



## Prudential Standard LPS 340

### Valuation of Policy Liabilities

#### Objective and key requirements of this Prudential Standard

A life company must make a valuation of policy liabilities under section 114 of the *Life Insurance Act 1995* ('the Act'). The valuation must be made in accordance with the principles and requirements set out in this Prudential Standard. The ultimate responsibility for the value of a life company's policy liabilities rests with the Board of a life company.

The key requirements of this Prudential Standard are that a life company must:

- classify life insurance business as friendly society business, life insurer non-participating business or life insurer participating business;
- make a separate valuation of policy liabilities for each approved benefit fund or statutory fund;
- for each friendly society approved benefit fund, make a separate valuation of policy liabilities for each class of life insurance business to which the fund relates;
- for each Australian or Australian/overseas fund of a life company other than a friendly society, make a separate valuation of policy liabilities for each class of life insurance business to which the fund relates, each category of business within such a class and each subcategory of business within such a category;
- for each overseas fund of a life company other than a friendly society, make a separate valuation of policy liabilities for each class of life insurance business to which the fund relates and each category of business within such a class;
- in respect of friendly society business and life insurer non-participating business, generally value policy liabilities in accordance with the relevant accounting standards;
- in respect of life insurer participating business, value policy liabilities in

accordance with the requirements set out in this Prudential Standard; and

- for all life insurance business, use the method specified in this Prudential Standard to calculate the best estimate liability.

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## Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

## Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act<sup>1</sup>, except where expressly noted otherwise.
3. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** which is carried on through its Australian statutory funds but not otherwise.<sup>2</sup>
4. This Prudential Standard applies to life companies from 1 July 2023.

## Interpretation

5. Terms that are defined in *Prudential Standard LPS 001 Definitions* (LPS 001) appear in bold the first time they are used in this Prudential Standard.
6. This Prudential Standard is written in the context of Australian legislation and bases of taxation. Appropriate adjustment should be made, for example to allow for different bases of taxation, where this Prudential Standard is being applied to overseas business.
7. Unless otherwise stated:
  - (a) the terms ‘Australian fund’, ‘Australian/overseas fund’, ‘Australian policy owners’ retained profits’, ‘class of life insurance business’, ‘investment account contract’, ‘investment-linked contract’, ‘life business’, ‘life insurance business’, ‘life policy’, ‘non-participating business’, ‘overseas fund’, ‘overseas policy owners’ retained profits’, ‘participating business’, ‘policy’, ‘policy liability’ and ‘section 12A or 12B policy’ have the meaning given in the Dictionary to the Act;
  - (b) the term ‘life insurers’ will be used to refer to life companies other than friendly societies;
  - (c) for life insurers, the term ‘category of business’ has the meaning given by section 75 or section 76 of the Act, as applicable;
  - (d) for life insurers, the term ‘subcategory of business’ has the meaning given by section 75 of the Act;

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<sup>1</sup> Refer to subsection 21(1) of the Act.

<sup>2</sup> Refer to section 16ZE and 16ZD of the Act.

- (e) the term ‘friendly society business’ refers to policies that, in accordance with section 16F of the Act, a friendly society is taken to have issued to a person;
  - (f) the term ‘life insurer non-participating business’ will be used to refer to non-participating business of a life company other than a friendly society;
  - (g) the term ‘life insurer participating business’ will be used to refer to participating business of a life company other than a friendly society;
  - (h) the term ‘gross policy liability’ will be used to refer to a valuation of policy liabilities gross of outwards reinsurance arrangements;
  - (i) the term ‘reinsured policy liability’ will be used to refer to a valuation of gross policy liabilities ceded under outwards reinsurance arrangements;
  - (j) the term ‘net policy liability’ will be used to refer to a valuation of policy liabilities net of outwards reinsurance arrangements, calculated as the difference between the gross policy liability and reinsured policy liability;
  - (k) the term ‘best estimate liability (BEL)’ will be used to refer to a liability calculated in accordance with the method specified in Part D of this Prudential Standard; and
  - (l) the term ‘risk-free best estimate liability (RFBEL)’ will be used to refer to a liability calculated in accordance with the method specified in Attachment F of *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112).
8. This Prudential Standard applies to a valuation of policy liabilities made under section 114 of the Act. It applies to a valuation of liabilities that arise under:
- (a) a life policy, including an investment account contract or investment-linked contract; or
  - (b) another policy, including a section 12A or 12B policy.
9. This Prudential Standard applies for reporting values for gross policy liability, net policy liability and reinsured policy liability in accordance with provisions of the Act. The liability values must exclude Australian policy owners’ retained profits and overseas policy owners’ retained profits.
10. For friendly society business and life insurer non-participating business the gross policy liability and reinsured policy liability must be determined in accordance with Part B of this Prudential Standard.
11. For life insurer participating business the gross policy liability and reinsured policy liability must be determined in accordance with either Part B or Part C of this Prudential Standard.
12. This Prudential Standard also specifies the method that must be used to calculate the BEL for all policies, regardless of whether they relate to friendly

society business, life insurer non-participating business or life insurer participating business. The BEL calculation method forms the basis for deriving RFBEL in LPS 112.

13. For all business, BEL must be calculated in accordance with the requirements outlined in Part D of this Prudential Standard.

## Part A – Policy classification and application

### Policy classification and application

14. For the purposes of this Prudential Standard, life companies must classify policies as either friendly society business, life insurer non-participating business or life insurer participating business.<sup>3</sup>
15. Where a policy that provides participating benefits is classified as an investment contract under **Australian Accounting Standards** a life company may, under subsection 15(4) of the Act, request that APRA declare the benefits to be non-participating so that the policy may be classified as life insurer non-participating business under this Prudential Standard.
16. Subject to paragraphs 18 and 19, a life insurer must make a separate valuation of policy liabilities for each statutory fund and must meet the following requirements:
  - (a) for each Australian or Australian/overseas fund, a life insurer must make a separate valuation of policy liabilities for each class of life insurance business to which the fund relates, each category of business within such a class and each subcategory of business within such a category; and
  - (b) for each overseas fund, a life insurer must make a separate valuation of policy liabilities for each class of life insurance business to which the fund relates and each category of business within such a class.
17. To apply the requirements in paragraph 16 of this Prudential Standard, where a policy includes benefits referable to more than one statutory fund, class of life insurance business, category or subcategory of business, a life insurer must unbundle the benefits and treat them as if they were stand-alone policies.
18. Participating business with insurance riders must not be unbundled, where the profits on the riders are deemed to be in respect of participating business and so allocated between policyholders and shareholders.
19. Where a life insurer writes non-participating **risk business** in both the ordinary and superannuation classes of life insurance business within a single statutory fund, the life company may group these classes when valuing the relevant policy liabilities, provided that income tax attributable to shareholder profit on the business is calculated at the same tax rate for both classes.

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<sup>3</sup> Friendly society business is neither participating nor non-participating.

## **Part B – Valuation of policy liabilities for friendly society business, life insurer non-participating business and life insurer participating business**

### **Friendly society business**

20. For friendly society business, policy liabilities are to be valued in accordance with the relevant accounting standards subject to meeting the requirements in paragraphs 21 and 24 of this Prudential Standard.
21. A friendly society must make a separate valuation of policy liabilities for each approved benefit fund. For each friendly society approved benefit fund, the friendly society must make a separate valuation of policy liabilities for each class of life insurance business to which the fund relates.
22. To apply the requirements in paragraph 21 of this Prudential Standard, where a policy includes benefits referable to more than one approved benefit fund, or class of life insurance business, a friendly society must unbundle the benefits and treat them as if they were stand-alone policies.
23. Adjustments to reconcile policy liabilities reported to ASIC under the relevant accounting standards with the sum of policy liabilities across the benefit funds must be reported in the management fund.
24. The valuation of policy liabilities must make explicit allowance of fees payable to the management fund under the benefit fund rules to cover the cost of operating and administering the benefit fund.

### **Life insurer non-participating business**

25. Policy liabilities in respect of life insurer non-participating business are to be determined in accordance with the relevant accounting standards, subject to meeting the requirements in Part A of this Prudential Standard.

### **Life insurer participating business**

26. For determining policy liabilities in respect of life insurer participating business, a life company must elect to use either:
  - (a) the accounting standard led method, described in paragraphs 28 and 29 of this Prudential Standard; or
  - (b) the VSA led method, described in Part C of this Prudential Standard.
27. The method that a life company elects at commencement must be used at all future reporting dates, unless the life company obtains written approval from APRA to use the alternative method.



*Accounting standard led method*

28. The policy liabilities for a subcategory must be derived from the AASB 17 carrying amount and shareholder profit for that group of contracts so that:
- (a) the policy liabilities plus any Australian Policy Owners' Retained Profits or Overseas Policy Owners' Retained Profits allocated to that subcategory (both amounts after declaration of bonus at the end of the reporting period) equals the AASB 17 carrying amount; and
  - (b) the amount of Life Act operating profit allocated to shareholders in respect of the current reporting period is the same as the AASB 17 shareholder profit.
29. The amount deducted from Australian Policy Owners' Retained Profits or Overseas Policy Owners' Retained Profits when a distribution is made to the owners of participating policies is the cash value of the declared bonus. An alternative basis for valuing bonus, consistent with the basis used for valuation of AASB 17 fulfilment cash flows (excluding the risk adjustment for non-financial risks) may be adopted by the Board provided that the Board gives priority to the interests of participating policy owners (as a group) when making the decision to adopt this basis.

**Part C – VSA led method for valuing policy liabilities for life insurer participating business**

30. In Part C of this Prudential Standard, the term 'profit' will be used to refer to the sum of policy owner profit, also referred to as 'bonus' and shareholder profit. The term 'future profits' will be used to refer to the sum of future bonuses and future shareholder profits.

**Overview of the VSA led method**

31. The policy liability must provide for both:
- (a) a best estimate value of the liability; and
  - (b) a uniform emergence of profit.
32. The profit emerging in the reporting period must recognise both:
- (a) the expected profits for the period; and
  - (b) the **experience profit** for the period.
33. The valuation method must provide for the emergence of profit when it is earned. The emergence of earned profit must not be deferred; nor must unearned profit be prematurely recognised.

34. Profits are earned on the later of:
- (a) the provision of a service to the policy owner; and
  - (b) the receipt (or recognition) of income relating to that service.
35. When the valuation results in expected future profits for a **subcategory** that are below the **adequacy threshold**, the value of the shortfall must be recognised immediately as a loss.
36. Profit for the period must not otherwise be affected by a change in the **best estimate assumptions** in respect of future periods, except that where previously recognised losses exist for a subcategory and that change in best estimate assumptions results in expected future profits emerging, the present value of those profits must be released to the extent necessary to offset those previously recognised losses.
37. In determining the best estimate liability and best estimate assumptions, the life company must have regard to the impact on the liability of the distribution of potential future outcomes. Where the benefits being valued contain options that may potentially be exercised against the company, or the potential liability outcomes have an adverse asymmetrical distribution, then the best estimate liability must include an appropriate value in respect of those options and/or asymmetries.
38. Approximate methods may be used in determining the policy liability of the company where the result so produced is not material or not materially different from that which would result from a full valuation process.

### **The valuation of policy liabilities**

39. The policy liability is equal to the sum of:
- (a) the best estimate liability;
  - (b) the value of future **best estimate bonuses**; and
  - (c) the value of future **best estimate shareholder profits**.
40. Declarations of bonus are an appropriation of profit for participating business. Accordingly, current year best estimate bonuses are excluded from the policy liability, allowing the emergence of this amount as operating profit in the period.
41. The relationship between best estimate bonuses and best estimate shareholder profits must, in respect of each future year, be consistent with:
- (a) the policy conditions; and
  - (b) the company's practice or stated philosophy.

**The best estimate liability**

42. The best estimate liability must be calculated in accordance with the requirements outlined in Part D of this Prudential Standard.

**New business - calculation of expected future profits**

43. When new policies are issued, the value at commencement of expected future profits must be determined on the basis of best estimate assumptions.
44. The best estimate assumptions, with the exception of the acquisition expense assumption, must be determined as at a single date, but that date may be:
- (a) the beginning of the reporting period during which the new policies are issued;
  - (b) the date of commencement of the business; or
  - (c) the end of the reporting period during which the new policies are issued.
45. The acquisition expense assumption is determined at the end of the reporting period during which the new policies are issued.
46. The best estimate assumption for **acquisition expenses** at commencement must be the greater of:
- (a) ‘**establishment fees**’ received at commencement; and
  - (b) actual acquisition expenses incurred, less expenses which the life company considers to be ‘one-off’ in nature.
47. Both must be consistently adjusted for tax in accordance with paragraphs 83 to 84.

***Treatment of losses***

48. If the projection reveals a value of expected future profits at commencement for new business in a subcategory that is below the adequacy threshold, then that loss must either be recognised, or dealt with in accordance with the provisions of paragraph 49. Any losses at commencement so recognised must be accumulated. If the subcategory subsequently generates profits above the adequacy threshold, the cumulative losses must be offset (see paragraphs 60 to 65).
49. Alternatively, new business may be grouped with existing in-force business for the same related product group for the purpose of calculating future profits. Where new business is so grouped, any losses at commencement for that new business cannot be accumulated or subsequently offset.
50. The approach used by the life company for treatment of losses on new business must be applied consistently over time.

## Reporting date recalculations

51. The recalculation methodology described in this section establishes how the policy liability changes and, hence, how profit emerges over the period. The objective of the methodology is to determine operating profit in accordance with the framework of the Act.
52. Two important aspects of this framework are:
- (a) the allocation of **operating profit** is a distinct process from the distribution of retained profits. It is the value of declared bonuses and shareholder transfers out of the fund which are distributions of retained profits (inclusive of the operating profit allocated in the period). It is the operating profit which is the amount allocated between policy owners retained profits and shareholders' retained profits; and
  - (b) operating profit includes shareholder profit and policy owner profit. It comprises:
    - (i) the value of current period best estimate bonuses (including best estimate interim and terminal bonuses and the value of best estimate reversionary bonuses) and best estimate shareholder profits; and
    - (ii) non-investment experience profit.
53. It is noted that the recalculation methodology means a change in assumptions (predominantly non-investment assumptions) may affect current year profit, through changes in the rate of best estimate bonus.

## *Recalculation of future profits*

54. A recalculation of expected future profits at the reporting date must be carried out as follows:
- (a) derive the value of expected future policy owner and shareholder profits at the reporting date as:
    - (i) the value of supporting assets;
    - (ii) less the best estimate liability;
    - (iii) less the value of current period bonuses and shareholder profits
  - (b) where:
    - (i) value of supporting assets is calculated according to paragraphs 55 to 56;
    - (ii) value of current period bonuses is determined as the cost of bonus according to paragraphs 57 to 59; and

- (iii) the relationship between bonuses and shareholder profits must be in accordance with paragraph 41.

### *Value of supporting assets*

55. The value of supporting assets is determined as:
- (a) the policy liability at the end of the previous reporting period;
  - (b) plus the cost of declared bonuses at the end of the previous period;
  - (c) plus the actual policy related cash flows and investment experience as reported in the regulatory financial statements;
  - (d) less the expected shareholder profits emerging over the period (in respect of interim and terminal bonuses) and the non-investment experience profit.
56. The value of supporting assets must be calculated so as to attribute no value of assets to terminated benefits.

### *Cost of bonus*

57. The cost of bonus at the reporting date (whether best estimate or declared) must reflect the cash value to the policy owners of those bonuses at the reporting date.
58. Where bonus at the reporting date does not acquire an immediate cash value, but rather value vests in the policy owner over some defined period of time, the life company, in determining the cost of bonus, must allow an appropriate value for that unvested bonus.
59. Terminal bonus is included in the calculation of cost of bonus to the extent it is immediately vested in the policy owner and is guaranteed.

### **Loss recognition**

60. Where at a reporting date the value of future profits for a subcategory falls below the adequacy threshold for that subcategory, the resulting shortfall is not spread over the benefit term (as are expected future profits above the adequacy threshold) but is recognised as an immediate loss at that date. This is achieved by setting the relevant future profits to an amount such that the value of future profits is equal to the adequacy threshold at the reporting date.
61. A record of cumulative losses is kept for each subcategory. Before a subcategory can have a value of future profits in excess of the adequacy threshold, cumulative losses must have been offset. Once cumulative losses have been eliminated for the subcategory it will return to a position of adequate future profits.
62. Cumulative losses may be run-off in accordance with the run-off of the business of the relevant subcategory.

63. If at a reporting date it is established, in respect of a subcategory which has cumulative losses recorded, that future profits are now expected the present value of that profit must be utilised:
- (a) firstly, in offsetting the cumulative losses; and
  - (b) then to the extent available, in producing future profits in excess of the adequacy threshold.
64. There must be no release of profit as a consequence of the combining of subcategories. Where there is grouping of previously separate subcategories, the policy liability of the combined subcategory must equal the sum of the policy liability of the separate subcategories immediately prior to the grouping. Cumulative losses that previously existed in respect of the separate subcategories must be extinguished, except in the case where cumulative losses existed for all separate subcategories.
65. The adequacy threshold for the value of future best estimate bonuses and shareholder profits participating benefits is equal to the difference between:
- (a) the best estimate liability, calculated using the discount rate (or rates) that the life company considers to be risk free based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows is to be used. The discount rate does not need to satisfy the definition of **risk-free discount rate** given in LPS 001 as described in paragraph 81; and
  - (b) the best estimate liability.

## Reinsurance

66. Outwards reinsurance that meets the definition of a life insurance contract is to be measured as if it were a negative liability, even though the measurement result may be recognised as an asset in the company's financial statements. For this purpose, the reinsured policy liability will therefore consist of both a reinsured best estimate liability and the value of reinsured future profits. For the purpose of this Prudential Standard, inwards reinsurance is to be treated the same as direct insurance business.
67. Where future profits are expected to arise in respect of a reinsurance arrangement (looked at from the reinsurer's perspective) the present value of those future profits is to be included in the reinsured policy liability as value of reinsured future profits. However, where losses are expected, these are to be recognised, except as allowed under paragraph 70.
68. If the reinsurance relates directly and solely to the direct insurance business of a single subcategory then the reinsurance may be included within that same subcategory for the purposes of paragraphs 60 to 65. If the reinsurance does not relate directly and solely to the direct insurance business of a single subcategory then the reinsurance must be appropriately allocated to subcategories for the purposes of paragraphs 60 to 65. That allocation must reflect:

- (a) the insurance and financial risks to which the reinsurance relates; and
  - (b) an appropriate relationship between those risks and the subcategories.
- 69. In undertaking the allocation described in paragraph 68, regard must be had for a diligent assessment of:
  - (a) the purpose of the company in entering the reinsurance; and
  - (b) the contribution of that reinsurance to the business of the company.
- 70. As a result of the allocation of reinsurance business to subcategories, losses expected in relation to the reinsurance business need only be recognised if they exceed the value of expected future profits in respect of the associated direct insurance business in the related product group, and vice versa. However, the future profits in respect of the reinsurance must continue to be determined separately from the future profits in relation to the associated direct insurance business.

## Part D – Best estimate liability (BEL)

- 71. Part D of this Prudential Standard applies to all types of life insurance business. The best estimate liability is a component of the policy liability for participating business valued according to the VSA led method set out in Part C of this Prudential Standard. The method used in determining the best estimate liability is also used in determining the risk-free best estimate liability for all types of life insurance business as defined in LPS 112.
- 72. The best estimate liability is determined as the value of the expected future payments and receipts under the policy based on obligations at the reporting date. This best estimate liability is equal to:
  - (a) the value of expected future benefit payments; plus
  - (b) the value of expected future expenses; less
  - (c) the value of expected future receipts.
- 73. Note that the benefit obligations projected include all contractual benefits. In the case of participating benefits, the best estimate liability includes bonuses declared prior to (but not on, or after) the date of valuation. In the case of non-participating benefits which include an entitlement, at the discretion of the company, to share in the investment experience of the assets backing the benefits, the best estimate liability includes current year and expected future **discretionary additions**. Friendly Society benefits are neither participating nor non-participating and the treatment of surplus allocations, for the purpose of calculating risk-free best estimate liability, is specified in LPS 112.
- 74. In projecting the expected future cash flows, the life company makes assumptions about the expected future experience, taking into account all factors which are considered to be material to the calculation, including:

- (a) investment earnings;
- (b) inflation;
- (c) taxation;
- (d) expenses;
- (e) mortality and morbidity; and
- (f) policy discontinuance.

The assumptions must reflect a best estimate of the likely experience.

### **Valuing liability options**

- 75. The best estimate liability and best estimate assumptions must have regard to any options or asymmetrical distribution of liability outcomes.
- 76. Where the distribution of potential liability outcomes is equally likely to result in a gain or loss, then it will normally be sufficient to adopt the mean of the assessed distributions of future experience for the best estimate assumptions and calculate the best estimate liability accordingly.
- 77. However, the life company needs to consider and assess the extent that variations in the assumptions may be correlated, and/or may compound one another, in adverse circumstances. In such cases the best estimate assumptions must be adjusted so that the best estimate liability is representative of the mean of the distribution of the potential liability outcomes.
- 78. Where the benefits contain options that may be exercised against the company, then either the value of those options must be determined (via a suitable option pricing method) and added to the best estimate liability, or the best estimate assumptions adjusted so as to appropriately capture the value of the options as part of the best estimate liability.
- 79. The requirements throughout this Prudential Standard in respect of best estimate assumptions and best estimate liabilities are to be interpreted in this context.

### **Investment earnings**

- 80. For participating business, when determining the best estimate liability the best estimate assumption for investment earnings must reflect the expected investment earnings applicable to the actual assets on which the cash flows depend. For all types of life insurance business, when determining the risk-free best estimate liability the best estimate assumption for investment earnings is specified in LPS 112.

### **The discount rate**

- 81. For participating business and other types of business where benefits under the policy are contractually linked to the performance of the assets held, when



determining the best estimate liability the gross rate used to discount expected future cash flows must reflect the expected investment earnings applicable to the assets backing the benefit being valued. For other types of business, when determining the best estimate liability, the gross rate used to discount expected future cash flows must reflect a rate that the life company considers to be risk-free based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows. For all types of life insurance business, when determining the risk-free best estimate liability the discount rate is specified in LPS 112.

82. For both best estimate liability and risk-free best estimate liability the discount rates may make allowance for assumptions that are expressed as a percentage of the value of assets, rather than allowing for those assumptions explicitly in the projection. This practice may apply in respect of certain expenses or taxes.

### **Taxation**

83. For business where tax is based only on profits, the best estimate liability must exclude the value of future tax payments. Otherwise, appropriate allowance must be made for the effect of taxation.
84. Where allowance for tax on investment earnings is required, it must be made in accordance with best estimate assumptions, but based on an asset profile which would be expected to yield a return equal to the discount rate assumption.

### **Servicing expenses**

85. The best estimate assumption for **maintenance expenses** must be sufficient to cover the expected maintenance cost of servicing each policy, in respect of in force business, in the year following the reporting date. The expected maintenance cost of servicing each policy is the expected maintenance expenses appropriately adjusted for one-off expenses.
86. The best estimate assumption for **investment management expenses** must be sufficient to cover the cost of managing an asset profile which would be expected to yield a return equal to the discount rate assumption.
87. Where servicing expense assumptions are expressed in monetary amounts, the assumptions beyond the coming year must be adjusted in line with best estimate inflation assumptions.

### **Other assumptions**

88. The best estimate assumptions in respect of all other assumptions used in the valuation of best estimate liabilities, must be assumptions about future experience which:
- (a) are made having regard to the advice of the Appointed Actuary;
  - (b) are made having regard to reasonably available statistics and other information; and

- (c) are neither deliberately overstated nor deliberately understated.

## **Part E – General requirements for all forms of policy and the Appointed Actuaries statement**

### **Allocation of expenses**

- 89. Unless stated otherwise, the principles and requirements described in Part E of this Prudential Standard apply to:
  - (a) allocating expenses across the Life Act reporting components including subcategories, categories, classes and statutory funds for reporting of policy liabilities for both life insurer non-participating business and life insurer participating business;
  - (b) allocating expenses across **APRA product groups** within each of life insurer participating and non-participating businesses and statutory funds for calculation of BEL for regulatory capital purposes; and
  - (c) allocating expenses into **expense categories** for the purposes of regulatory capital calculation and valuation of policy liabilities of life insurer participating business under the method outlined in Part C of this Prudential Standard.
- 90. The allocation of certain expenses to expense categories, and particular APRA product groups and Life Act reporting components will require greater judgement than others. Allocation of such expenses must be based on a considered analysis of the particular circumstances of the company – the objective in incurring that expense and the outcome achieved. If at the end of this process there remains doubt as to the appropriate expense category, the expense must be allocated to maintenance expenses.
- 91. There will be circumstances in which an expense derives from an activity outside the normal business activities of the company and is not recurrent in nature. It is appropriate to recognise the one-off nature of such expenses for the purposes of allocating expenses into expense categories.
- 92. The principles and requirements described in Part E of this Prudential Standard are equally applicable to the circumstances of allocation of the actual expenses and the expected expenses of the company.
- 93. Expenses are to be allocated to the following expense categories:
  - (a) acquisition expenses;
  - (b) maintenance expenses;
  - (c) investment expenses; and
  - (d) one-off expenses.

94. When determining BEL, each expense category must include all relevant expenses whether direct or indirect and in aggregate the expense categories must include the total expenses of the company other than one-off expenses determined in accordance with paragraphs 105 to 106. Total expenses for this purpose are total operating expenses.
95. When determining BEL, each APRA product group must include all relevant expenses whether direct or indirect and in aggregate the APRA product groups must include the total expenses of the company.
96. To the extent that an expense can be readily allocated to a particular expense category, a particular Life Act reporting component or APRA product group, it must be so allocated.
97. It is recognised that there are circumstances where arrangements (internal or external) provide for the limitation of the expenses borne by a particular APRA product group or a Life Act reporting component. Such arrangements, to the extent substantiated as *bona fide* by the life company, may be reflected in the final allocation of expenses provided transparency of the allocation process is retained.
98. An expense which cannot be readily allocated to a particular expense category, APRA product group or a Life Act reporting component must be appropriately allocated reflecting the following:
  - (a) the functional activities to which the expense relates; and
  - (b) an appropriate relationship between those functional activities and both the expense categories, the APRA product groups and the Life Act reporting component.
99. In undertaking the allocation described in paragraph 100 regard must be had for a diligent assessment of:
  - (a) the purpose of the company in incurring a particular expense; and
  - (b) the contribution of that expense to the business of the companywhile retaining the integrity of the principles and requirements outlined in Part E.

### ***Apportionment process***

100. Processes of apportionment will be required, to a greater or lesser extent, in undertaking the allocation of expenses. These processes must be based on recent analyses of the operations of the life business and the identification of appropriate **expense drivers** and related expense apportionment ratios.

### ***Service agreements***

101. Where activities of the company are being provided externally, through a service agreement or other contractual arrangement, the allocation of the

company's expenses relating to those activities must be reasonably consistent with the principles and requirements of this section. Where the service company fees are unreasonable as a basis for the allocation, the life company must determine an alternative allocation applying the principles and requirements of this section on a 'look-through' basis.

102. The information required to undertake this allocation should be sought from the service provider. Where practical difficulties arise in accessing the required information other methods, such as reference to appropriate industry benchmarks, may be employed.

### *Acquisition expenses*

103. Acquisition expenses are defined in terms of the activities related to the acquiring of new business. The acquisition of new business can generally be considered to include activities of the company such as product marketing, sales, underwriting and administration, undertaken prior to and at the point of issuing the policy and establishing it in the policy records of the company.
104. The new business expected to derive from a particular expense may not necessarily be acquired in the same period in which the expense occurs. The new business must, however, be expected to arise as a result of that expenditure. To the extent the expenditure has only a tenuous link with the acquisition of new business - for example, general growth and development expenses - it is not considered to be an acquisition expense.

### *One-off expenses*

105. One-off expense must be of itself:
- (a) material in accordance with the provisions of paragraphs 112 to 114;
  - (b) not incurred as part of the normal ongoing operations of the company; and
  - (c) not regularly recurring in nature.
106. One-off expenses, while allocated to expense categories for financial reporting purposes, need not be explicitly allocated to expense categories, APRA product groups and Life Act reporting components for the purposes of this Prudential Standard.

### *Friendly societies*

107. The paragraphs 108 to 111 are relevant to a friendly society for policy liability valuation and regulatory capital calculation.
108. For expense allocation purposes a friendly society is to be regarded as two separate companies, namely:
- (a) the management fund in isolation; and
  - (b) the sum of all the benefit funds.

109. All the expenses of the society are to be allocated to the management fund, except in certain cases when some direct costs are allocated to a benefit fund where that benefit fund rules allow this.
110. The expenses of the benefit funds (other than certain direct costs) are represented by the fees payable to the management fund under the benefit fund rules. For the purpose of allocating those expenses to the relevant expense categories in accordance with paragraph 93, the provisions under paragraphs 101 to 102 in relation to service agreements are applicable.
111. Where an allocation of the expenses of the management fund relating to life insurance activities into expense categories is not undertaken, acquisition expenses must be taken as 50 per cent of the total expenses related to the life insurance business.

### **Materiality**

112. A life company may take into account materiality when valuing its policy liabilities. Particular values or components are considered material to the overall result of a calculation if misstating or omitting them would produce results likely to be misleading to the users of the information.
113. For a life company which is not a friendly society, policy liabilities and regulatory capital calculation (including determination of BEL) are subject to materiality standards applied at a statutory fund level.
114. For a friendly society, policy liabilities, regulatory capital calculation (including determination of BEL), and determination of surplus distribution or allocation are subject to materiality standards applied at a benefit fund level.

### **Approximate methods**

115. When determining BEL, approximate methods may be used, where the result so produced is not material or not materially different from that which would result from a full valuation process.

### **Adjustments and exclusions**

116. APRA may, by notice in writing to a life company, adjust or exclude a specific requirement in this Prudential Standard in relation to that life company.

### **Determinations made under previous prudential standards**

117. An exercise of APRA's discretion (such as an approval, waiver or direction) under a previous version of this Prudential Standard continues to have effect as though exercised pursuant to a corresponding power (if any) exercisable by APRA under this Prudential Standard.