changes at an individual policy level might not be material, and the Appointed Actuary will apply his/her judgment in relation to such matters.

Appendix A: Extract from LPS 320

APRA's Prudential Standard LPS 320 (Actuarial and Related Matters) contains the following references to the need for life insurance companies to seek product advice by Appointed Actuaries:

Actuarial advice regarding policies and reinsurance

17. A life company must not issue or modify a policy unless either:
 - (a) the Appointed Actuary has given written advice about:
 - (i) the proposed terms and conditions on which it is to be issued or modified;
 - (ii) the proposed basis on which the surrender value is to be determined;
 - (iii) if the policy provides for benefits to be calculated by reference to units, the proposed means by which the unit values are to be determined;
 - (iv) if the life company is a friendly society, the proposed approved benefit fund rules or modification of the benefit fund rules; and whether the benefit fund rules will result in unfairness to any prospective or existing members of the benefit fund; and
 - (v) if the life company is a friendly society, any change to the investment management or strategy of an approved benefit fund beyond that disclosed in the approved benefit fund rules; or
 - (b) the proposed modification is assessed by the life company as not being material under the written policy approved by the Board for the purposes of paragraph 20 and the Appointed Actuary has been advised of the proposed modification and advises the life company that the modification is not material.
18. The Appointed Actuary's written advice may relate to a number of policies of a similar kind.
19. A life company must not enter into, modify or terminate a reinsurance arrangement unless the Appointed Actuary has given the company written advice as to the likely consequences of taking such action.
20. A life company must have a written policy, approved by the Board, which:
 - (a) sets out the situations where the Appointed Actuary's written advice may relate to more than one life policy under paragraph 18;

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- (b) enables the life company to decide whether any proposed modification to a policy is material or not for the purposes of paragraph 17(b) of this Prudential Standard, taking into account the likely impact of the modification on policy owners and the financial position of the life company; and
- (c) sets out who must consider the advice under paragraph 17 or 19 and, in particular, the situations where the advice must be considered by the Board.

END OF INFORMATION NOTE