**LIFE INSURANCE AND WEALTH MANAGEMENT PRACTICE COMMITTEE**

# Technical Paper: Application of Regulatory and Accounting Standards on Policy Liabilities to Friendly Societies

**September 2014**

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## Contents



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## A. Status and purpose of Technical Paper

1. This Technical Paper – last issued in July 2009 – has been updated by the Life Financial Reporting Sub-committee ("LFRSC") on behalf of the Life Insurance and Wealth Management Practice Committee ("LIWMPC") of the Institute of Actuaries of Australia ("Institute").

2. This Technical Paper 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.

3. Feedback from Institute members is encouraged and should be forwarded to the LIWMPC's Friendly Society representative, Richard Land, at richard.land@mercer.com.

## B. Background

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

5. 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).

6. These differences mean that actuaries working with friendly societies need to consider how the Act, APRA's Life Prudential Standards and accounting standards should apply in those circumstances. This Technical Paper deals with some of those considerations.

## C. Friendly society profit allocation under the Act

7. 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."

8. In addition, the requirements of APRA's Prudential Standard LPS 700 (Friendly Society Benefit Funds) (LPS 700) and Prudential Standard LPS 110 (Capital Adequacy) (LPS 110) need to be considered prior to making a distribution of surplus.

## D. Policyholder retained profits and policyholder equity

9. APRA's Prudential Standard LPS 340 (Valuation of Policy Liabilities) (LPS 340), defines the policy liability in respect of life insurance contracts as the sum of:

(a) the best estimate liability;

(b) the value of future best estimate bonuses; and

(c) the value of future best estimate shareholder profits.

10. Current year best estimate bonuses are an appropriation of profit for participating business.

11. For friendly society benefit funds, the nature of surplus not yet allocated to policyholders may vary depending on the benefit fund rules. Paragraph 4.1.2 of accounting standard AASB 1038 (Life Insurance Contracts) (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."

12. There are three different scenarios that may apply for friendly societies which depend on the description of how surplus may be allocated in the benefit 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.

13. LPS 340 reflects these different scenarios, noting in paragraph 40 that "friendly society benefits are neither participating nor non-participating", and that "benefits provided under benefit funds where there is a provision for distribution of unallocated surpluses to policy owners are to be valued as if they were participating. Benefits provided under benefit funds where there is no provision for distribution of unallocated surpluses to policy owners are to be valued as if they were non-participating." The discourse below is consistent with this requirement.

14. 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.

15. Where the entire surplus is to be transferred to the management fund, or where policyholder surplus is smoothed in some way, it may be necessary to determine profit carriers and margins as set out in LPS 340 to ensure that the surplus emerges in an orderly fashion for distribution according to the rules and policyholder benefit expectations.

16. 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.

17. 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:

(a) part of the policyholder benefit liabilities (which, in this case, are explicitly aligned to the value of the fund asset); or

(b) explicit surplus; or

(c) 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).

18. For those funds which provide for distributions of surplus to policyholders, any explicit surplus (after allowing for any distribution in the current period) is 'unallocated surplus that has been classified as liabilities' for the purpose of applying valuation standard LPS 340, 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.

19. 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.

## E. Defined contribution funds

20. In a defined contribution fund, the benefit is derived from contributions made by the member together with the investment performance of the assets of the benefit fund.

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

### E.1 Life investment contracts

22. 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.

23. Typically, friendly society benefit funds with such characteristics would be unit-linked contracts or investment account contracts with no discretion regarding bonus setting. The appropriate reporting accounting standards are:

(a) AASB 139 (Financial Instruments: Recognition and Measurement) (AASB 139) to the extent that it gives rise to a financial instrument; and

(b) AASB 118 (Revenue) (AASB 118) to the extent that there is a management services element under the contract.

24. Contracts that do have an insurance risk element can be unbundled for valuation purposes with the insurance risk being separately valued.

### E.2 Life insurance contracts

25. If a defined contribution fund is characterised by the presence of:

    (a) insurance risk; and/or

    (b) a discretionary participation feature (including where there is discretion as to the amount or timing of bonus distributions),

    then the defined contribution benefit fund satisfies the definition in AASB 1038 of a life insurance contract. The appropriate standards are AASB 1038 and LPS 340.

26. Typically, friendly society benefit funds with discretionary participation features are investment account contracts with discretion to carry forward amounts as unallocated surplus. Unallocated surplus is typically held for a number of reasons, including meeting regulatory and target capital requirements and providing an investment fluctuation reserve. 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. 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.

27. 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. Following the declaration of the bonus (or providing for the bonus), there would then be no surplus under this arrangement.

28. Alternatively, the policy liability might be set equal to the account balance pre bonus. The balance of the fund (excluding seed 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).

## F. Defined benefit funds

29. In a defined benefit fund, the amount of any benefit is specified in, or determined in accordance with, a formula set out in benefit fund rules and the amount of the benefit is not directly related to the assets of the approved benefit fund or the investment performance of those assets.

30. Defined benefit funds carry investment or insurance risk. Hence these are insurance contracts within the definition in AASB 1038. LPS 340 then applies.

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

**F.1 All surplus is used for benefit enhancements**

32. 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.

33. 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.

34. 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.

35. 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 bonuses.

36. 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.

37. 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.

**F.2 All surplus belongs to the management fund**

38. In this case, a profit carrier (or similar, if an approximate method is used) 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 Technical Paper does not address the appropriate profit carrier, as it will depend on the nature of the benefit fund. It should be noted, though, that approximate methods may be used where appropriate, in accordance with paragraph 36 of valuation standard LPS 340.

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

### F.3 Surplus may be transferred to the management fund or to improve member benefits

40. 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.

41. 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.

42. 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 profit carrier.

43. 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).

44. 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.

## G. Board discretions and policyholder expectations

45. 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.

46. 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.

47. 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.

48. When valuing benefit fund liabilities, the actuary should consider whether management fees (specified and surplus transfers) are:

    (a) adequate to cover the expenses incurred in operating the fund;

    (b) reasonable for the benefits being provided; and

    (c) 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.

49. 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 TECHNICAL PAPER**