ACTUARIAL STANDARDS RELEASED!

The actuarial standard for the Valuation of Policy Liabilities was released in final form in October.

The Solvency and Capital Adequacy Standards were released in final form in November.

The LIASB would like to express its gratitude to all participants in the industry who contributed to the various development phases of these documents; both during, and prior to, the term of the LIASB. The final release of the actuarial standards is a significant achievement for the industry, and provides a credible and consistent framework within which the life insurance industry can operate and promote itself.

FINALISATION OF THE SOLVENCY AND CAPITAL ADEQUACY STANDARDS

Introduction

During the months October and November, the LIASB dedicated itself to the finalisation of the Solvency and Capital Adequacy Standards. The exposure draft process for the two standards, in the period July - September, resulted in 26 submissions being received by the LIASB.

The level of sophistication of many of those submissions was appreciated, and greatly contributed to the LIASB’s final processes of evaluation and decision making.

There were some common areas of concern raised with the proposed methodology in the standards; many of which went to the determination of the Resilience Reserve component. This is not surprising when it is considered that this can be one of the most significant components of a statutory fund’s capital requirements, but further, the basis of derivation of the resilience reserve parameters is one of the most complex aspects of the methodology.

Again the thanks of the LIASB go to the Resilience Working Group, whose further advice was sought on these issues of detail. The discussion below has been based to an extent on the advice received from that group. By its very nature, discussions on this topic are technical - the information below has been provided, however, in response to direct queries by those in our audience who seek to understand to this level of detail.

The Model

The model adopted by the Resilience Working Group (RWG) is somewhat different from other stochastic models, in that it considers movements in value of both the assets and the liabilities. Implicit in the model is an assumed crediting rate philosophy (the importance of this assumption is discussed below) which links the value of the assets and liabilities by consequence of a link between the yield underlying the asset value and the crediting rate reflected in the liability value.

It is as a consequence of these relationships or links that the model produces results which at first may appear to be counter intuitive. For instance, a higher fixed interest yield may result in a slightly higher resilience reserve than for lower yields. The reason: a higher fixed interest yield, in terms of the model, produces a higher crediting rate and consequently larger relative changes to the yield and relatively higher reserves.

The pattern produced by the model is not an unreasonable pattern of behaviour in practice. In times of higher yields, crediting rates can tend to become more aggressive and as a consequence higher reserve requirements not unreasonable.


**Crediting Rate Policy**

As has been implied by the above section, the crediting rate policy assumed in the modelling process is critical to the final results produced. This is an area in which the views of the LIASB and the RWG have differed.

The RWG took the view that the crediting rate of the company would, in practice, adjust rapidly in response to changes in interest rate levels in the market. The LIASB takes the view that there will be a delay or lag between the crediting rates employed by life companies and levels of interest rates in the market. The industry has, historically, over credited in times of falling interest rates.

**The Yield Change Parameters**

The yield change parameter for the fixed interest sector is higher in the final standards than that recommended by the RWG for the reasons discussed above.

In all other respects the recommended yield change parameters (numbers or formulae) have been adopted.

Some submissions commented on the results produced by the capital adequacy formula approach, particularly at the extremes of high or low current yields. While these anomalies are acknowledged, the LIASB and RWG agree that the formula approach produces appropriate levels of yield change in most likely asset shock and crediting rate scenarios. If the market were ever to enter a phase of extreme yield levels, it is likely the details of the solvency and capital adequacy standards (including the yield change parameters) would be reviewed.

**Diversification Factor**

The diversification factor was the subject of considerable discussion in the submissions received. Having introduced the sophistication of an explicit diversification allowance, there were calls to extend the allowance to other sectors including cash, currency and overseas equities.

The RWG comments that “while it would be possible to have... additional asset classes... these additional classes may not behave independently as implied by the diversification formula, particularly under a financial shock.”

Consideration was also given to the allowance for diversification between the various other risk categories (pricing risks etc). It was determined that such correlations were not readily capable of quantification.

Further, it has always been the concern of the LIASB that the integrity of what is an approximate allowance for the correlation between the asset (or other risk) sectors would be significantly reduced by increasing the number of sectors covered. In this context, the RWG added “the formula is a result of a trade-off between having a simple formula and a formula that covers all circumstances.”

**Other Issues**

There were of course other issues raised in the submissions, two of the more commonly raised matters were:

**Investment-Linked Risk Margin:** there was an argument to provide for a zero margin on the basis that a riskless position was achievable and that the zero margin provided an incentive to improve processes. The LIASB was not convinced by these arguments.

**Expense Reserve:** the call for greater precision in the definition of non fixed acquisition costs was not consistent with what the LIASB had previously described as a simple test where the multiple was a proxy for such precision.

**Chairman’s Concluding Comments**

“Within the submissions there were of course different and conflicting views expressed, so it is inevitable that not all proposals could be supported.

The Board has endeavoured, within the standards, to provide certainty in the principles to be adopted, and to avoid the excesses of detail which can result from an attempt to address various practical circumstances.

Nevertheless, the Board wishes all writers to know that very careful consideration was given to every point made. The standards issued reflect the considered opinion of the Board in every respect.”

P Vinson
THE VALUATION STANDARD

Clarification of Operating Profit

The Institute of Actuaries of Australia (IAA) is to be congratulated on its recent seminar “Lifting the Veil on MoS”. In what was a very professional series of presentations, the IAA successfully communicated the key principles and features of ‘margin on services’ (the valuation principles and methods encoded in the Valuation Standard) to the broader audience.

An issue of confusion identified as part of this process is clarified below.

The operating profit of the life company is determined, in part, by the release of planned profits for the period. Planned profits include best estimate bonuses (and associated shareholder profit margins). Operating profit is not determined by the bonuses actually distributed in respect of the period. (The wording of section 8.8 of AS1.01, may be misleading if read in isolation. Taken in the full context of the standard and its principles, it provides for the appropriate treatment as described above.)

NOTICE BOARD

UPCOMING

Surrender Value Standard Second Discussion Draft (due December 1996)
Investment Performance Guarantee Discussion Draft (due March 1997)
Review of Issues Arising from Standards in Practice Second quarter 1997

NOTE: The implementation date of both the Surrender Value Standard and the Investment Performance Guarantee Standards has been deferred to 31 December 1997, allowing proper time for the development of, and consultation on, these documents.

Despite this, companies should consider the practicalities of the Surrender Value Standard in particular, well in advance of the release of the final standard, which as set out in the proposed timetable below will likely be in the latter half of 1997.

PROPOSED TIMETABLE FOR THE SURRENDER VALUE STANDARD

1996: 20 December Release Discussion Draft
1997: 28 February Close Submissions on the Discussion Draft
      1 May Release Exposure Draft
      1 July Close Submissions on Exposure Draft
      1 September Release Actuarial Standard