

# Revised Actuarial Standards to coincide with the implementation of International Financial Reporting Standards

## Explanatory Statement

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This statement is issued by the authority of the Life Insurance Actuarial Standards Board (the Board) under:

- *Life Insurance Act 1995*, subsection 101(1) and subsection 109(9)
- *Acts Interpretation Act 1901*, subsection 33(3)

and relates to the actuarial standards more fully described below that were made and revoked by resolutions of the Board on 5 December 2005.

The resolutions are recorded in the *Record of resolutions of the Life Insurance Actuarial Standards Board: actuarial standards* of that date ('the Instrument').

## 1. Legislative background

Under subsection 101(1) of the *Life Insurance Act 1995* ('the Life Act'), the function of the Board is to make actuarial standards for the purpose of this Act.

Actuarial standards are made by resolution of the Board, and subsection 109(9) of the Life Act provides for the Board to keep a record of its proceedings (including its resolutions). The Instrument is a record for the purposes of subsection 109(9). It records the relevant resolutions and attaches the new actuarial standards. Together these documents comprise the relevant legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The actuarial standards, while made generally pursuant to the function of the Board set out in subsection 101(1) of the Life Act, cover a number of specific topics, and in some cases these are contemplated by particular sections of the Life Act.

In this regard section 65 provides for the Board to make a solvency standard for life companies, section 70 provides for a capital adequacy standard and section 73B provides for a management capital standard. These all provide for APRA's agreement to the actuarial standard. APRA's agreement was given on 5 December 2005, prior to the Board making the relevant resolutions.

In addition, section 114 of the Life Act provides that a valuation of policy liabilities referable to a statutory fund of a life company must be made in accordance with the actuarial standards.

Subsection 33(3) of the *Acts Interpretation Act 1901* provides that where an Act confers a power to issue an instrument the power shall, unless the contrary intention appears, be construed as including a power exercisable in the like manner and subject to the like conditions (if any) to revoke any such instrument. The Board has exercised this power in revoking a number of old actuarial standards (which were made on 28 March 2002), which the new ones replace.

## **2. Purpose of the Instrument**

The Instrument records that, on 5 December 2005, under subsection 101(1) of the Life Act, the Board made the following actuarial standards on 5 December 2005:

- Actuarial Standard 1.04: Valuation of Policy Liabilities (for the purposes of subsection 114(2) of the Life Act);
- Actuarial Standard 2.04: Solvency Standard (for the purposes of subsection 65(1) of the Life Act);
- Actuarial Standard 3.04: Capital Adequacy Standard (for the purposes of subsection 70(1) of the Life Act);
- Actuarial Standard 6.03: Management Capital Standard (for the purposes of subsection 73B(1) of the Life Act); and
- Actuarial Standard 7.02: General Standard (for general purposes)

On the same date, under subsection 101(1) of the Life Act, and subsection 33(3) of the *Acts Interpretation Act 1901*, the Board revoked the following actuarial standards made on 28 March 2002:

- Actuarial Standard 1.03: Valuation of Policy Liabilities;
- Actuarial Standard (Friendly Society) 1.02: Valuation of Policy Liabilities;
- Actuarial Standard 2.03: Solvency Standard;
- Actuarial Standard 3.03: Capital Adequacy Standard;
- Actuarial Standard 6.02: Management Capital Standard; and
- Actuarial Standard 7.01: General Standard.

It should be noted that the following actuarial standards, which were made on 28 March 2002, remain in force (that is, they are unaffected by the resolutions of LIASB recorded in the Instrument):

- Actuarial Standard 4.02: Minimum Surrender Values and Paid-Up values; and
- Actuarial Standard 5.02: Cost of Investment Performance Guarantees

### **3. Background to the Changes**

On 23 November 2004 the Board released an Issues Paper on the prudential implications for life insurers and friendly societies of the adoption in Australia of accounting standards consistent with the International Financial Reporting Standards (IFRS). In that Issues Paper the Board noted that a number of significant issues had been raised by IFRS. The Board also noted likely ramifications of those issues for life insurers and friendly societies and suggested possible responses in terms of amendments to LIASB standards. In addition, the Board noted some matters other than IFRS issues that would be addressed at the same time.

The Board received several submissions in response to its Issues Paper. After taking these into account, along with subsequent IFRS developments, the Board released Discussion Drafts of the following standards in May 2005:

- AS1.04: Valuation of Policy Liabilities Standard ('the Valuation Standard')
- AS2.04: Solvency Standard
- AS3.04: Capital Adequacy Standard
- AS6.03: Management Capital Standard

These Discussion Drafts contained the amendments that the Board considered were necessary to implement IFRS and to address the other matters raised in the Issues Paper, except for changes to the resilience reserve sections of the capital standards which were being looked at by a Taskforce of the Institute of Actuaries of Australia (IAAust). The Board received 13 submissions in response to the Discussion Drafts.

At the end of June 2005, the Board released further Discussion Drafts of the *Solvency Standard*, *Capital Adequacy Standard* and *Management Capital Standard* containing the amendments that the Board considered were necessary to the resilience reserve sections based on that part of the work of the Resilience Reserve Taskforce of the IAAust that the Board accepted as robust and largely complete at that time.

The revised resilience reserve requirement was similar to the existing requirement except that it was updated to:

- address credit risk shocks;
- specify the number of scenarios to be tested; and
- provide guidance as to the underlying principles of financial strength to be applied in situations not covered by the prescribed resilience test.

The Board received 7 submissions in response to these further Discussion Drafts.

At the end of September, 2005, the Board issued Exposure Drafts of the four standards.

At the same time, the Board also issued an Exposure Draft of AS7.02: *General Standard*, which, among other things, included definitions relating to any new concepts in the revised standards. As the material in the *General Standard* is either only background for the other standards or provides only dictionary definitions, the Board had earlier decided that it was appropriate for it to be introduced and issued at this stage of the consultation process.

The Board received 17 submissions in response to the Exposure Drafts.

The Board considered the many specific comments made in the submissions and as a result made a number of further changes to the standards with the aim of:

- incorporating explicit transition arrangements into the standards themselves;
- reviewing the impact of the standards in areas where major concern was expressed and where change was appropriate;
- correcting and changing items where it was apparent from the submissions received that the Exposure Draft proposals required refinements; and
- amending references, formatting and other minor inconsistencies between the various standards.

These changes were incorporated in the final standards.

This Explanatory Statement summarises the overall changes made to the standards as a result of this entire process, and outlines the reasoning behind those changes. It begins with an overview of the impact of the revised standards on regulatory capital, and then reviews each of the matters addressed by the Board.

## **4. Impact of the Standards on Regulatory Capital Requirements**

### **4.1. Increases in regulatory capital**

A number of submissions expressed concern that the new standards would significantly and unjustifiably increase capital requirements when the Board had specifically stated:

*“...that it is not its intention to generally increase capital requirements for life insurers at this time.”*

In making that statement, however, the Board has repeatedly made it clear that there may be some increases for individual companies as a result of:

- aligning liability valuations with accounting requirements;
- improving codification to close ‘loopholes’; or
- addressing matters that had been flagged in the Issues Paper (and before).

Notwithstanding its overall position on this, the Board recognised the need to modify certain of its proposals during the development process, in light of submissions received. The impact of the revised standards is therefore no longer as significant as appeared at some stages during the consultation process.

The Board is of the view that the revised standards are consistent with the objectives and the principles that the Board has previously established, and where the changes are justified and appropriate. In that context, there are a number of areas where increases in capital requirements may be inevitable for some companies. These areas include:

- use of a risk free rate to determine the capital adequacy liability;
- inadmissibility of the value in excess of net tangible assets in respect of financial services subsidiaries;
- codification of credit risk reserves; and
- codification of sufficiency levels for the purpose of setting reserves for any unusual risks.

For statutory funds where these issues are not significant - because of fund structure, the nature of the business being written or the actuary’s reserving practices - there should be no substantial change in capital requirements. Indeed, there are some changes (such as refinements to resilience reserve requirements concerning diversification, interest rate shocks and asset disaggregation) which may reduce capital requirements.

The areas of potential increase in capital requirements referred to above are discussed in detail in the next section, but it is appropriate to provide some comment here.

*Risk free rate to determine the capital adequacy liability*

The key change by which insurance liability valuations have been aligned with accounting requirements is through the use of a risk free discount rate for valuing liabilities. While accounting changes do not, of themselves, alter the capacity of a company to meet its obligations to policyholders and creditors, the change to risk free discount rates represents an improvement to the quantification of liabilities which the Board believes is technically justified and needs to be reflected in the standards if they are to meet, and be seen to meet, their objectives.

The capital adequacy liability has therefore been based on a “risk free” rate with a cap of a mid swap rate. While this change may increase capital requirements relative to interpretation and application of the existing standard, and although it has been prompted by changes to accounting standards, it produces a level of reserves that the Board considers to be consistent and appropriate under the prudential principles and objectives of the capital adequacy framework.

Furthermore, this change is consistent with a principles based approach, with current developments in the field of financial economics, and with the Board's reassessment of the credit risk factors used to calculate resilience reserves.

*Other areas of potential increase in capital requirements*

In other areas the extent of any increase in capital requirements will depend on the manner in which the existing standards are being interpreted and applied. In particular, the Board is now codifying requirements which were not spelt out in the past (such as the requirement for non-sovereign credit risk reserves, the treatment of holdings in subsidiaries and associates that are financial services entities, and the treatment of unusual risks not explicitly covered by the standards). Where the interpretation or application of the existing standards differs from the explicit codification in the revised standards, some capital increase may arise.

Where the impact on companies of the changes is significant, explicit transition arrangements have been introduced.

Further detail on specific issues is provided in Section 5 below.

## **4.2. Transition Arrangements for Capital Relief**

Explicit transition arrangements have been incorporated into the capital standards. These have the effect of spreading any increase in the capital requirements over a period of 2 years after the new standards become effective (or such other period as agreed to by APRA on a company-by-company basis). They will allow life companies that are significantly affected by the new standards sufficient time to implement any changes that are necessary to either lower their risk profile or increase the assets in the relevant fund.

The transitional arrangements will only apply where there is a material impact, and will be subject to APRA's consent.

## **5. Specific Matters Addressed in the Standards**

### **5.1. Assets Not Measured at Fair Value through Profit and Loss in General Purpose Accounts**

Notwithstanding the potential for differences between general purpose financial statements and regulatory financial statements, the Board believes that the measurement of life company assets at fair value is necessary in order for the objectives of the Life Act to be met. For the Board's standards to be effective, it is the Board's view that all of the assets of a statutory fund and all assets supporting the management capital requirement of a general fund should be measured at fair value in the regulatory financial statements. Furthermore, in the case of a statutory fund, movements in that fair value must be recognised through profit and loss. All assets

supporting the management capital requirement of a general fund that are not fair valued may be recognised for admissibility purposes at their net tangible assets. APRA has made changes to Prudential Rules No. 35 on a consistent basis, with reconciliation to the general purpose financial statements to be shown as appropriate.

## **5.2. Difference between Fair Value and Market Value**

Where assets are measured at fair value under IFRS, this will generally be at the current market bid price of the asset. The Board however considers that it is appropriate to make an explicit allowance for realisation costs as a deduction from the reported fair value of assets for solvency, capital adequacy and management capital purposes and has amended the standards accordingly. This adjustment is included as part of the inadmissible assets reserve which, overall, may be negative to accommodate this adjustment.

This adjustment is not, however, to be applied to the current termination value (CTV) minimum – i.e. CTV is to be based on the published surrender value / unit price, regardless.

The Board also believes that it is appropriate, for solvency and capital adequacy purposes, that all liabilities that represent the present value of future cash flows should be present valued using the solvency and capital adequacy assumptions. This is reflected in the revised requirements for the treatment of other liabilities. Note, however, that liabilities for defined benefit superannuation fund deficits are not further adjusted for adverse circumstances.

The economic reality for many products is that benefit payments, and hence policy liabilities, are ultimately dependent on the value of the assets, net of tax. However, under IFRS there is a general principle that assets and liabilities are measured separately. There is therefore a risk, given the different measurement bases that apply to assets, policy liabilities and deferred tax liabilities, that inconsistencies will result in changes to reported net assets that do not reflect the economic reality of the business.

Prior to the introduction of IFRS, it has been normal practice to make adjustments within the value of unit liabilities and other investment performance based liabilities reported in the financial statements, for differences in asset values, tax items (including adjustments and any differences in discounting for deferred tax), or any other estimates as reported in the financial statements relative to the value of those same items as used for published unit prices.

These are current well established and accepted practices under pre IFRS standards, and are required under the existing *Valuation of Policy Liabilities Standard (AS1.03)* to ensure that the basis of asset valuation implicit in the valuation of policy liabilities is not out of line with the basis of valuation of the assets in the financial statements. While not explicitly referred to, such practices would also logically flow through to the determination of solvency and capital adequacy liability under existing standards AS2.03 and AS3.03 respectively.

To avoid the risk of imposing spurious capital requirements, the Board has now included an explicit requirement that the solvency liability and the capital adequacy liability should, in such circumstances, be aligned with the net realisable market value of the assets and related liabilities upon which the liability ultimately depends. However, the Board acknowledges that where policy benefits are based on asset values and related liability values as disclosed in the regulatory financial statements, then such an alignment of the solvency and capital adequacy liability may essentially entail adjustments that merely offset one another. Therefore, in such circumstances it is allowed that both adjustments may be ignored.

### **5.3. Contract Classification**

Under IFRS the accounting treatment of a life insurer's policy liabilities will no longer be determined solely according to a single accounting standard. Instead, the accounting treatment will depend on the type of contract issued, with different contracts issued by the one insurer being treated differently for accounting purposes. The key determinant in the accounting treatment will be whether the contract is considered a *life insurance contract* or a *life investment contract*.

Although the Board agrees with the need for consistent classification of contracts across the industry for regulatory reporting purposes, the Board has not attempted to set down rules for the classification of contracts. This will remain the responsibility of the AASB (for general purpose reporting under its various accounting standards) and APRA (for regulatory reporting as specified under new Prudential Rules No. 49).

However, in response to the change in general purpose accounting treatment of *life investment contracts*, the Board has restructured the *Valuation Standard* to similarly require different valuation methodologies for *life insurance* and *life investment contracts*.

*Life insurance* and *life investment contracts* arising under a single policy that are unbundled must be included in separate related product groups.

The Board does not expect the unbundling requirements to cause major difficulties for Australian life insurers because business which has a deposit component which can be separately measured from any insurance riders is, in most cases, already unbundled. This is due primarily to the requirement that investment linked business be held in a separate statutory fund. In addition, the requirements largely align with insurers' existing practices in relation to separating out the revenue and expense component of premiums and claims under pre IFRS reporting requirements.

### **5.4. Policy Liabilities and Regulatory Reporting Requirements**

Where a contract includes an *insurance* element, and it is not unbundled such that the deposit (i.e. *investment*) element can be accounted for separately, then the liability for the entire *life insurance contract* must be valued in accordance with the insurance valuation principles and methodologies which are essentially unchanged from those under the existing *Valuation Standard* (AS 1.03) - namely the calculation of a best

estimate liability and the use of the Margin on Services (MoS) profit methodology. A similar approach will be required for the *insurance* element of a contract that can be unbundled, or for a contract that includes a discretionary participation feature.

Where a contract is a *life investment contract* (or the deposit component of an unbundled *life insurance contract*) and consists of one or more financial instrument elements or management services elements, then the liability for the contract is to be measured as the sum of the liabilities in respect of each of these elements determined in accordance with the relevant accounting standards, subject to the financial instrument element being measured at fair value where that option is available under the accounting standards.

The Board was concerned that the regulatory profit and loss and balance sheet provide an appropriate, realistic picture of the capital position of the life company and each fund individually consistent with other regulatory requirements, including the capital requirements under the actuarial standards. This is particularly important given that it is the regulatory financial statements that are the source of asset and other liability values against which capital requirements are assessed.

Some element of divergence between regulatory accounts and general purpose accounts has therefore proved necessary. In that context it is appropriate for the Board to adopt a definition of policy liability for *life investment contracts* which, while being built upon valuations of the various components in accordance with accounting standards, brings all of those components into a single policy liability figure. This includes elements such as deferred acquisition costs which, in general purpose accounts, may be recorded as an asset.

The solvency and capital adequacy liabilities for *investment contracts* continue to be based on a projection methodology in accordance with the principles for *insurance contracts*.

## **5.5. Policy Liability Underpin and Deferred Fee Recognition**

Consistent with the Board's concerns that the capital and reporting requirements under the Life Act should be both appropriate and realistic, the Board has provided relief for those companies that are adversely affected to a significant extent by the accounting treatment for deferred fee revenue and deferred acquisition costs. This has been provided in two ways.

Firstly, the Board has removed the policy liability minimum from the *Solvency Standard* and, by implication, from the *Capital Adequacy Standard*. In doing so, the Board has decoupled the prudentially focused provisions of the Life Act from the concept of 'accounting solvency' used by the Corporations Law and under general purpose accounting.

However, this step raises the possibility of negative shareholder retained profits in a statutory fund. The Board has therefore also allowed that companies may, with APRA's agreement, seek transitional relief which would allow a lower measure of policy liability (based on the existing methods of valuing policy liabilities) to be

adopted in the regulatory financial statements for some closed portfolios of business. This relief is available until 31 December 2009 and provides companies with some freedom to distribute surplus assets more effectively within the company, subject to the fund continuing to satisfy capital adequacy and solvency requirements.

## **5.6. Risk-free discount rates, mid-swap rates and Capital Adequacy**

The revised version of AASB1038 requires the use of a *risk free* discount rate to measure the policy liability for insurance business where the benefits are not dependent on the performance of the assets backing the liabilities. AASB1038 defines *risk free* rates as the current observable, objective rates that directly relate to the nature, structure and term of the cash flows.

The Board agrees that such a discount rate is appropriate for measuring the policy liability of insurance business that is not dependent on the performance of the underlying assets. Furthermore, the Board wishes to minimise, as far as possible, any unnecessary differences between general purpose financial reporting and regulatory financial reporting. Accordingly, the Board has amended the *Valuation Standard* to align the discounting methodologies within the actuarial standards with the use of a *risk free* rate as mandated by AASB1038.

Consistent with the use of *risk free* discount rates for the calculation of the best estimate liability, the Board has also amended the *Solvency* and *Capital Adequacy Standards* to require, for both *insurance contracts* and *investment contracts*, the use of a discount rate equal to the discount rate defined in the *Valuation Standard* for *insurance contracts*, but with a maximum of the mid swap rate to be consistent with the assessment principles underlying these standards.

The risk-free rate is defined in the *General Standard* and is the same as the definition in AASB 1038.

The mid swap rate has been defined as the rate (or rates) equivalent to a series of current, observable and objective Australian Dollar interest rate swap mid rates (derived from the relevant zero coupon rather than the par curve) that relates to the term of the future liability cash flows. For non-AUD denominated liabilities the “equivalent” rates include the relevant non-AUD currency swap rates.

In principle, when determining the mid swap rate, separate zero coupon discount rates should apply to cash flows of different outstanding terms. To the extent that such an approach is not feasible in practice, a single rate may be used such that, when applied to all cash flows, the resulting present value is expected to be materially the same as the sum of the present values of the separate cash flows discounted at an appropriate zero coupon rate.

The use of a swap rate yield reflects the overall level of security implicit in the liabilities to policyholders on long term fixed or guaranteed benefits that are not necessarily callable.

The use of a mid swap rate for solvency is not inconsistent with the current use of 10 year government bond yields, noting that a “risk free” rate need not necessarily equate to government bond yield at all times.

The use of a mid swap rate for capital adequacy may be substantially less than the assumption of best estimate earning rate on the supporting assets, less a margin under the pre-IFRS standards. A particular issue arises in respect of participating business when, in the context of a post-resilience scenario of falling bond yields, the guaranteed benefits are exposed and valued at the then (very low) mid swap rate.

The Board has concluded that it is appropriate to maintain the strength of the *Capital Adequacy Standard* relative to IFRS requirements. In particular, it is considered appropriate in a post-resilience scenario that a company that is considered to be a “going concern” must be able to cover its accounting liabilities in respect of guaranteed benefits (which would be determined using a “risk free” rate) assuming future adverse experience consistent with the capital adequacy assumptions. Such a liability would also be at least comparable to the solvency liability that would need to be satisfied in such circumstances. This is consistent with the use of a mid swap rate for capital adequacy.

Furthermore, and more specifically, it is also consistent with the principles established by the Board which presume that, following an adverse market movement of the severity allowed for in the resilience tests, a company would be expected to de-risk and secure the guaranteed benefits that had already accrued. The move to risk free rates (with a cap of a mid swap rate) reflects this thinking. It is inconsistent to allow for the benefit of earning future material investment margins under a scenario where they would not be able to be achieved.

The Board notes that the proposed change in the method of selecting the discount rate may represent a significant departure from existing practice for business where the benefits are not dependent on the performance of the assets backing them. As such, the Board recognises that a precise recalculation of total policy liabilities from inception (as is otherwise required on initial adoption of IFRS) may be difficult and/or not feasible. Therefore the Board has amended the *Valuation Standard* such that policy liability calculations performed under the previous methodology may be taken to satisfy the principles of the new regulatory methodology where the result is not materially different from that which would have arisen, had the new methodology applied from the outset.

## **5.7. Inflation and Investment Expense Assumptions**

The Board has amended the requirements for the inflation rate assumption to be consistent with the risk-free discount rate assumed. The solvency assumption for inflation is now required to be the rate of inflation implied by the difference between the yield on the appropriate national government security and the real yield on an equivalent indexed bond (for terms consistent with those of the liability cash flows).

For capital adequacy, the inflation assumption is also to be set consistently with the discount rate assumption.

The standards also clarify that the assumptions for investment management expenses and tax on investment earnings must be sufficient to cover the expenses arising in respect of an asset profile which would be expected to yield a return equal to the discount rate assumption. To the extent that this is a mid swap rate, the tax and investment expense assumptions would therefore be based on an investment portfolio consisting of high quality corporate bonds of equivalent term to the liabilities.

## **5.8. Liability Adequacy Threshold**

The expression “liability adequacy threshold” refers to the point under the new accounting standards at which a loss is recognised. Loss recognition may now occur at a higher liability quantum than it did under pre IFRS standards.

A consequence of the change to the discount rate is the need to refine the calculation of the liability adequacy threshold for business where benefits are dependent on the performance of the underlying assets.

Under MoS, the liability adequacy threshold (being the minimum level of policy liability, at which point loss recognition applies) is essentially the best estimate liability. As a result of the discount rate change, the liability adequacy threshold for products providing fixed benefits, such as annuities or risk products, is now to be based on a best estimate liability determined at a *risk free* rate.

For participating business, it is appropriate that the liability adequacy threshold should similarly be the liability in respect of the guaranteed (i.e. fixed) benefits and, consistent with the threshold for other fixed benefits, this should be determined at a *risk free* rate.

However, the Board did not feel that it was appropriate, at this stage of the process for implementing IFRS for insurance contracts, to make substantial changes to the way in which profit on participating business is recognised. Accordingly, the best estimate liability for participating business continues to be determined using a discount rate equal to the expected earning rate on the underlying assets.

To reconcile these two positions, the Board has determined that for participating business loss recognition should apply at a point when profit margins fall below a level which is greater than zero, that level being equal to the difference between a best estimate liability determined at a risk free rate and a best estimate liability determined at a fund earning rate.

The Board also considered that such an approach would ensure a more appropriate recognition of losses in respect of the expense component of investment linked business and so the requirement has been made generically applicable to all business where benefits depend on the performance of the underlying assets.

## 5.9. Strengthened Principles Based Approach

The Board has made alterations to the standards to strengthen and reinforce the substance of the principles underpinning them.

According to the Life Act, the purpose of the *Solvency Standard* is to ensure, as far as possible, that, at any time, the financial position of each statutory fund of a life company is such that the company will be able, out of the assets of the fund, to meet all policy and other liabilities referable to the fund at the time as they become due.

Accordingly the *Solvency Standard* has been amended to clarify that the prescribed requirements set out within the standard are designed to meet the obligations of the fund under circumstances where a judicial manager would most expeditiously seek for them to be secured. It may be presumed that this would most likely be achieved by a transfer of all of the assets and liabilities of the fund to a third party who would then be responsible for meeting the obligations as they fall due, out of the transferred assets. Items such as tax assets and reinsurance assets need to be assessed accordingly.

However, if the actuary considers that the circumstances of the fund are such that the obligations under the fund are more likely to be secured by some other means (e.g. by a run off of the obligations in situ), then the actuary may need to establish additional reserves for the additional risks or costs that might be incurred under that scenario and that are not otherwise reflected in the prescribed requirements of the standard; for example the costs of judicial management.

Furthermore, the current standards require the actuary to establish additional amounts within the solvency and capital adequacy requirements in situations where the particular combination of risks affecting a statutory fund is not otherwise considered within the standard. The standards now include some specific guidance as to the level of sufficiency to be applied to reserves established for that purpose.

Under this guidance, the actuary may presume that, for a typical life insurer with a balanced set of risks, the prescribed reserving requirements produce a level of reserves sufficient to withstand, during a 12 month period, a combination of adverse circumstances that would be expected to arise once every 200 years in the case of the solvency requirement. In so doing conservative response times are assumed and allowance is presumed to be made for plausible risk reduction actions to be implemented by management.

On the basis of this presumption, reserves for risks not otherwise considered within the standards may be consistently determined. However, the presumption means that it is not necessary for the actuary to also, in addition, undertake modelling of the risks already covered by the prescribed requirements.

The revised *Solvency Standard* further clarifies that:

- The solvency requirement must not be less than that calculated using the basis prescribed in the standard.

- In considering the scenarios of adverse experience the actuary must take into account all material risks (and the interdependencies between them that might apply under adverse conditions), regardless of whether they are discussed in the standard or not.

Equivalent guidance has also been included specifically in respect of unusual resilience risks. In that case, however, the adverse circumstances presumed to be reserved against are those arising once every 20 years.

The relationship between the general sufficiency level and that assumed to apply for the purposes of the resilience test has been clarified. Broadly, the general sufficiency level is higher as it relates to the combination of risks (of which resilience is just one) which may to some extent offset one another.

The sufficiency levels chosen are intended to be consistent with an implied level of strength equivalent to a “BBB” Standard and Poors or equivalent rating for solvency.

Similar requirements (at an appropriately higher probability of sufficiency) have also been included in the *Capital Adequacy Standard*. The general sufficiency level chosen for capital adequacy is one in 400 years, while that assumed to apply for the purposes of the resilience test is one in 100 years. These are intended to be consistent with an implied level of strength equivalent to an “A” Standard and Poors rating for capital adequacy.

In applying these principles it should also be noted that:

- the sufficiency test is only to apply to those risks that are material and not already covered by existing prescribed methodologies;
- operational risk is considered to be indirectly covered by other requirements of the standards and so need not ordinarily give rise to additional reserving requirements; and
- the threshold after 12 months is after de-risking. This means that it is after removing all risks that are under management control and which may plausibly be eliminated within that time frame – e.g. asset or currency mismatch risks. It therefore does not necessarily imply that further reserves are to be held for future asset falls following a prior fall of the specified severity.

## **5.10. Credit Risk Factors**

The resilience reserve provisions in the existing standards (para 11.5 of *Solvency Standard AS 2.03* and para 11.6 of *Capital Adequacy Standard AS 3.03*) have been improved by the introduction of a specific allowance for credit risk via specified additions to the adverse fixed interest yield movements and a further asset value deduction. While this may appear in isolation to represent an increase in capital requirement relative to the status quo, it will, in part, be offset by the related change of moving from government bond based discount rates to swap based discount rates for the solvency liability calculation. The additional yield movements and default factors vary by credit rating, with higher adjustments for capital adequacy than for solvency.

The basis underlying the credit risk factors is broadly consistent with the requirements under the proposed prudential standards for authorised deposit-taking institutions (ADIs) incorporated by Basel II (adjusted to a probability of adequacy consistent with the Board's solvency and capital adequacy framework).

The credit reserving factors reflect the pattern of risks over time and allow for the offsetting benefit of credit risk margins (excluding the cost of default) that are expected to be received within a 12 month period. As such, only a minimal reserve is required in respect of short term, higher quality instruments.

The table of counterparty grades in the *General Standard* has also been expanded to include short term ratings applied by rating agencies in addition to the usual longer term ratings.

State and territory government investments have been treated in the same manner as federal government investments for credit risk purposes. This is consistent with the treatment that applies for asset concentration purposes.

The standards contain specific requirements in relation to mortgage securities that depend on the mortgage's loan to valuation ratio (LVR), the nature of the collateral and whether lenders' mortgage insurance has been obtained.

The use of an external trust credit rating is permitted in place of a look through to the individual assets, where the rating has been provided by a recognised rating agency. However, where an external trust rating is to be used, the trust must be counted as a single asset for asset concentration purposes.

## **5.11. Resilience**

The resilience reserve requirements have been altered in a number of other areas.

### *Resilience Shocks*

It is necessary and appropriate for the actuary to consider all relevant shock scenarios and at least test the two scenarios now referred to in the standards. In most cases, it would only be necessary to test the two specific scenarios. However, where the circumstances of the fund are such that other scenarios are potentially relevant then they must also be tested.

Interest rate shocks are not symmetrical, and the application of equal up and down shocks in the existing standards insufficiently reflected the likelihood of an upward movement, and overstated that of a downward movement. Changes have therefore been made in the *Capital Adequacy Standard* to reflect this asymmetry. No change has been made to the *Solvency Standard* as it already includes a cap on the downward shock.

The downward yield shock test for capital adequacy is now 25% of the mid swap rate plus 0.2%. The upward shock test for capital adequacy is 25% of the mid swap rate plus 1.3%. This produces a downward shock of appropriate likelihood based on the

experience of the past 35 years, but which, relative to the existing requirement under AS3.03, is reduced in low interest environments and increased in high interest rate environments (which appears to better reflect historic interest rate variation dynamics). The upward shock has also been modified to better align with that implied by historical experience.

#### *Disaggregation of Assets*

The Board also recognises that assets within a given asset sector are not necessarily homogeneous, and that certain characteristics of assets typically included in one sector may be more indicative of assets in a different sector. An example is property, where the expected cash flows from long term lease contracts with high quality tenants may be more akin to a fixed interest investment.

In recognition of this the standards have been enhanced to enable companies to disaggregate such assets for resilience purposes on the proviso that certain requirements are met to APRA's satisfaction. These include that:

- the shocks applied to the separate sub-assets are equivalent, in total, to the shock that would apply to the asset as a whole;
- the disaggregated sub-assets are appropriately credit risk rated; and
- the totality of the cash flows under the overall asset are fully represented by the disaggregated sub-asset cash flows.

#### *Diversification*

The Board acknowledges that the previous approach to the diversification factor (DF) used in the resilience reserve calculation did not effectively deal with liability movements that essentially move in parallel with fixed interest asset movements. The Board has addressed this problem by allowing the option to use a diversification factor of 1 on individual asset sectors (rather than all sectors, as at present) where it produces a more favourable outcome than applying the same factor (DF or 1) across the board. This allows some recognition to be given to the relative independence of movements in different asset sectors while at the same time allowing the natural matching of fixed future obligations with fixed interest assets to be recognised.

No reserve is required for currency shocks where the portfolio is appropriately hedged for currency risks.

#### *“Look-through”*

For resilience purposes, the treatment of unlisted geared assets has been clarified to require a “look-through” to the underlying assets and liabilities, which must be recognised in their entirety. In other words, where a trust is geared, the entire gearing must be reflected, not just that in excess of a market average. The actuary must also consider any additional credit risk created by the intermediary.

The Board also clarified that trust investments (listed or unlisted) should principally be treated on a look through basis. Nonetheless, a practical option of not looking-through listed trusts is provided, subject to them then being treated as equity. If an asset is not looked through then it is also to be treated as a single investment for asset concentration purposes. Equity, property and interest bearing securities have been defined to be consistent with this treatment.

Where investment in a given unlisted or controlled investment entity represents more than 1% of the value of the statutory fund, it must, however, be looked through.

Where listed property trusts (LPTs) are treated as equity there may be some basis for adjusting the base yield for equity used for the resilience tests from the current ASX 200 yield (as currently permitted under the standards). In such circumstances the actuary needs to ensure that the base yield chosen produces resilience shocks consistent with the risk profile of the overall equity portfolio. In particular, any change to allow for LPTs would need to consider the extent that the amount of LPTs held differs from the weighting of these in the ASX200.

#### *Bonuses*

When determining resilience reserves it should be noted that the *Capital Adequacy Standard* allows for the use of discretions in accordance with section 3.2 of that standard. Resilience reserves may therefore allow for the appropriate, justifiable and equitable use of future excess bonuses (after providing for bonuses in line with policyholder expectations) to cover resilience reserves.

The standards also clarify that the use of discretions in relation to bonuses may also be applied when adjusting for credit risk, although no change may be made to the discount rate used to value the resulting liabilities.

### **5.12. Treatment of the Excess of Net Market Value over Net Assets (EMVONA)**

The new accounting standards will affect the basis for the consolidation of subsidiaries. In the parent entity accounts, investments in subsidiaries held in statutory funds will need to be measured at fair value if backing policy liabilities. However, in consolidated accounts, investments in subsidiaries held in statutory funds and those held by the general fund will effectively be measured at net assets. It will thus not be permissible to recognise EMVONA in the consolidated accounts.

To ensure the effectiveness of the Board's standards, the Board's view is that prudential standards should continue to be based on unconsolidated regulatory financial statements. Consequently, the inability to recognise EMVONA in the consolidated accounts does not have any direct impact on the capital position of life insurers, and so is not explicitly addressed in the revised standards.

However, the Board has more explicitly addressed the inadmissibility of intangible assets within a statutory fund by incorporating in the *Solvency and Capital Adequacy Standards* requirements that were previously only in the *Management Capital Standard*.

### **5.13. Treatment of Subsidiary and Associated Entities**

The accounting treatment of EMVONA, and APRA's prudential response to that treatment for ADIs and general insurers, has also prompted the Board to review the

treatment of subsidiary and associated entities under the *Solvency, Capital Adequacy and Management Capital Standards*.

#### *Financial Services Entities*

While maintaining the principles that underpin the “total balance sheet approach” to capital measurement of life insurers, the Board has sought to clarify the treatment of financial services entities (in all three capital standards). The requirement that the value ascribed to an associated or subsidiary entity exclude the amount of any prudential capital requirements has therefore been absorbed into a new section dealing specifically with financial services entities and expanded to also exclude the value in excess of net tangible assets, where the entity is a financial services entity.

The term “financial services entity” has been defined in the *General Standard* by listing the types of entities that will qualify as financial services entities. It includes all those entities that are subject to the same systemic, reputation, brand or environmental risks as the life company, or that may be perceived by the entity’s customers to be sufficiently related to the life insurance company that a material contagion risk exists.

The Board has also made a minor clarifying change, that the prudential capital requirements to be allowed for in respect of foreign entities are those applying in the local jurisdiction.

#### *Other Subsidiary and Associated Entities*

The *Solvency* and *Management Capital Standards* allow for three different possibilities of treatment of other subsidiary and associated entities that are not financial services entities:

- If the associated or subsidiary entity has operations that are dependent on those of the life insurance company, or is itself an operational entity of the group to which the life insurance company belongs, then the value ascribed to the entity for solvency and management capital purposes must not exceed net tangible assets.
- To the extent that the associated or subsidiary entity has a degree of financial or operational independence from the life insurance company that could lead to it having some value in excess of net tangible assets under adverse circumstances affecting the life insurance company, then some additional value may be ascribed to it accordingly. In such a situation, the admissible value must reflect:
  - the likely realisation value of the entity under the circumstances of the scenario under contemplation; and
  - the likely circumstances of the sale of the entity e.g. any perception of a forced sale or constrained ability of the life insurer to separately sell the entity due to supply/demand conditions in the market.
- If the associated or subsidiary entity is financially and operationally independent of the life insurance company, then the value ascribed to it must not exceed the value in the company’s regulatory financial statements.

### *Treasury Shares*

Furthermore, the *Solvency* and *Capital Adequacy Standards* permit the holding of treasury shares (holdings in the life company or a listed its parent) on behalf of policyholders as an admissible asset under certain conditions. This has been achieved by broadening the existing exemption for investment linked business to cover all business where the benefits under the policy are contractually linked to the performance of the assets held, i.e. including participating and investment account business.

### *Other Clarifications*

The Board has however made a minor change to clarify that the value of a subsidiary need not be reduced below a value of zero provided that there is no recourse to the life company in relation to the entity's obligations.

The Board has also clarified that the resilience treatment of assets that are partially inadmissible should only reflect the nature of the component that remains admissible, looking through where necessary to the underlying assets supporting that component.

## **5.14. Tax Effecting of Termination Values**

The Board has clarified that the minimum termination value (MTV) / CTV minimum under the *Solvency* and *Capital Adequacy Standards* respectively is not an extreme scenario test under which tax benefits (and other cash flows) might be considered. Rather, it provides a suitable high level confirmation of capital adequacy consistent with public expectations.

Accordingly, the Board has amended both the *Solvency* and *Capital Adequacy Standards* to confirm that allowance for tax relief is therefore not permitted on the increase in capital from the policy liability to the MTV / CTV. However, where the MTV / CTV is calculated as the present value of an income stream that present value calculation can take account of future tax amounts as part of those cash flows, where the corresponding calculation of best estimate liability is based on valuing net of tax payments and if tax relief is available under the relevant scenario.

## **5.15. Policyholders' Retained Profits**

The Board has considered the extent to which the assets supporting participating policyholders' retained profit (PRP) may be used to support the solvency and capital adequacy requirements in respect of non-participating business.

The Board's view is that policyholders would reasonably expect that PRP that was originally set aside to support their benefit expectations would, in time, accrue to the benefit of policyholders. Only in circumstances where PRP is in excess of the amount required to meet policyholder expectations might some PRP be available to support other business, and then only on a basis that provides an appropriate commercial return on that capital support.

In respect of participating business, explicit reference is now made in the *Capital Adequacy Standard* to those provisions under the Life Act which govern the role, purpose and distributions from policy owners' retained profits.

The Board has also strengthened those sections of the *Capital Adequacy Standard* that deal with discretions so that they allow for the likely distribution of PRP under the scenario being considered.

At the same time, the standard has been modified to recognise that the value of future best estimate shareholder profits within the policy liability (after allowing for the effect of the adverse conditions being assumed) is potentially available to provide capital support.

### **5.16. Asset concentration Limits**

The Board has revised the asset concentration limits as follows:

- the limit on residual assets not listed in any of the inadmissible asset categories is now 1%;
- assets now included within the 5% limit include real estate (whether income producing or not) and other real property assets (provided they are income producing) – i.e. this is intended to include land, buildings, infrastructure, etc;
- limits of \$5 million have generally been increased to \$20 million;
- a separate category has been created for premiums receivable by a reinsurer. The limit (25% or \$20m) is the same as for other amounts secured by insurance policies; and
- other minor wording refinements have been made.

In making these changes the Board has clarified that assets exposed to a common risk are to be treated as a single asset. Also, where a fund has cumulative exposures to a single counterparty across a range of asset types, the limit in respect of any particular asset class is to be reduced by the exposure to that same obligor that is allowed as admissible in respect of all lower asset classes.

### **5.17. Allowance for Reinsurance**

The Board has amended the standards to ensure that reinsurance assets of a statutory fund are treated in the same way as other assets and are therefore to be subject to the asset inadmissibility and resilience reserve requirements. For these purposes the Board considers that:

- all exposures to a reinsurer or reinsurance group are to be considered as a single counterparty exposure; and
- where arrangements with a reinsurer involve both liability and asset components, these may be taken as a single net exposure to the extent that they are subject to a legally enforceable right of set-off.

A specific asset concentration limit of the greater of 25% of the value of the assets of the statutory fund (VASF) and \$20m has been introduced for reinsurance secured by a specialist reinsurer.

The Board has clarified the treatment of reinsurance assets for the purposes of the standards:

- In order for the credit and inadmissible asset risks involved with reinsurance arrangements to be properly identified and assessed, the requirements of the relevant standards are to apply on a gross of reinsurance basis, with the gross policy liability requirements and any related reinsurance values separately quantified;
- Nonetheless, any reinsurance arrangements are to be valued and assessed on a basis consistent with their associated policy liabilities under the scenario or test being considered;
- Where a reinsurance arrangement gives rise to an asset of the fund, this arrangement is to be treated as an asset within the relevant standard;
- Where, under the adverse circumstances of the relevant standard, the value of such an asset would rise then that effect must be included in the solvency and capital adequacy requirement – offsetting the consequences of the adverse circumstances on the other assets and direct insurance liabilities of the company. However, that increased asset value must then be assessed for inadmissible asset purposes (e.g. asset concentration) as well.

The impact on profit margins of buying reinsurance needs to be separately identified.

The amended *Valuation Standard* therefore clarifies that the principles of the standard apply to both the calculation of the gross policy liability and the reinsured policy liability. Thus where future profits or losses are expected to arise in respect of a reinsurance arrangement, the present value of those future profits or losses is to be included in the reinsured policy liability as a value of reinsurance profit margins.

For loss recognition purposes, reinsured policy liabilities must be allocated to related product groups with the value of reinsured profit margins combined with the value of future profit margins relating to the direct business of that related product group. If the reinsurance then results in an inadequate level of profit margins for the related product group, the resulting net losses are to be recognised. However, margins in respect of the reinsurance must continue to be determined separately from the profit margins in relation to the associated direct insurance business, which will facilitate the IFRS disclosures.

The Board has also included a new provision requiring that in order for an insurance or reinsurance arrangement to qualify for inclusion within asset concentration limits, the reinsurance arrangement must, subject to a suitable grace period from risk inception, comprise an executed and legally binding contract. Reinsurance with draft or incomplete documentation can at best qualify under the lowest limit i.e. 1% of the value of fund assets.

Finally, the Board has extended the treatment of retrocessions in section 10.5.2 of the *Solvency and Capital Adequacy Standards* to include retrocessions to an associated or

subsidiary company, provided that the receiving company is accepted by APRA as suitable for the purpose of that section of the standards. The Board recognises that a consequence of this change will be that APRA approval will be required even where the retrocession is to the parent. APRA has agreed to approve arrangements that already exist under the current requirements.

## **5.18. Other Assets and Liabilities**

### *Defined Benefit Superannuation Fund Surpluses/Deficits*

IFRS have highlighted the issue of the treatment in an employer's accounts of surpluses and deficits arising in a defined benefit superannuation fund sponsored by that employer. The Board has amended the standards to align them with the IFRS requirements. In particular:

- The calculation of other liabilities for the purposes of the *Solvency Standard*, *Capital Adequacy Standard*, and *Management Capital Standard* has been adjusted in those circumstances where the amount includes a deficit arising from a defined benefit superannuation fund and the deficit has been determined in accordance with the "corridor approach" defined under AASB119 *Employee Benefits*, ensuring that the full deficit is recognised for solvency and capital adequacy purposes; and
- An insurer will be required to treat any surplus in a defined benefit superannuation fund as an inadmissible asset.

Defined benefit superannuation fund deficits will not need to be recalculated for the purposes of the *Solvency* or *Capital Adequacy Standard*, nor subject to adverse experience or asset shocks, given that their status is different from other liabilities; i.e. resilience reserve tests and adverse scenarios tests are not to be applied to defined benefit assets or liabilities.

### *Future Income Tax Benefits Under Tax Consolidation*

In some cases future income tax benefits may now be regarded from the perspective of a life company that is part of a consolidated group as receivables or other assets. Where that is the case, it is the Board's view that they should be treated accordingly under the standards, but that under the principles of the standards, such treatment should not be materially different from the treatment of explicit tax benefits, provided that a suitable, robust and enforceable tax sharing and funding arrangement is in place.

## **5.19. Friendly Societies**

For reporting periods commencing on or before 31 December 2004 friendly societies were exempted from the general purpose financial reporting standards applying to life insurance companies by virtue of ASIC Class Order 99/1225. That class order has since lapsed.

The Board has therefore aligned the regulatory financial reporting requirements for friendly societies with those for other life insurance companies and amended the

*Valuation Standard* to extend its provisions to friendly societies. Friendly societies will now be required to adopt the MoS methodology for their *life insurance contracts*. The Board understands that the IAAust is intending to provide guidance on the practical application of MoS to friendly societies, taking account of their simplified products and fund structures.

All friendly society expenses must be allocated to the Management Fund, with the exception of direct costs which can be allocated to a Benefit fund but only if the Benefit Fund rules provide for this.

## **5.20. Eligible Foreign Life Insurance Companies**

In 2004 the *Life Insurance Act 1995* was amended by the *US Free Trade Agreement Implementation Act* to include provisions for *eligible foreign life insurance companies*. As a result the Board has amended the standards to extend their provisions to the Australian business written by an *eligible foreign life insurance company*.

## **5.21. Changes in the mortality bases**

The Board is of the view that, in the light of mortality improvements since the standards were originally developed, some strengthening of the annuitant mortality assumption for the *Solvency Standard* is warranted. In the absence of a detailed industry analysis the inclusion of an underpin of 90% of best estimate is seen as an appropriate means of achieving this.

## **5.22. Other Matters**

The following additional miscellaneous matters have also been considered in reviewing the standards:

- No significant changes have been made to the allocation of expenses. In particular, no attempt has been made to distinguish deferrable and non-deferrable acquisition expenses in respect of life investment contracts. The Board does not consider that it is appropriate for the actuarial standards to attempt to interpret accounting standards.
- Some additional guidance has been added on the setting of margins in the capital adequacy liability within the quantitative ranges.

The opportunity has been taken to clarify the wording of the standards in a number of places.

## 6. Implementation of Standards

After careful consideration, the Board has adopted 31 December 2005 as the effective date of the standards. While the time between the final standards becoming available and the effective date is short, the Board believes that implementation in conjunction with IFRS is appropriate and that delay will not provide any material benefit to the industry. The Board has taken steps to ensure that the draft final standards are available to the industry and is confident that the changes in them are already well known through the exposure and consultation process, while transitional arrangements will provide scope for any adjustments to company affairs that may be required.

The Board also understands that APRA is considering extensions of reporting deadlines which will allow time for companies to make any system changes to accommodate the new reporting regime.

Notwithstanding this, the application date of the *Valuation Standard* for friendly societies has been set as 31 May 2006. This later date is appropriate given that no friendly society has a 31 December 2005 annual reporting date and the first annual reporting date thereafter for a friendly society is 31 May 2006. This will enable friendly societies to continue to apply the previous standards for quarterly reporting purposes up until they produce their first full financial statements under IFRS.