REVIEW OF THE ACTUARIAL STANDARDS

Background

The process of review of the three actuarial standards – AS1.01 Valuation Standard, AS2.01 Solvency Standard and AS3.01 Capital Adequacy Standard – commenced in December 1997 when the LIASB announced its intention, in Newsletter No.9, to undertake such a review.

The consultation processes of the LIASB in this review been have included:

- Request for written submissions from industry representatives and other interested parties in respect of the implementation and interpretation in the standards.
- Discussions with representative practitioner groups from the industry. This included a session with approved auditors of life companies, appointed actuaries of life companies and actuaries involved in actuarial audits of life companies.
- Regular updates through the Newsletters, of the issues arising in the consultation processes and the LIASB’s considerations in respect of those issues. This mechanism was used to seek further industry input on certain particular issues to allow the LIASB to better understand the range of industry views.
- Request for professional advice from the Institute of Actuaries of Australia (IAA) in respect of certain assumptions for solvency and capital adequacy purposes for disability income business.
- Acceptance of the role of the IAA in developing professional guidance material to supplement the actuarial standards, where there was an identified need for further detailed guidance on the practical application of the principles of the standards.

Incorporation of Expense Standard

The processes for review of the actuarial standards AS1.01, AS2.01 and AS3.01 overlapped with the LIASB’s processes for development of an ‘Expense...
Standard’ in respect of the allocation of expenses for the purposes of the actuarial standards.

The provisions in respect of the allocation of expenses are incorporated in these modified actuarial standards – predominantly in AS1.02.

Revised Actuarial Standards

The objective of the review was to consider issues of practical interpretation and application of the actuarial standards.

It was not the intention of the review to revisit the underlying principles of the standards and accordingly, there was no expectation of significant change to the standards as a result of the process.

As described above, alternative vehicles have been used by the LIASB to provide further clarity on the interpretation of aspects of the standards – newsletters and professional guidance. Modification to the wording of the standards themselves has been made only where considered essential to preserve the integrity of the principles.

Modification to AS1.02

The incorporation of provisions for the allocation of expenses was the most significant change to the valuation standard.

Changes were also made to the introduction and to section 9 of the standard in respect of the meaning of profit. The purpose of these modifications is to reinforce the operational context of the standard in the light of the release of accounting standard AASB 1038. In particular, the modifications clarify the nature of operating profit within the Life Act framework (and hence within the context of the standard) as including both policy owner and shareholder profit. No change to the application of the standard in this regard is intended to result from these modifications to the wording.

Modification to AS2.02

Resilience Reserve Parameter

The exposure draft process of the LIASB explicitly sought comment on the appropriateness of the resilience reserve parameter for interest bearing securities in the Solvency Standard.

In response to the submissions received, the parameter has been changed with the objective of making it more responsive to the prevailing economic conditions.

The following issues were considered in determining an appropriate new level for this parameter:

*Extract from P Hodgett Memo.*

Diversification Factor

*Await outcome of meeting*

Issues Arising AS3.02

New Business Reserve

A submissions on the exposure draft highlighted an issue with provisions in this standard for recognising certain sources of capital in meeting the new business reserve requirements.

The standard has been modified to reflect that, while excess capital existing in another statutory fund may be recognised, that capital can not be considered committed to the subject statutory fund. (Only when it is physically transferred to the fund could that capital be considered committed.)

The modification to the wording is a clarification of the original intent and should not alter practice which has reflected an appropriate application of these provisions. However, the LIASB has noted the significance of the provisions in respect of recognising or anticipating source of capital. The responsibilities of the Actuary in this regard should not be taken lightly.

EXPENSE APPORTIONMENT

AS1.02 includes provisions – primarily in section 6 - in respect of the allocation of expenses between expense categories and products. In the processes of developing and consulting on these sections, the LIASB produced and issued detailed commentary on the processes of apportionment where direct allocation of the expenses was not possible.

This material, while considered of inappropriate detail for inclusion in the final standard, provides useful background to the considerations of the LIASB and the intent of the final provisions. It is therefore reproduced in this Newsletter for the
The Judgement Process

The allocation of a particular expense between expense categories or related product groups requires a diligent assessment of both the objectives of the company in incurring the expense and the contribution of the expense to the business of the company.

Normally, before engaging in an activity and incurring expenses, a company would specify the purpose of the activity. If it did not, the purpose would have to be inferred from a review of relevant documentation or from a discussion with relevant senior officials. These processes should be carried out with care and are the primary assessment.

As an activity proceeds, one’s expectation of the outcome develops and ultimately the outcome becomes known. Consideration can be given to the value which it is expected will be, or which has been, contributed to the business of the company by that outcome. The outcome may match the original purpose or it may be different. This is the secondary assessment.

Further, consideration should be had for the appropriateness of the results which will be produced in utilising the derived expense allocation in the context of the fundamental principles of the actuarial standards. In particular, the fundamental principle of AS1.02 is to provide for the appropriate emergence of profit, at a category (as defined in the Life Insurance Act) level, within each statutory fund of the company.

From these assessments it is then necessary to apply judgement to arrive at the relevant allocation proportions. In many cases an objective or statistically based apportionment will clearly be appropriate. However, in other cases there will be no alternative to a more subjective approach. Any necessary judgment should only be arrived at after careful consideration and discussion. That judgement, and the rationale for it, should be appropriately documented.

It is acknowledged that it will not always be the case that an obvious relationship exists between a functional activity and the expense categories. Similarly, the most appropriate relationship between a functional activity and the related product groups will not always be clear. Further, it may be the case that any such relationship varies over time. In assessing the most appropriate relationship, the analysis process should be a dynamic one, while having due regard for the importance of consistency from year to year.

The Apportionment Process

The apportionment processes should, as far as is practical, be objective and robust. In respect of actual expenses, the apportionment processes should reflect current operations. Hence, any internal analyses of operations should, for these purposes, normally be based on the experience of a period of at least 12 months, ending not more than 6 months prior to the date of allocation.

In respect of expected expenses, to the extent that the future operations are expected to differ from the current operations, the apportionment processes should reflect the expected operations in the immediate future to the extent appropriate within the principles of the relevant actuarial standard.

The processes of apportionment should be subject to annual review and be appropriately documented. However, regard should also be had for the desirability of maintaining reasonable consistency of approach from year to year; change should occur only where strong justification exists.

Expense Drivers

Many companies are organised along functional activity lines. It is common for one department, or business unit, to administer a wide range of products. It is also common for a single business unit, or cost centre, to carry out more than one functional activity. In these situations it is necessary to apportion the expenses between the functional activities and the various related product groups. The apportionment should be carried out by identifying appropriate expense drivers and related apportionment ratios.

The determination of expense drivers is a matter of judgement, and must necessarily reflect the business and operations of the particular company. However, the following sections provide guidance on possible drivers. This guidance should not be taken as either comprehensive or definitive.

In a service business the majority of expenses in most business units, or cost centres, are employee related expenses (salaries, on-costs, rent etc). It is often appropriate to analyse or estimate the proportion of each individual’s time spent on each activity and use the aggregate of the salary weighted proportions for all the employees in the
cost centre to develop ratios for the apportionment into the various functional activities. This should be done as carefully as practical, with the process being well documented and subject to regular review.

Where it is possible to estimate the proportion of each individual employee’s time spent administering the various products, it may also be appropriate to use salary weighted proportions for the apportionment of expenses between related product groups. In other cases the apportionment of expenses to related product groups may more appropriately refer to product level statistics. Examples of some of the more common product level statistics are:

- Amount of assets
- Number of policies (members) in force
- Number of premium paying policies (members)
- Number of premium receipts
- Number of new policies (members)
- Number of cases underwritten
- Number of claims
- Amount of premium income
- Amount of commissions paid
- Amount of new business premium
- Amount of claims

Different product groups involve different amounts of effort and difficulty in their administration. The assessment of these differences should be based on analysis or, where necessary, judgement. An example of such a judgement which might be made is that superannuation business requires more effort than non-superannuation because of the additional tax, regulatory, and documentation issues. In arriving at the expense drivers, it may be appropriate to apply weights to the statistics for different product groups to reflect these differences. The weights should, based on analysis or judgement, be those regarded as appropriate to the degree of effort and difficulty involved.

There may exist some expenses, more indirect in nature, where the types of expense drivers discussed above are not appropriate. Such expenses may be loosely referred to as ‘overhead’ or ‘underpinning’ expenses of the company and may for instance, include expenses related to the Board or corporate insurance expenses. It is desirable that the amount which falls to this type of expense be as small as possible. Given the nature of these expenses, an appropriate expense driver may be total other expenses. (That is, these expenses may be apportioned between expense categories and related product groups in proportion to the allocation of total expenses, excluding these expenses.)

One-off Expenses

In general, the expenses of a company in a reporting period result from activities which form part of the normal ongoing business operations of the company and are recurring in nature. There are circumstances, however, where expenses fall outside these broad criteria - that is, the expenses are one-off in nature.

It is expected that such one-off expense will be uncommon. Examples of circumstances which may result in one-off expenses are major redundancy programs and/or merger implementations.

The following characteristics are considered relevant to the assessment of an item of expense as a one-off expense:

- the particular expense is, of itself, considered material in accordance with the provisions of the relevant actuarial standard; and
- the expense results from an activity which is outside the normal operational activities of the company; and
- the expense is not likely to recur, in substance (rather than exact form), in subsequent periods; and
- the expense adds to the total ‘normal’ expenses of the company (that is, it does not result from the diversion of items of expense from one activity or one period to another.)

The allocation of one-off expenses between expense categories or related product groups should be undertaken in accordance with the principles of the standard. However, it is noted that the particular nature of the one-off expense should, to a significant extent, define its classification for allocation purposes (classification as an acquisition expenses would be expected to be rare).

Illustrative Examples

The following sections provide further guidance on the application of the principles for allocation of expenses in the context of specific examples known to involve particularly difficult judgement.

The examples discussed should not be taken as an exclusive list - individual companies will be able to identify other similarly difficult examples. The
The guidance provided should not be taken as either comprehensive or definitive.

The allocation of expenses for the purposes of the relevant actuarial standards will always be a matter for professional actuarial judgement. That judgement should be made in accordance with the principles of the standard.

Product Development Expenses

Generally a company engages in product development activity on a continuing basis with regular launches of ‘new’ products:
- which have varying amounts of change, or difference, from their predecessors; or
- which are in response to legislative change.

The expenses incurred in respect of that activity can be considered to have the nature of ‘product upgrade’ expenses.

Where product development is not of the nature of ‘product upgrade’, and can more directly be related to the acquiring of new business or to a particular product group, then the principles of the standard require allocation of the related expenses accordingly.

The purpose of ‘product upgrade’ activity can be to maintain the overall health and vitality of the company in the expectation that the general success and visibility of the company generates a climate which encourages existing customers to maintain their relationship with the company as well as being beneficial or necessary for new sales. This can benefit both existing customers and new customers by keeping unit expense levels down.

While such ‘product upgrade’ expenses would generally fall to maintenance expenses there may be circumstances in which a part of the expenses – that part which can be related to the acquiring of new business - should be attributed to acquisition expenses. Any such allocation should use careful judgement formed only after consideration of both the purpose of the company in carrying out the activity and the contribution of the activity to existing and new customers respectively.

Similar considerations apply in regard to the allocation of such ‘product upgrade’ expenses to related product groups. In the environment of continuous product development activity, one of the objectives of that activity is to maintain the overall health of the company’s business. Accordingly, such expenses might not be considered directly attributable to a particular related product group, and to this extent they could be attributed to all relevant related product groups and appropriately allocated between them.

There may be instances where:
- a product development is started but not completed;
- a product is developed but not launched; or
- a new product launch is a complete failure and leads to negligible new sales.

Where the product development expenses incurred are of a ‘product upgrade’ nature as described above, then, the considerations for allocation could proceed on the basis presented above. That is, the expenses could be allocated to maintenance expenses and appropriately allocated between relevant related product groups. Such allocation would be considered appropriate to the extent an assessment is made that some future contribution is expected to derive from the product development expenses. To the extent this is not the case, allocation should be to acquisition expenses which would lead to immediate loss recognition.

Corporate Advertising Expenses

Similar considerations apply in the case of expenses incurred in corporate advertising where the purpose is to advertise the company name rather than particular products. Increasing market awareness of the company can generate a climate which encourages existing customers to maintain their relationship with the company as well as being beneficial for new sales. Again, such expenses should generally fall to maintenance expenses. However it may be appropriate that a part of such expenses be attributed to acquisition expenses, to the extent that expense can be related to the acquiring of new business. The allocation should be determined using careful judgement based on a consideration of the objectives and the outcomes of the advertising campaign.

Distribution Management Expenses

In the case of distribution management, different companies have different purposes for their distribution networks. One company may require its distribution network solely to make sales. Another may require its distribution network to both make sales and provide service to existing customers. The specific circumstances, including the structure of intermediary remuneration and associated expenses, must be reviewed to determine how to most appropriately allocate the expenses incurred between expense categories and, with composite objectives, judgement will be
necessary to determine the most appropriate allocation.
NOTICEBOARD

UPCOMING

Discussion Drafts for Harmonisation of Standards

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