PROGRESS ON THE SOLVENCY STANDARD

Introduction

The exposure period for the Discussion Draft of the Solvency Standard closed on 31 January. The LIASB received some 50 individual submissions on the draft and has considered the issues raised in those submissions at a Special Meeting on 4 March.

While it was hoped to release an Exposure Draft of the Standard in early April, to do so would be premature given the status of certain projects which are directly relevant to the final form of the standard and are progressing simultaneously:

• The Resilience Reserve Working Group is expected to complete their report reviewing stochastic modelling processes and the implied levels of resilience reserves. The report is being presented to the Institute of Actuaries of Australia at sessional meetings late in March/April.

• The Inadmissible Assets Working Group is due to provide their final report to the LIASB by the end of April.

• Further, the ISC has requested data from individual companies in respect of Valuation, Solvency and Capital Adequacy results under the most recent versions of the respective actuarial standards. This information is to be lodged by 1 April (1 May for December balancing companies) and analysed by the ISC for reporting to the LIASB in May.

Finalisation of the detailed parameters of the Solvency Standard cannot be completed until the reports or analyses from these various projects are available to the LIASB. Given availability of this information, the LIASB is confident of its ability to present an Exposure Draft which represents the most advanced research in these areas and takes full account of the impact of the proposed regime on the individual companies and the industry as a whole.

Given the deferred release of the Exposure Draft until May 1996, the LIASB felt it appropriate to communicate at the earliest possible opportunity, to the extent possible, the direction of the Solvency Standard on the basis of LIASB consideration of the submissions received.

It is important to realise, however, that in commenting on the major issues at this stage, the LIASB is indicating the general nature of the expected amendments rather than final details. The following discussion on amendments to the Standard should not be treated necessarily as the final word. All parties will have the opportunity to make further submissions following the issue of the exposure draft; the LIASB does not intend to enter into discussion or argument on the basis of this newsletter.

Bunyan’s Burden - The Pilgrim’s Progress Revisited

We thank all those who made submissions for their thoughtful contributions. It is clear that the opportunity to take part in the development of this very important standard has been welcomed. The Board regrets that, in view of the large number of submissions, it is not practicable to give detailed written comments to each individual contributor. We hope, in due course, to prepare a more extensive summary of the issues than included in this newsletter and respond with this to all contributors.

The Solvency Standard proposals

(a) Expense Reserve

This issue was by far the one most frequently commented on by contributors. Over 90% of respondents agreed with the principle of an expense reserve but all but one expressed reservation about the quantum proposed in the discussion draft.

The Board accepts that the original proposal was unnecessarily strong and advises that it will, in the exposure draft, significantly weaken the amount of the required reserve.

However, it rejects the suggestion made by some that the amount of the reserve should be determined on the judgement of the appointed actuary. The requirements for a Solvency Standard demand a high degree of prescription and this is an area
where the Board feels it is imperative to specify the requirement.

In the interests of simplicity and to avoid spurious accuracy the structure of the expense reserves will remain as based on “non commission acquisition expenses”. Arguments that the Standard should be based only on fixed acquisition expenses were reviewed sympathetically but unless or until an expense apportionment standard is promulgated, the Board does not believe it appropriate to consider such a basis. Similarly proposals that one off costs, very recent expense restructures and other special situations should be recognised were not regarded as suitable for adoption since they cannot at present be adequately specified.

As a result of its discussion the Board has agreed to:

• reduce the gross multiple to be applied to non commission acquisition expenses from 2 to 1, and

• allow the effect of tax relief at the nominal rate (ie, 0%, 15%, 39%) applicable to the particular class(es) of business where it can be established that there is expected income against which the tax benefit will be obtained, and

• to reduce the calculated amounts totalled over all statutory funds by up to $5 million; by recognising the existence of statutory capital to the extent it is held in eligible assets which are admissible and accord with section 43(3) of the Act. (The allocation of the total reduction across statutory funds will not be prescribed).

(b) Simplicity of the Calculations

The LIASB had made an acknowledgment of the complexity of the calculation process in the Discussion Draft by including a section which looked at the practicalities of the process.

The Exposure Draft will reflect an amendment in this respect, with the comparison of Solvency Liability and Minimum Termination Value (step 3.1(c) in the calculation process) being required to be performed at the Related Product Grouping level. This should have the result that the practical circumstances described in the Discussion Draft will in fact be achievable in practice.

(c) Inadmissible assets

Many submissions commented on the detailed factors included in the discussion draft. The LIASB recognises that a number of changes to the proposed Standard are appropriate.

In particular it is intended to:

• remove the inconsistency in the discussion draft between mortgages and unsecured loans; the Board is likely to propose that a first mortgage for an amount not greater than 65% of market value is admissible up to 5% of the value of all assets in the relevant statutory fund but will retain the 1% limit for all other mortgages, including first mortgages not satisfying the 65% limit, and all unsecured loans.

• recognise the concerns of small funds in respect of exposures to bank bills/deposits and semi government bonds by allowing $5 million minimum in the bills/deposits of any one bank or in the bonds of any one semi-government authority to override the respective 25% limits which will otherwise be maintained.

• recognise the principle of matching (to semi-government bonds) for annuity subfunds and the limited market generally in indexed linked bonds so that for such a matched annuity subfunds there will be no asset concentration limits.

Several respondents argued that for ordinary shares the 5% limit is inappropriate for those companies whose market capitalisation exceeds 5% of the total market. The Board does not accept this argument since no fund is totally invested in equities for non investment linked funds.

The other major issue in the comments received was in connection with subsidiary companies (which are financial institutions) of a statutory fund. The basic principle adopted by the LIASB - that it should not be possible to release capital within these subsidiaries by restructuring the business - will not be revisited. However, the Exposure Draft will better express the intended requirement, which may best be described as:

• for an interdependent subsidiary - net tangible assets less the subsidiary’s capital requirement;

• for any other subsidiary - market value less the subsidiary’s capital requirement.

(d) Resilience Reserves

It was suggested in some submissions that this reserve should not be required for risk business. The Board does not agree. The assets supporting this business are subject to the same market movements as similar assets supporting other business.
The LIASB does agree that the other liabilities of the company should be subject to resilience reserve requirements.

Many of the comments made on resilience expressed concern about the lack of hypothecation of assets. The LIASB agreed in principle, that the formulation of the resilience reserve requirement should recognise subcategories as defined in the Act. Having recognised the concerns in principle, the Board is mindful of the practical difficulties involved in finalising the requirement for the Standard. These concerns were foreshadowed in the Discussion Draft of the Capital Adequacy Standard. The LIASB will be giving further consideration to this matter, in the light of submissions received on the Capital Adequacy Discussion Draft.

(e) Reinsurance

The LIASB agrees that for a specialist reinsurer registered in Australia, the retrocession to the parent company should not be subject to the 5% admissibility limit. The LIASB has asked the ISC to discuss this issue further with the reinsurers.

Direct writing companies will continue to be allowed credit for reinsurance of liabilities only in respect of reinsurance with Australian registered companies.

It is noted that there were other matters which received substantial comment including:
- discretions,
- pricing risks,
- materiality,
- overseas business.

All these items and other issues raised by individual correspondents will be subject to review before the exposure draft is finalised.

In the meantime the LIASB hopes its thinking on the major issues of expense reserve, inadmissible assets and resilience reserve will be of interest to life companies, accountants, actuaries and others.

SPECIAL MESSAGE - 1995 Balance Date results for ISC

The ISC wishes it to be known that all companies when supplying the details required for policy liabilities, the Solvency Standard and the Capital Adequacy Standard as at their 1995 balance date, are to use the previously advised basis for preparing those details, ie the relevant discussion drafts. Do not anticipate any changes foreshadowed in this newsletter.

No doubt companies will be evaluating for themselves, where it may be possible to do so, the effect of the changes. The ISC believes that it may have enough information from the pro formas to make its own evaluation. If necessary it may ask, after review, for supplementary information from offices.

CONFIDENTIALITY OF SUBMISSIONS

The Due Process of the LIASB provides, in respect of the Exposure Draft process, that "all submissions received will be public documents, unless confidentiality is specifically requested. The LIASB will prepare a compilation of the submissions received addressing major issues raised therein. This will be available for inspection on request."

It is noted that there are no specific imposts in respect of the Discussion Draft process.

The LIASB appreciates the frankness with which submissions are prepared, and values the fullness of information made available. The LIASB recognises that the issues of profit measurement and capital requirements, being integral to the financial management of the company, can be sensitive ones. It is definitely not desired that a concern for the confidentiality of the exposure process result in any hesitancy to lodge submissions or a hesitancy to fully disclose issues of concern in those submissions.

Accordingly the LIASB would like to clarify that at the Discussion Draft stage, the individual submissions received will remain confidential - that is, available only to LIASB members.

At the Exposure Draft stage, a compilation of submissions will be prepared by the LIASB, taking all care to retain the anonymity of the individual submissions, and this summary will be publicly available. On request the individual submissions
must also be made available to the public. However, should a greater confidentiality be preferred, the alternative of making a specific request in the submission to this effect exists, and such requests will be respected by the LIASB.

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**NOTE - UPCOMING WORKSHOP**
The LIASB is intending to hold a workshop on the Discussion Draft of the Surrender Value Standard, scheduled for 23 May 1996, from 2.30pm to 6.30pm, and to be held in Sydney, venue to be confirmed.