MEMBERSHIP

The Board is pleased to announce that Ted Rudge has been formally appointed a member of the Board, as replacement for Peter Carr (whose transfer to New Zealand late in 1995 necessitated his resignation.)

Ted is Group Chief Actuary with National Mutual and in the past has been heavily involved in the life insurance development work of the IAA. He brings great experience to the Board.

It is with regret that we announce the resignation of Trevor Matthews. In taking up his new responsibilities as General Manager, Financial Services with National Australia Bank, combined with his responsibilities as President Elect of the IAA, Trevor finds he is unable to commit the time necessary to Board processes.

The appointment of a new member to replace Trevor has not been finalised.

The Board wishes to acknowledge the efforts of Peter Carr and Trevor Matthews during their time as members.

PROGRESS ON THE CAPITAL ADEQUACY STANDARD

Introduction

The exposure period for the Discussion Draft of the Capital Adequacy Standard closed on 1 April 1996. The Board received some 20 individual submissions on the draft. In considering those submissions it became obvious that there were many issues of common applicability to the solvency standard and capital adequacy standard. Therefore there was logic in progressing the development of these standards simultaneously.

Accordingly, the release of the Exposure Draft for Solvency has been deferred, and will coincide with the release of the Exposure Draft for Capital Adequacy. These exposure drafts will be released in early July.

It is stressed that this slippage does not imply a delay to the implementation date of the requirements.

The Processes of the Board

The concentrated efforts of the Board over the last two months, have gone to the finalisation of these exposure drafts. Final submissions from the various working groups -Resilience Working Group and Inadmissible Assets Working Group- and analyses from the ISC’s 1995 Valuation, Solvency and Capital Adequacy data collection, will provide the information necessary to make final decisions on the detail of the exposure drafts.

In its final considerations, the Board has liaised closely with representatives of the IAA. The reasons for these meetings have been two fold:

- to provide the Board the benefit of the expertise of the IAA in particular areas of development of the final standards, and
- to provide the IAA with an understanding of the Board’s purpose and an insight into the evolving directions of the standards, to allow them to contribute appropriately to the process.

Substantial consideration and discussion has gone in to the finalisation of the exposure drafts, and in certain areas the thinking of the Board has evolved as a result of those processes. The Board is also aware of the importance of communicating, not only the final results of that process but an understanding of the reasoning of the Board in arriving at that position.

It is of course not possible to capture all of the detail of those discussions, but it is hoped through this Newsletter to convey a feel for the thought processes of the Board which will allow consideration of the soon to be released exposure drafts in the context of their intended purpose.

The Need for a Philosophical Framework
The approach to developing any standard has been the same; the first and most important stage has been to discuss critically and agree upon the philosophy underlying the standard. (Newsletter 3 provided an insight to this process in respect of the earlier development of the Solvency Standard.)

This approach has been taken for a number of reasons:

1. the ensuing discussion and decision processes of the Board, in respect of the provisions of the standards, would be most efficient if undertaken in the context of a clear philosophy.

2. the standards themselves must clearly and definitively state the principles. To a greater or lesser extent the standard will include details on methodologies, but it was clear from the outset that the standards could not provided detailed guidance for all circumstances that may arise in a business as complex and diverse as life insurance.

3. the standards will have greatest credibility, and will sustain the scrutiny of the wider audience, where there is integrity throughout the provisions, of a clear underlying philosophy.

The philosophical approaches for the Solvency and Capital Adequacy Standards have been the issue of many a discussion at Board meetings. Happily, of late, the philosophy has proved a great assistance in taking final positions on the detail of the approach. The simultaneous development of the Solvency and Capital Adequacy Standards in this last stage has emphasised the importance of the philosophies and has assisted in the Board ensuring the maintenance of the integrity of those philosophies.

At this stage the Board feels it would be helpful to emphasise the philosophies themselves, so the desired outcome from each standard is clarified and misconceptions corrected. A discussion of some of the detailed provisions of the standards in the context of these philosophies (in later sections) should assist in interpretation of the philosophies and in understanding their implications.

The first thing to note is that there are two philosophies, discrete and independent; one for each of the standards. The result is that the capital adequacy standard is not necessarily a stronger solvency standard; or more importantly, the solvency standard is not necessarily a weaker capital adequacy standard. (It should perhaps be acknowledged that this result reflects an evolution of earlier interpretations of the desired outcomes of the standards.)

Each requirement stands on its own, serves different purposes and brings its own consequences. This is consistent with the intentions and provisions of the legislation.

Which brings us to the second important issue. The Board has a legislative responsibility in producing these standards, and must therefore develop them in full recognition of the legal framework and implications.

The Board has no responsibility in respect of target capital requirements. It is a management issue, and an area for professional advice by the Actuary. To the extent a target capital requirement is established, it will reflect the philosophical requirements of a particular company.

The Philosophies underlying the Solvency and Capital Adequacy Standards

In looking to explain the philosophies, we could attempt to recreate the detailed discussions/debates that have preceded them. Alternatively, we could labour through their development from first principles, commencing with the respective sections 65 and 71 of the Life Insurance Act 1995.

This is not the intention - and would not we believe be beneficial in any event. There is a lot of history behind the development of this capital regime, a lot of written material has been produced and there has been many presentations given. It would not be unfair to say there is a measure of pre conception about the purpose of the standards.
The Board sees the following as the essential features of the philosophy of the Solvency Standard:

**The Solvency Standard**
- considers capital needs in the context of a run off situation, under judicial management
- assumes the statutory fund is closed to new business
- aims to meet obligations to policy owners (and creditors) while the fund withstands shocks (adverse experience).

For Capital Adequacy, the essential features are:

**The Capital Adequacy Standard**
- considers capital needs in the context of an active and viable ongoing concern
- assumes the statutory fund is open to new business
- aims to meet reasonable expectations of policy owners (and creditors) while the fund withstands larger shocks (significant adverse experience).

The Board accepts, that as a consequence of these philosophies, it is possible that in certain circumstances, no additional capital is required, for capital adequacy purposes, over the Solvency Requirement.

The circumstances in which this may arise (for example, a slowly growing fund or a declining fund) do not suggest any inconsistency with the underlying philosophies.

While accepting this, the Board expects that in most circumstances, and particularly at the company level, the Capital Adequacy Requirement will exceed the Solvency Requirement.

**Resolving Issues**

An example may be the best way to demonstrate the Board’s approach to resolving issues, and the importance of the philosophies in doing so.

Submissions on the Capital Adequacy Discussion Draft highlighted a weakness of terminology in the description of the calculation of the Margin for Investment Linked Risks (IL Margin). The discussion draft incorporated this margin as part of the other pricing risks considered in the determination of the Capital Adequacy Liability (CAL is the adjusted best estimate liability, allowing for adverse risks in the pricing factors.)

The IL Margin was not added to the Current Termination Value (CTV), against which the CAL was compared to establish the floor value for policy liability risks.

When the Board revisited this issue, discussions reaffirmed the position taken in the discussion draft as appropriate. At the risk of being overly simplistic, the IL Margin provides for errors in the pricing or administrative systems supporting investment-linked business. This risk should be reflected in the value of those liabilities on an adverse basis. It could be argued that those same errors will equally impact the CTV of the business. However, it was reasoned that in the context of an ongoing concern, there was little risk of the CTV being realised immediately. As the situation could be managed within a longer time frame, it is appropriate that the reserve for these risks be embedded within the CTV to the extent it exceeds the CAL.

In working through this reasoning, the treatment in a run off situation was questioned. In such a scenario, the risk of immediate redemption was greater, and protection of the policy owners guaranteed obligations would require the Minimum Termination Value (MTV) plus IL Margin as the floor value.

When one looks to the Solvency Requirement to determine if this floor value is provided, it highlights the absence of the IL Margin from the discussion draft of that regime. It was the Board’s conclusion that, in maintaining the integrity of the two philosophies, an IL Margin of prescribed minimum level should exist in the solvency regime. The amount of this reserve needed to be held in addition to the MTV (or Solvency Liability if greater.)

**Particular Proposals**

The discussions of the Board over the last two months have resulted in a development of their position in respect of certain of the detailed provisions of the standards. Discussed below are two particular issues - asset hypothecation and diversification - and the Board’s current thinking on them. The discussion of hypothecation, in particular, will further highlight some of the implications of the above philosophies:
(a) **Asset Hypothecation**

The Board has given further consideration to this matter, in the light of submissions received. This was an issue where the philosophies clarified the approach to be taken in principle. The Board agreed prior to the release of discussion drafts that the recognition of asset hypothecation to particular liabilities within the statutory fund was not appropriate in the context of the Solvency Standard. In this scenario of running off the business, or even winding up the fund, the legal position is that the assets of the statutory fund are first available to meet the obligations of policy owners. There would be no legal recognition of an internal allocation between groups of policy owners of those assets.

The Capital Adequacy Standard, however, looks at the capital requirements of an ongoing concern. The requirements of a going concern should appropriately recognise the way in which the business is managed - provided this is within the provisions of the legislation. Accordingly, the Board accepted the principle of hypothecation of assets to particular liabilities within the framework established by the Act. That framework recognises such management of pools within a statutory fund - these being referred to as subcategories.

The legislative framework also restricts transfers out of statutory funds if the Capital Adequacy Standard is not met. Accordingly the management of statutory funds will likely reflect this framework, with the retention of profits within the fund in excess of the required capital adequacy level. Not allowing for hypothecation of assets would conflict with this management practice.

Having established the principles fairly clearly, the issue the Board faces is the striking of a practical approach to calculating the resilience reserve. Submissions indicated a variety of approaches to the management of ‘subcategories’ within statutory funds. The Board has no desire to inhibit or restrict these management practices. However, it is necessary to strike an approach which is sufficiently prescriptive so as to provide for consistent interpretation and minimal scope for manipulation.

(b) **Diversification**

Many submissions raised concerns with the additive nature of the reserves for separate risks implicit within the structure of the capital requirements. The Board has given consideration to this concern in respect of the determination of the resilience reserve; and has come to believe that the reserve levels by asset class are set at a level which assumes 100% exposure to that class. That is, there is no recognition of the benefits of diversification across the asset sectors. The Resilience Working Group has been asked to consider this matter and provide recommendations to the Board which appropriately make allowance for this diversification, yet do not excessively complicate the calculation process.

From discussions to date, an approach which is gaining acceptance is the incorporation, in the determination of the resilience reserve, of a factor calculated along the following lines:

“the square root of the sum of the squares of a parameter in respect of each of the four main asset sectors”

This allowance for diversification will apply to both the solvency and capital adequacy regimes, the benefits of diversification being equally applicable and consistent with the respective philosophies.

The Board is not convinced at this stage - in part, due to the expected predominance of the Termination Value in the calculation process - of the appropriateness of recognising diversification effects across other risk areas, for example across the pricing risks, or even as between the different pricing risks. Even if it could be theoretically justified, to do so would introduce complexities to the calculation process which the Board considers excessive.

(c) **Other**

Newsletter 4 summarised structural changes to be made to the Solvency Discussion Draft following that exposure process. It can be assumed that, those changes remain and to the extent relevant to Capital Adequacy, will be consistently applied.

The one exception is in the area of inadmissible assets and the limit for Australian semi government securities. On reconsideration of this issue, the Board accepts industry submissions that the 25% limit is onerous and should be altered to 100%.

(d) **Disclaimer**

The preceding discussion 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 drafts; the Board does not intend to enter into discussion or debate on the basis of this Newsletter.
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#### SPECIAL MESSAGE - Surrender Value Discussion Draft

The Surrender Value Workshop was held on 23 May 1996, and was well represented by senior practitioners from life insurance companies, as well as involved consulting organisations.

The proceedings were not recorded and while comprehensive notes were taken of the issues raised, it is important that written submissions be provided to the Board, substantiating those issues, providing greater detail and or examples and where possible suggesting approaches to addressing an issue.

The close date for submissions is **30 June 1996**.