The Pilgrims’ Progress -
A Tale of the solvency discussion draft

Introduction

The discussion draft stage of the LIASB’s due process for the solvency standard began in December. This followed many evening meetings of the Board at the offices of the ISC at which the draft’s antecedent, the Guidance Note of the Institute of Actuaries of Australia, was discussed, reviewed and developed; and copious volumes of coffee consumed.

It may be useful to the various parties vitally interested in the outworking of the process to know more of how the Board went about its task to this point. Of course there are other standards at various stages of development - this is part of the story of just one of them.

The pilgrims discuss their task

Before we set off on the journey towards a standard on solvency, Peter Vinson (our Chairperson), suggested that we spend a little time sharing our understanding of our task. Certainly it is set out in the Act, but we needed to exchange views on what the legal responsibility translates to in terms of approach and principles, and on what the key issues were.

Early in this dialogue we asked ourselves whether there was anything characteristically different between the states of solvency and capital adequacy other than that the latter was stronger than the former. We decided there was. Expressed simply these differences are that:

- a life office that is just insolvent should have enough reserves over and above its policy and other liabilities to give a Judicial Manager every chance of achieving a satisfactory outcome from a Court administered insolvency; and
- a life office that is at least capital adequate, and hence free to pursue its reasonable business plans, should have enough reserves to have every chance as a going concern of not falling into insolvency.

In respect of some business factors, this distinction between an office under judicial management and as a going concern could lead to a qualitative difference between the two standards, while for other factors the distinction would lead to a quantitative difference reflecting the relative strength of the two standards.

The distinction also could affect, we decided, not just the relative probabilities one would be happy to see attached to adverse business outcomes, but also the timeframes over which those probabilities would be relevant.

For example, given the Act’s envisaged transparent market value based financial reporting format, avoiding insolvency is a year to year issue for a healthy life office, but once insolvent the need is for a suitable outcome from a workout (or transfer of business) taking perhaps three years or so.

We were also clear that the requirements of the standard would relate directly to the risks in the business - an office with lower risks in its business than another would need lower solvency reserves.

On this latter principle, we were conscious of a rather vaguely defined concern that the standards should allow a level playing field with banks and others. As the risks in banking and life insurance are quite different, and as the regulatory capital regimes should be based on the risks relevant to each, this principle boiled down to seeking similar levels of robustness to business outcomes, not similar capital formulas.

In discussing issues such as this, we were acutely aware of striking a proper balance between the security of policyholders on the one hand and not imposing unreasonable capital demands on the industry on the other.

However, we decided that we could not be deterred from setting a proper standard just because another industry, say the unit trust industry, does not have the same regulatory approach. Instead, we would be more influenced by the practice of rating agencies or the like in such cases.

As it began its journey the LIASB was extremely fortunate that the Institute of Actuaries of Australia was so far advanced in its work to pave the way for a standard, and that the Institute’s draft guidance
note for its members on solvency was of such high professional quality. Nevertheless, the Board knew it could take nothing for granted and set about the task of review and further development. At the forefront of our minds was the subject of resilience.

**Resilience**

While the discussion draft covers many areas, all of which we were to review and develop using the Institute’s work as our base, no other area represented quite the same challenge as resilience.

Resilience is the ability of a fund which contains investment account or traditional investment policies to withstand rapid adverse changes in the market value of its assets.

While an investment-linked fund simply has its unit prices recalculated and is perfectly resilient in the face of such shocks, other funds are not. Depending on the extent to which terminal bonuses and the like can be adjusted, a fund that is not perfectly resilient needs additional reserves to secure its ongoing solvency.

Furthermore, those reserves need to be readily available in the event of a market slump (and then need to be expeditiously rebuilt afterwards) for the industry to demonstrate its solvency to the world at large.

This feature of the solvency regime is particularly important under a transparent, market value based reporting format, and even more so given the significance of investment account policies in the Australian industry. To add to the context, the ISC was able to provide us with industry aggregates for solvency reserves based on the Institute’s draft guidance note. This summary data was drawn by the ISC from the June 1995 ‘dry-run’ returns in its possession.

The Board needed to be satisfied that enough work had been done in this area for either the solvency or capital adequacy standard to be reliably finalised. We also felt that we needed to roll up our sleeves and do some simple modelling ourselves so that we could get a better feel for the practical issues involved. This we did, and then began to seek advice from a range of experts.

One of the principles we committed to from the outset was to consult widely and to indicate the direction of our thinking as openly as possible along the way. Nowhere was this more true than in the area of resilience. We consulted with finance academics and with market practitioners expert in capital markets. And all the time we fed back issues to the Institute.

Our discussion draft is still qualified in this area, but we are particularly pleased that the Institute moved to establish a resilience working group during the consultation process to help address remaining areas where we are seeking further insight. We have met with, and have been given a useful briefing by, this group and are awaiting some additional results before moving closer to finalising the resilience reserve rules.

In the meantime, we believed it best to indicate the direction of our thinking in the discussion draft, based on the extensive, but not final, work available to us so far. That way your views will also be given the fullest possible airing.

**Inadmissible assets**

The approach taken to inadmissible assets reserve followed a similar path of consultation with relevant experts to test our own judgement.

Bill Bartlett (our non-actuary member) and Bob Glading (our Government-appointed member) assembled a willing working group of accountants, legal experts and actuaries to advise the Board on the inadmissible asset provisions of the standard. As with resilience, while results are not final they are sufficiently advanced to allow us to proceed to the discussion draft.

**Expense reserve**

During the course of our discussions it became apparent that one important qualitative difference between solvency and capital adequacy standards relates to the area of expense reserves.

While the Institute’s draft guidance notes had included a reserve for capital adequacy purposes (in effect to ensure that an office could meet reasonable new business expenses), they had not envisaged a solvency reserve to ensure it could meet semi-fixed overhead expenses (normally supported by new business) during a judicial management. The Board considered that a reserve for this latter purpose is necessary, and included it in the discussion draft.

An important aspect of these expense reserves is that they are not necessarily additive - what is needed for solvency is not necessarily needed for capital adequacy.

**Other aspects**
Space does not permit a commentary on the many other areas of the discussion draft and on every aspect of the process that led to it. Suffice it to say that the traditional actuarial areas of the Institute’s draft guidance notes in the end needed little refinement, making our task manageable and making for less comment.

Also making our task manageable was the ISC Secretariat. Nothing much would have been achieved without their energy and skill in translating the position reached through our dialogue into the next draft - and always on time. The Secretariat also helps keep our feet on the ground as we ramble across the various fields involved in this work.

**Speaking of keeping our feet on the ground**

As our pilgrimage moves an important step closer to its destination of a solvency standard we are keen to listen to your views. We are also keen to ensure that we keep a weather eye out for the materiality of the calculation work involved in applying the standard in practice.

The purpose of a discussion draft is to flush out all the issues and to learn of better, more practical ways of doing the work. Please do not hesitate to share your opinions with us ... we will deal with each and every submission on its merits as we collectively see them.

**SPECIAL MESSAGE**

It is recognised that there has been some slippage in the expected release dates of the actuarial standards, as set out in the Attachment to this Newsletter. It should not be inferred from this that the commencement date of the new regime will be deferred. With the release of the Capital Adequacy Standard Discussion Draft in March 1995, it is the opinion of the Board that the main policy directions of the proposed standards will have been exposed. Given that the concepts underlying the actuarial standards have been evolving for some five or more years, it is felt that the industry should be, or be capable of being, well positioned to comply with the new requirements on the scheduled commencement date.

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