RELEASE OF JOINT STATEMENT BY LIASB, AASB AND APRA

The LIASB released today, in conjunction with the Australian Accounting Standards Board (AASB) and the Australian Prudential Regulation Authority (APRA), the attached Joint Statement.

This Joint Statement has been produced in response to the release, by the AASB, of accounting standard AASB 1038 – Life Insurance Business in November 1998 and the recent release, by APRA, of Prudential Rule No 35 - Financial Statements (PR35) under the *Life Insurance Act 1995* (the Life Act).

The LIASB, AASB and APRA became aware, through their respective consultation processes, of uncertainty within the industry in respect of the degree of consistency of certain aspects of AASB1038 and actuarial standards, AS1.01 as it applies to the valuation of policy liabilities. The LIASB, AASB and APRA have jointly consulted on these issues and are of the common view that they are matters of difference of interpretation of the respective instruments, rather than any substantial difference of policy intent. The Joint Statement confirms the position of the two standards makers and of APRA, in respect of these issues of apparent inconsistency.
JOINT RELEASE TO LIFE INSURANCE INDUSTRY
By AASB, LIASB and APRA

8 April 1999

Introduction

The Australian Accounting Standards Board (AASB) released accounting standard
AASB 1038 – Life Insurance Business (AASB 1038) in November 1998. The
Australian Prudential Regulation Authority (APRA) has recently released replacement
Prudential Rules (PR35) for financial statements under the Life Insurance Act 1995
(the Life Act). PR35 requires disclosures in financial reports, premised on a
calculation of policy liabilities in accordance with the Life Insurance Actuarial
Standard Board’s (LIASB’s) actuarial standard AS1.01 - Valuation of Policy
Liabilities (AS1.01). AASB 1038 and PR35 apply to the financial statements of life
companies in respect of financial years ending on or after 31 December 1999. AS1.01
(as modified from time to time), applicable for financial years ending on or after
31 December 1996, continues unchanged.

Different principle objectives underlie the respective regimes – AASB 1038
prescribes general purpose reporting requirements in accordance with accounting
principles; and PR35 prescribes special purpose reporting requirements in accordance
with the prudential regulation framework of the Life Act. However, in the
development of the respective regimes the AASB, LIASB and APRA have
endeavoured to achieve these objectives through a single set of financial reports.

The achievements to date should not be underestimated. Australia is unique in the
extent to which we have achieved:
– reconciliation between the accounting and actuarial aspect of financial reporting
  for life insurance business; and
– compatibility between the general purpose and statutory (prudential) reporting
  frameworks,
sufficient to facilitate a single set of financial reports.

It is the joint view of the AASB, LIASB and APRA that this is the clear intention of
the respective regimes. The extent of success in achieving this objective in practice,
will depend largely on the attitude taken by industry practitioners in interpreting and
implementing the requirements.

The following sections address issues of concern known to have emerged in the
industry about the consistency of AASB 1038 and AS1.01 in measuring/valuing
policy liabilities.
**Measurement/Valuation Methodology**

AASB 1038 provides for the measurement of policy liabilities on the basis of present values of cash flows – that is, adopting a projection methodology. It also makes provision for the use of an accumulation methodology, where the results so achieved would not be materially different from the results of applying a projection methodology.

AS1.01 similarly provides for both the projection and accumulation methods. In the application of both, it is required that the fundamental principles of the standard for the appropriate emergence of profit – as stated in section 1 of AS1.01 – are complied with.

While AS1.01 does not explicitly provide that the accumulation method is a surrogate for the projection method, nor subject its use to a materiality test, this is considered by the LIASB to reflect nothing more than a difference of style in the wording of the requirements of the respective standards. The LIASB does not consider that the standards differ in terms of the principle for assessing appropriate circumstances in which to use the accumulation methodology.

**Related Product Group**

AS1.01 provides a definition of related product group, consistent with the principles of appropriate profit emergence and the ‘hierarchy’ of business segregation required by the Life Act. That definition is as follows:

“A grouping of products where those products are considered by the Actuary to exhibit benefit characteristics and pricing structures sufficiently similar as to justify grouping for the purposes of profit margin calculation, loss recognition or reporting. A related Product Group must not extend over subcategories, where a subcategory is defined in the (Life) Act.”

AS1.01 takes the approach that the basis of grouping the products of a company should not be prescribed, but rather should be responsive to the different business mixes and pricing approaches which exist in practice. Grouping at a lower level of segregation than provided by the above definition is not prohibited by AS1.01. This flexibility, of course, is only to be exercised to the extent compliance with the overall principles of appropriate profit emergence are complied with. Further, the actuarial standard implies a consistency of product grouping from year to year and imposes requirements on the re-constitution of product groupings – amalgamating or splitting.
The requirements of AASB 1038 acknowledge the significance of the appropriate grouping of products to the determination of revenues and expenses, including loss recognition. Guidance is provided in AASB 1038 on the meaning of a group of related products – the wording of which is intended to provide a set of principles (independent of Life Act terminology and actuarial judgement) for the determination of appropriate product groupings. Accordingly the guidance adopts wording different from the definition included in AS1.01. The AASB 1038 guidance is as follows:

“A group of related products would be products that have substantially the same contractual terms and were priced on the basis of substantially the same assumptions.”

The AASB, LIASB and APRA consider that products (or cohorts of business of a product) which are considered to have sufficiently similar benefit characteristics and pricing structures to allow grouping for the purposes of AS1.01 should also be able to be considered to have substantially the same contractual terms (benefit characteristics) and be priced on the basis of substantially the same assumptions (pricing structures). That is, the AASB, LIASB and APRA consider that sufficient consistency exists between the provisions of the respective standards to support, in practice, the same grouping of products for the purposes of both AASB 1038 and AS1.01.

In particular, the first application of the AASB 1038 should not necessitate the reconstitution of related product groups established for the purposes of AS1.01.

It is acknowledged that the product range of a life company may be varied and complex. The pricing processes of a life company are acknowledged as being dynamic processes. It is not intended that the establishment of a separate product group be required by reason only of a minor change in a benefit feature of, or an assumption used in pricing, a particular product or cohort of business of a product.

**Participating Business**

AS1.01 prescribes differences in the detail of method as it applies to business where there is a discretionary entitlement to the investment return associated with the benefits (refer section 8 of the standard). Predominantly this method is applicable to participating business, where that term takes its definition from the Life Act.

However, AS1.01 acknowledges the applicability of this method to non-participating business, where the entitlement of the policy owner to share in the investment experience of the product is at the discretion of the company. (The definition of non-participating business in the Life Act recognises such discretion, provided it is managed within prescribed limits - refer Prudential Rule No.22.)

AASB 1038, in its description of these differences in method, employs the terminology ‘participating business’ and ‘non-participating business’. The definition of these terms in AASB 1038 is not, however, linked to their respective Life Act definitions.
The AASB, LIASB and APRA consider that the definition of participating business in AASB 1038 is sufficiently broad to encompass the concept of discretionary investment business more generally. No inconsistency between the application of AASB 1038 and AS1.01 in this regard is intended, or considered, to exist.

**Unvested Policyholder Benefit Liabilities / Policy Owner Retained Profits**

The Life Act acknowledges the potential for negative policy owner retained profits. Such circumstances can arise either from a period of negative operating profit where opening retained profits are insufficient to offset it, or from bonuses in a period being ‘topped up’ to an extent greater than that supported by opening retained profits.

However the provisions of AASB 1038, in retaining the integrity of the principle that policy owner entitlements (including unvested policyholder benefits) are a liability, prevent the explicit disclosure of negative unvested policyholder benefit liabilities. Rather, where circumstances arise which require that the liabilities of policyholders (vested and unvested in aggregate) be ‘topped-up’, the amount of that ‘top-up’ must be recognised as an expense in the period it arises.

In accordance with this treatment under AASB 1038, to the extent negative policy owner retained profits (unvested policyholder benefit liabilities) exist in total when AASB 1038 is first applied, adjustments to opening balances will be required.

The negative policy owner retained profits should be disclosed in the note to the financial statements reconciling Corporations Law profit to Life Act profit as required under PR35.

**Opening Positions under PR35 and AASB 1038**

It is considered by APRA, that there is continuity of financial results under the Life Act financial reporting framework. The introduction of PR35 is considered to impose new disclosure requirements only – that is, a change in presentation of results. The determination of policy liabilities remains in accordance with AS1.01 which has not changed.

Accordingly, APRA would not expect to see significant restatements of opening positions as a consequence of the first application of the PR35 requirements. Further explanation from the company would be sought by APRA in respect of any such occurrences; especially where the restatement impacts on the relative opening positions of policy owner retained profits and shareholder retained profits (Australian participating).

It is noted that it would not be appropriate for the AASB to prescribe an opening position on the first application of accounting requirements other than in terms of the provisions of those new or pre-existing accounting standards. That is, an opening position consistent with the requirements of the Life Act could not be explicitly provided for.
However, as has been outlined above, it is the intent of the AASB, LIASB and APRA that the policy liability result obtained under the requirements of AASB 1038 and AS1.01 be consistent.

Subject to the exception discussed above of a negative opening balance of unvested policyholder benefit liabilities, the first application of the requirements of AASB 1038 should not, of itself, be the cause of any changes in the opening amounts of policy liabilities or retained profits.