December 5, 1986

PROFESSIONAL STANDARD NO. 1
ACTUARIAL REPORTS AND ADVICE TO A LIFE INSURANCE COMPANY

1. Introduction

1.1 This standard replaces Professional Standard No. 1 "Life Insurance Companies: Financial Condition Investigations" first issued in June, 1982. It expands the content to all responsibilities of the appointed actuary of an Australian life insurance company. The matters covered by the previous standard are now included in sections 5 and 6 below.

1.2 The standard has been finalised on a basis consistent with the latest draft Guidance Note on the Appointed Actuary. Until such time as changes to the Life Insurance Act complementary to the Appointed Actuary Guidance Note are enacted and the final form of the Institute's Guidance Note is determined, the term "Appointed Actuary" in this Statement should be treated as referring to the actuary appointed by the Company for each particular actuarial duty currently specified under the Act.

1.3 The financial soundness of life insurance business depends substantially on the way appointed actuaries discharge their responsibilities, as also does the reputation of the actuarial profession. As a result it is incumbent on appointed actuaries to ensure, to the extent of their authority, that Australian life insurance business is conducted on sound financial principles.

1.4 Most of the matters with which the appointed actuary is concerned are not capable of precise assessment but are, rather, matters of judgement. In some circumstances, this judgement may appropriately be based on the appointed actuary's views of the most probable outcome - perhaps, for example, in relation to bonus rates. If however, judgement is required in a matter which may affect the solvency of the company, much more rigorous standards should be applied. (Two such contrasting situations are exemplified in 5.2.2 below).

2. Explanation of Certain Technical Words Used

2.1 "Experience related non-participating"

The Life Insurance Act classifies policies as either participating or non-participating. Participating policies are entitled to share in the surplus or profits made by the company. Non-participating policies traditionally have fully defined and guaranteed benefits and premiums. However, in recent years policies have been developed which are legally non-participating yet one or more of their elements such as benefits, premiums or some other factor can be varied by the company in a discretionary

.../2

manner. Often such variation is related to the experience of the company in respect of one or more factors such as expenses, investment returns, mortality or morbidity. To simplify the text of these notes the description "experience related non-participating policies" has been used where appropriate to cover the range of such policies.

2.2 "Estate"

The word "estate" is commonly used by actuaries to denote reserves of a capital nature used in a number of ways in supporting the life insurance business of a company. There is no universally agreed precise definition but conceptually it is:

"the excess of assets held by the company in respect of its life insurance business over the amount it needs to be able to meet the liabilities in respect of that business. Typically it comprises margins in assessed values of liabilities and assets, disclosed reserves, undistributed surplus, and the shareholders fund."

The word "estate" has been used where appropriate in the text to denote such reserves.

2.3 "Reasonable benefits"

Under participating and experience related non-participating policies either the premium or the benefits may be varied. This may enable a company to underwrite risks more confidently in the knowledge that adjustments can be made as experience unfolds. A purchaser of such a policy shares the risk to some extent and is entitled to be treated equitably in the light of that experience. The expression "reasonable benefits" is used in connection with such policies to describe benefits which fall within a range which could be reasonably held to recognise these features and all the matters described in 7.3 below.

3. General

3.1 In carrying out his responsibilities the appointed actuary of a company, among other things:

3.1.1 must comply with the requirements of the Life Insurance Act and other relevant legislation;

3.1.2 must satisfy the Articles of Association or other instruments constituting the company;

.../3

3.1.3 should seek to ensure, within the bounds of reasonable probability, the long term financial soundness of the life insurance business of the company;

3.1.4 should seek to achieve equity in the distribution of surplus to participating policyholders in general, between different groups of such policyholders, and to shareholders;

3.1.5 should seek to achieve equity in the treatment of experience related non-participating policies in a manner which is broadly consistent with the distribution of surplus but which recognises the different contract structures involved.

3.2 The statutory duties specified in the Life Insurance Act which the appointed actuary of a company must carry out are:

3.2.1 to investigate and report on the financial condition of the company in accordance with Section 48;

3.2.2 to approve premium rates, and report if required, in accordance with Section 78;

3.2.3 to approve increases in commission rates in accordance with Section 79.

3.3 The assessment of the financial condition of a company is particularly affected by:

3.3.1 the premium rates on which existing business has been, and current new business is being, written;

3.3.2 the nature, terms and conditions of the contracts in force and currently being sold with particular reference to all options and guarantees, and the scope for adjusting the terms and conditions in the light of emerging experience;

3.3.3 the existing investments, the continuing investment policy and likely future investment experience;

3.3.4 the marketing plans, in particular the expected volumes and costs of sales;

3.3.5 the current and likely future level of expenses and taxes;

3.3.6 the current and likely future experience in respect of the risk elements;

.../4

3.3.7 the current and likely future experience in respect of forfeiture and surrender rates;

3.3.8 the extent of the company's estate, its position in the various statutory funds, the ability to transfer it between them, and additional capital which the company is able and willing to add in further support;

3.3.9 the arrangements for reinsurance.

3.4 The appointed actuary should ensure that the company is aware that he will be unable to properly carry out his responsibilities unless it makes available to him adequate information on the items listed in 3.3 above and other relevant information. In this regard he should specify his needs and, if the appropriate information is not forthcoming, he should qualify his report or state his inability to give approval as the case may be.

4. Premium Rates

4.1 The appointed actuary has a prime responsibility to satisfy himself that the premium rates being charged for new business are suitable. He must also satisfy himself on the continuing suitability of premium rates for existing policies which can be varied in terms of policy conditions. That is to say premium rates should be sufficient to enable the company in due course to meet its emerging liabilities having regard to the items listed in 3.3 above.

4.2 The appointed actuary should determine premium rate and benefit structures so that, as far as possible, equity will be able to be maintained without undue practical difficulty between different groups of new and existing business. He should also seek to ensure that premium rate and benefit structures will not present the company with undue practical difficulty in maintaining a suitable asset structure relative to them.

4.3 The statement that a premium rate is suitable cannot in fact be an absolute statement - it is inevitably a probability statement because it depends on the future experience of such things as mortality, morbidity, the return on investments, tax and expenses of administration. The adequacy or otherwise of premium rates cannot, therefore, be other than a matter of judgement. The required judgement will, or course, need to be based on the use of sound techniques. It should specifically take into account the complex matters involved in contracts containing various options or guarantees particularly where the exercise of an option by a policyholder for his own benefit or the honouring of a guarantee could result in material cost to the company.

.../5

4.4 Usually a suitable premium basis, while commercially justifiable, will involve the company in financial strain by writing new business. That strain may arise because in writing the business the company incurs expenses which exceed the first premium received. It may also arise because reserves in respect of future liabilities will need to be held which exceed the amount accumulated from the net cash flow of the business. This strain must be financed by drawing from the estate of the company not already committed to support existing business. The appointed actuary should indicate any limits on the volume of business that may be prudently accepted taking account of the estate not already committed to support existing business and additional capital which the company is able and willing to add in further support.

5. Financial Condition Investigations

5.1 Introduction

5.1.1 Sections 5 and 6 set down those matters which the Institute considers the appointed actuary should address in examining and reporting on the financial condition of a life insurance company. They may well go beyond the requirements of the Life Insurance Act.

5.1.2 Section 48(1) of the Act requires every company to "cause an actuary to make an investigation into its financial condition, including a valuation of its liabilities in respect of its life insurance business, and to furnish it with a written report of the results of the investigation."

5.1.3 In examining the financial condition of a company an appointed actuary should consider all the items listed in 3.3 above and any other matters he considers relevant. This investigation would normally be on an open-to-new-business basis but he should also consider the possibility that the company might be closed to new business. In particular, he should consider the liabilities, the corresponding assets, and their inter-relationship. He should do this from two points of view - the solvency of the company and its ability to provide reasonable benefits to its participating and experience related non-participating policyholders. It may be that different valuation methods or bases are appropriate for each purpose. He should consider the possibility of insolvency or the company's being unable to provide reasonable benefits to its policyholders from factors within and outside the control of the company. In

.../6

relation to those under the control of the company he should assess the limits within which the company should act and advise it accordingly. In relation to those outside the control of the company he should take whatever action he considers necessary.

5.1.4 Appendix 1 contains a detailed check list of the matters the appointed actuary would normally consider in making a financial condition investigation.

5.2 <u>Assets</u>

5.2.1 Subject to any statutory regulations, the responsibility for investment policy rests with the directors of the company. However, the appointed actuary should decide whether, in his judgement, the investment policy pursued by the directors is, or could become, inappropriate having regard to the nature and term of the company's liabilities. If this is the case he should, in his report, advise the company of the constraints on investment policy which he regards as necessary to protect policyholders.

5.2.2 The financial condition of a life insurance company depends fundamentally on the relationship between the nature and term of the assets and of the corresponding liabilities. The importance of this will vary widely from one situation to another, for example:

(a) Towards one extreme, for a company with a large portfolio of long established participating business, and where the company is transacting (and seems likely to continue to do so) a steady volume of new business which is small in relation to the existing business, the possibility of insolvency arising from mis-matching of assets and liabilities may be minimal;

(b) Towards the other extreme, for a company transacting a volume of non-participating new business which is very large in relation to the existing portfolio and which has only a small estate, matching of asset proceeds to liability outgo may be critical to solvency. The dangers are increased if there are guarantees or options which could, in certain circumstances, require a different distribution of assets by term.

.../7

5.2.3 As in the case of investment policy, the responsibility for the values to be placed on the assets in the company's balance sheet rests with the directors. The appointed actuary should consider the suitability of those values for the purpose of his investigation. If he considers they are unsuitable in any respect he should comment and adopt values which he considers are appropriate for the purpose.

5.3 Data

5.3.1 Regulation 5 of Part 1 of the Second Schedule of the Life Insurance Act requires an appointed actuary to certify the accuracy of the data used in carrying out his investigation if he is an employee of the company or to state what precautions he took to ensure its accuracy if he is not an employee. If an appointed actuary has any doubts about such accuracy he should advise the company. If he cannot obtain a satisfactory clarification he should qualify his report.

5.4 Liabilities

5.4.1 In making his investigation the appointed actuary should deal with the company as a whole and separately with each of the statutory funds operated by the company. Further sub-division may be necessary, for example when

(a) a single statutory fund covers
(i) liabilities in more than one currency, or
(ii) both ordinary and superannuation business, or

(b) some liabilities of a statutory fund should be related to values of part of the assets of that fund.

5.4.2 In his report the appointed actuary should comment on the main features of the valuation methods and assumptions. If there has been any change in valuation methods or assumptions from the preceding investigation, the reasons for the change should be explained and, unless the appointed actuary is satisfied they are not material, the effects of the change on the valuation results should be quantified.

.../8

5.4.3 All material valuation assumptions, whether explicit or implicit, should be stated and the appointed actuary should be satisfied as to their suitability in relation to the recent and expected experience of the company. He should also seek to ensure that the valuation basis adopted is robust enough to cope with changing conditions.

5.4.4 The appointed actuary should use liability valuation methods that are appropriate to the contracts in question, and the purpose of the valuation, taking into account not only the principal benefit, but any ancillary guaranteed benefits such as surrender and paid-up values, and any options. It is noted that although the form of the Second Schedule to the Act envisages a net premium valuation method, the appointed actuary should adopt for all or part of the life insurance business whichever valuation methods he considers most appropriate to the policies concerned.

5.4.5 The appointed actuary should make appropriate provisions

(a) for the likely future experience of the risk elements such as mortality and morbidity;
(b) for future expenses of continuing the existing business;
(c) either explicitly or implicitly, for future bonuses consistent with reasonable benefits for the company's participating policyholders;
(d) for overall reserves to meet adverse contingencies.

5.4.6 In deciding the interest rates to be used, the appointed actuary should examine the earnings on investments having regard to the values placed on assets and the investment policy of the company. He should consider the likely future rate of return after tax on the existing assets and that possible on future investments. In relation to the existing assets, he should assess the nature of the portfolio and consider what rate of return, capital and income, is likely to be realised over the future period relevant to the liabilities.

.../9

5.4.7 The appointed actuary should satisfy himself that, for the purpose of the statutory return required by Section 48 of the Act, the value placed upon the aggregate liabilities of a statutory fund in respect of policies is not less than the value calculated on the minimum basis set out in the Fourth Schedule of the Act and that the basis of valuation is such as to ensure that no policy is treated as an asset. He should recognise that the minimum basis under the Act may be weaker than proper for the company.

5.4.8 The Act does not recognise some important types of policies. The Institute is of the opinion that the appointed actuary should satisfy himself as to the value placed on the aggregate liabilities of the policies recognised by the Act, as required by Section 49(3) of the Act, and that for the remainder of the policies a proper value should be placed on the liabilities pursuant to Section 49(2).

5.5 Premium Rates

5.5.1 The appointed actuary should comment if in his judgement the premium rates charged by the company are, or could become, unsuitable. (If a review of premium rates is recommended, it need not be completed as a part of a financial condition report).

5.6 Reinsurance

5.6.1 The appointed actuary should examine the company's reinsurance arrangements including any financial provision implicit therein. If he considers these arrangements are inappropriate or inadequate he should advise the company to seek appropriate modifications.

5.7 Benefit Illustrations

5.7.1 The appointed actuary should indicate the rates of bonus or investment performance results which he considers it would be reasonable for the company to use in illustrating policy benefits to policyholders.

6. Distribution of Surplus

6.1 The directors are responsible for deciding the distribution of surplus - usually after considering the recommendation of, or with the approval of, the appointed actuary. In addition the Life Insurance Act provides that the distribution cannot be made unless the appointed actuary approves it.

.../10

6.2 Recommending or approving a distribution of surplus disclosed by a financial condition investigation is complex and requires considered judgement. The framework within which the appointed actuary should exercise this judgement is that:

6.2.1 the distribution must comply with Section 50 of the Life Insurance Act;

6.2.2 the distribution must satisfy the Articles of Association or other instruments constituting the company;

6.2.3 he should seek to achieve equitable treatment between participating policyholders in general, between different groups of such policyholders and shareholders.

6.3 The appointed actuary should take into account that the surplus disclosed by a financial condition investigation is dependent on the methods and bases used in the valuation of the liabilities and assets. He should ensure the methods and bases are appropriate for the purpose. He should also take into account that surplus consists of operating profit increased or reduced by a release from or addition to the estate included in the liabilities and assets. Separate consideration of each may be necessary.

6.4 In any report regarding distribution of surplus the appointed actuary should

6.4.1 identify the major components of surplus since the previous investigation

6.4.2 give the reasons upon which his recommendation or approval is based

6.4.3 report on the short term outlook for surplus distributions to policyholders and transfers between statutory funds and shareholders' funds.

7. Soundness, Reasonable Benefits and Equity

7.1 When the appointed actuary reports on the financial condition of the company in terms of Section 48 of the Life Insurance Act, makes recommendations on the distribution of surplus or approves the treatment of surplus in terms of Section 50 of the Act:

.../11

7.1.1 he should seek to protect the ongoing financial soundness of the company;

7.1.2 he should seek to ensure that reasonable benefits are provided to participating and experience related non-participating policyholders;

7.1.3 he should seek to achieve equitable treatment between different groups of participating and experience related non-participating policyholders.

7.2 There is no universally agreed definition of equity and a decision about it can only be a matter of judgement. In making his judgement an appointed actuary should give consideration to the following:

7.2.1 the sources of the surplus disclosed, the relative contribution to it by the different groups of policyholders and by the shareholders, and the release of estate previously committed to support existing business;

7.2.2 the relative risks taken by the participating and experience related non-participating policyholders in paying premiums for benefits either of which may be varied, and by the shareholders in contributing capital;

7.2.3 the need to maintain the overall viability of the company for existing policyholders;

7.2.4 prevailing attitudes within the actuarial profession.

7.3 Likewise a decision about reasonable benefits for the different groups of participating and experience related non-participating policyholders can only be a matter of judgement. In making his judgement an appointed actuary should give consideration to each of, and the inter-relationship between, the following:

7.3.1 the terms and conditions including the premium rates, options and guarantees on which the policies were issued;

7.3.2 the information conveyed by the company to the policyholders in connection with the sale and subsequently;

7.3.3 the experience of the company, subsequent to the issue of the policies, in relation to each of the elements in their terms and conditions such as mortality, morbidity, the return on investments, tax and expenses of administration, forfeiture and surrender experience;

.../12

7.3.4 the need, if any, for each policy to make a contribution, from the surplus it generates, to the company's estate in recompense for and appropriate to the support it may have received from the estate and the company generally.

7.4 In seeking to protect the ongoing financial soundness of the life insurance business of the company the appointed actuary should have regard to all the items listed in 3.3 above and should pay particular attention to:

7.4.1 the need to preserve sufficient estate in the company for the ongoing support of the continuing business, both existing and new, especially taking account of the likely new business strain which may arise from the company's marketing plans;

7.4.2 the need for a solvency margin to minimise the possibility of the company getting into financial difficulty.