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Actuarial Standard 1.04

VALUATION OF POLICY LIABILITIES

Life Insurance
Actuarial Standards Board

TABLE OF CONTENTS

Page

INTRODUCTION 2

The Standard 2
Application of the Valuation Standard 3

PART A – CONTRACT CLASSIFICATION AND POLICY LIABILITIES IN RESPECT OF LIFE INVESTMENT CONTRACTS 5

SECTION 1 Contract Classification and Application 5
SECTION 2 Policy Liabilities in Respect of Life Investment Contracts 6

PART B – PRINCIPLES FOR DETERMINING POLICY LIABILITIES IN RESPECT OF LIFE INSURANCE CONTRACTS 8

SECTION 3 The Principles of the Valuation 8
SECTION 4 The Valuation of Policy Liabilities 10
SECTION 5 The Best Estimate Liability 13
SECTION 6 Profit Carriers and Profit Margins 16
SECTION 7 Acquisition Expenses 18

PART C – METHODOLOGIES FOR DETERMINING POLICY LIABILITIES IN RESPECT OF LIFE INSURANCE CONTRACTS 20

SECTION 8 New Business - Calculation of Profit Margins and Acquisition Expense Recovery Components 21
SECTION 9 Reporting Date Recalculations - Benefits Providing no Discretionary Entitlement to Share in the Investment Experience of Assets Backing them. 22
SECTION 10 Reporting Date Recalculations - Benefits Providing a Discretionary Entitlement to Share in the Investment Experience of Assets Backing them. 25
SECTION 11 Loss Recognition 28
SECTION 12 Reinsurance 29

PART D – GENERAL REQUIREMENTS FOR ALL FORMS OF POLICY AND ACTUARY'S STATEMENT 31

SECTION 13 Allocation of Expenses 31
SECTION 14 Materiality 34
SECTION 15 Initial Calculation of Policy Liability 35
SECTION 16 Statement Relating to the Valuation 36

INTRODUCTION

The Standard

The actuarial standard for the valuation of policy liabilities is established under the Life Insurance Act 1995 *(the Act)*, and is an integral component of the financial reporting regime for life insurance companies implemented under that Act.

A valuation of the policy liabilities of a company is performed at least once a year as part of the regulatory reporting of the company. The value of the policy liabilities appears in the regulatory financial statements in the balance sheet of the company. The increase (or decrease) in policy liabilities of the company over the financial year contributes directly to the operating profit.

Important in the development of an integrated financial framework for the life industry were considerations of:

- methodologies for determining the policy liabilities of the life company in respect of Life Insurance Contracts which are consistent with objectives of realistic profit reporting;
- proper and timely release of profit arising in respect of Life Insurance Contracts over the life of the business;
- in respect of Life Investment Contracts, measurement of policy liabilities that follows the requirements of relevant accounting standards (to the extent that the financial reporting of Life Investment Contracts under such standards is appropriate for the purposes of the Act);
- requirements for disclosure of this information in a transparent and comparable format; and
- approaches to prescribing minimum capital requirements to support those liabilities and provide an indicator of the financial position of the company.

The actuarial standard for the valuation of policy liabilities addresses the first three of these issues, with a concern for the objectives of disclosure and reporting. The issue of capital requirements is addressed by separate actuarial standards - the Solvency Standard, the Capital Adequacy Standard and the Management Capital Standard.

Accordingly, this actuarial standard prescribes:

- in respect of Life Investment Contracts, that the valuation of policy liabilities is to generally comply with the requirements of the relevant accounting standards, and

- in respect of Life Insurance Contracts, a set of principles, and in accordance with these principles an actuarial methodology, for the valuation of the policy liabilities of the life company.

Application to Friendly Societies

The Act was amended in 1999 to extend its application to friendly societies that undertake life insurance business. However, previous versions of this standard were only applicable to life companies (registered under the Act) other than friendly societies. A separate standard applied to 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 companies by virtue of ASIC Class Order 99/1225. That class order was rescinded with effect for reporting periods commencing on or after 1 January 2005. It is therefore appropriate that regulatory financial reporting requirements be similarly aligned with effect from the application date of this revised standard and that this Standard applies to Friendly Societies.

With the rescinding of the ASIC class order, it is appropriate, for the purposes of applying the Valuation Standard, for benefits provided in benefit funds where there is a provision for distribution of unallocated surpluses to policy owners to be valued as if they were participating. Benefits provided under benefit funds where is no provision for distribution of unallocated surpluses to policy owners are to be valued as if they were non-participating.

Application of the Valuation Standard

The Valuation Standard is made for the purposes of section 114 of the Life Insurance Act 1995.

It applies:

a) in respect of all life insurance business (including life insurance business carried on outside Australia) of a registered life company (including a life company which is a friendly society); and

b) in respect of the life insurance business of an eligible foreign life insurance company, other than life insurance business carried on outside Australia; and

c) to a valuation of the policy liabilities of the company made for the purposes of the Act; and

d) for all valuations made in respect of periods ending on or after 31 December 2005 in the case of life insurance companies (other

than friendly societies) and on or after 31 May 2006 in the case of friendly societies.

Except for paragraph 1.5, it will continue to apply until replaced. Unless the Valuation Standard is replaced at an earlier date, paragraph 1.5 will cease to apply to valuations made in respect of reporting periods ending on or after 31 December 2009.

The 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 Standard is being applied to overseas business.

PART A – CONTRACT CLASSIFICATION AND POLICY LIABILITIES IN RESPECT OF LIFE INVESTMENT CONTRACTS

For the purposes of this Standard and reporting under the Act, policy liabilities in respect of life investment contracts are to be determined in accordance with the relevant accounting standards, subject to any available options being restricted to the fair value based options.

SECTION 1 Contract Classification and Application

APRA's Prudential Rule 49 clarifies the basis on which policies written by life insurers are to be classified for the purpose of regulatory financial reporting. In particular it distinguishes between those policies issued by life companies that meet the definition of a Life Insurance Contract for regulatory reporting purposes and those that do not (referred to as "Life Investment Contracts").

Prudential Rule 49 also identifies key components of policies written by life companies and stipulates the circumstances in which such components must be unbundled for regulatory reporting purposes.

1.1 **For the purposes of this standard, an unbundled component of a policy is to be treated as if it were a stand-alone policy. After allowing for unbundling, Life Insurance Contracts (including contracts with Discretionary Participation Features) and any associated Life Investment Contracts must be dealt with in separate Related Product Groups.**

1.2 **After allowing for any unbundling, the Policy Liability in respect of a Life Insurance Contract (including a contract with Discretionary Participation Features) must be determined in accordance with the requirements of Parts B and C of this standard.**

1.3 **After allowing for any unbundling, the Policy Liability in respect of a Life Investment Contract must be determined in accordance with Section 2 of Part A of this standard.**

1.4 **Section 2 of Part A of this standard is not to be used for the purposes of calculating the Solvency Liability under the Solvency Standard or the Capital Adequacy Liability under the Capital Adequacy Standard. For those purposes, the prospective valuation methodology outlined in Parts B and C of this standard will apply to all elements of the life insurance business issued by the company, regardless of how it is classified, albeit using**

assumptions as specified in the Solvency Standard or the Capital Adequacy Standard.

1.5 Where the Actuary determines, and can demonstrate to the satisfaction of APRA, that the calculation of the Policy Liability in accordance with paragraph 2.1 would reduce the retained profits of the statutory fund to such an extent that it would unreasonably hinder the distribution of surplus assets from that fund, then, for policies that were in force at 31 December 2005, the Policy Liability may, with APRA's agreement, be determined in accordance with the requirements of Parts B and C of this standard.

1.6 Part D of this standard applies to all of the life insurance business issued by the company for the purposes of the Act.

SECTION 2 Policy Liabilities in Respect of Life Investment Contracts

Life Investment Contracts consist of at least one Financial Instrument, being the element that gives rise to a financial asset or financial liability. They may also contain additional elements in respect of management services, embedded derivatives or participation features.

The net contractual obligations under a Life Investment Contract which arise under the Financial Instrument Element of the contract (and any associated management services that are not unbundled) is referred to as the Life Investment Contract Liability, consistent with the terminology adopted under AASB 1038.

Life Investment Contracts with Discretionary Participation Features that are regulated under the Life Insurance Act 1995, are treated in their entirety as if they were Life Insurance Contracts and so are not subject to this section of the standard. They may, however, still be subject to certain minimums or disclosures the quantification of which is subject to this section of the standard.

Embedded derivatives within a Life Investment Contract are financial instruments and must be allowed for within the Financial Instrument Element for the purpose of this Valuation Standard.

Policy Liability of a Life Investment Contract

2.1 The Policy Liability in respect of a Life Investment Contract is determined as

Policy Liability =	LICL + MSE

where

LICL = the Life Investment Contract Liability, being the liability arising in respect of the Financial Instrument Element

MSE = the net liability (asset) in respect of the Management Services Element.

Life Investment Contract Liability

2.2 The Life Investment Contract Liability, being the component of the Policy Liability that arises under a Life Investment Contract issued by an Australian life insurance company that relates to the Financial Instrument Element (and any associated management services that are not unbundled), is to be determined in accordance with the fair value through profit and loss provisions of the relevant accounting standards (whether or not the Financial Instrument Element is measured on that basis in the general purpose financial statements).

Management Services Element

2.3 The Policy Liability that arises under a Life Investment Contract is to include the net amount of all liabilities and assets arising in respect of the Management Services Element of the contract. These liabilities or assets include, but need not be limited to, the value of Deferred Fee Revenue and Deferred Acquisition Costs. The measurement of these liabilities and assets is to be in accordance with the relevant accounting standards.

Reinsurance of Life Investment Contracts

2.4 The Policy Liability is determined gross of reinsurance (as defined for the purposes of the Act). The recognition and measurement of outwards reinsurance that does not involve the transfer of Insurance Risk are to be undertaken separately in accordance with the fair value through profit and loss provisions of the relevant accounting standards (whether or not they are reported on that basis in general purpose financial statements).

PART B – PRINCIPLES FOR DETERMINING POLICY LIABILITIES IN RESPECT OF LIFE INSURANCE CONTRACTS

SECTION 3 The Principles of the Valuation

Overview

The purpose of this part of the standard in prescribing a set of principles for the valuation of the policy liabilities in respect of life insurance contracts is to achieve the two essential objectives of:

- determining, as at the reporting date, a realistic determination of the policy liabilities of the company in respect of Life Insurance Contracts; and
- providing for the emergence of profit in respect of Life Insurance Contracts as it is earned.

The Best Estimate Liability
The first of these objectives may be met by determining a best estimate value of the liabilities being the value of the expected future contractual payments to policy owners on the basis of best estimates of future income and outgo.

The Profits
The second of these objectives may be met by determining a best estimate value of the expected future profits to emerge under the policies. The explicit provision for future profits, through Bonuses and/or Profit Margins, is a mechanism to facilitate the release of profit as it is earned through the provision of services and the receipt of the related income.

The sum of the Best Estimate Liability and the value of the expected future profits is called the Policy Liability.

It is not the purpose of this Standard to prescribe a single methodology for the valuation of policy liabilities in respect of Life Insurance Contracts. The principles of the Standard will normally be achieved by adopting a projection methodology. However, it is recognised that alternative approaches - such as an accumulation methodology - may in some cases be appropriate in achieving the principles.

3.1 It is the principles which are paramount in determining the Policy Liability; methodology is incidental to the principles. Projection or accumulation methodologies may be appropriate provided the Actuary can demonstrate that the principles have been met.

3.2 The Policy Liability must provide for both:

a) a best estimate value of the liability of the company in respect of obligations under Life Insurance Contracts; and

b) a uniform emergence of profit in respect of Life Insurance Contracts relative to one or more appropriate Profit Carriers.

3.3 While Profit Carriers are an explicit component of the valuation where a projection approach is used, the Profit Carriers are implicit where an accumulation approach is appropriately used.

3.4 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.

3.5 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.

3.6 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.

3.7 When the valuation results in expected future profits for a Related Product Group that are below the Adequacy Threshold for that product group, the value of the shortfall must be recognised immediately as a loss.

3.8 Subject to circumstances covered by paragraph 3.7, profit for the period must not otherwise be affected by a change in the Best Estimate Assumptions in respect of future periods, except that:

a) where previously recognised losses exist for a Related Product Group 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; or

b) where that change is in the Best Estimate Assumption for the discount rate (and future investment earnings and related economic assumptions, where relevant) due to market changes only, and the benefit has no discretionary entitlement to share in investment experience, the present value of the expected future profits which are generated by the change must be released.

Where the change in Best Estimate Assumptions would result in a release of expected future profits otherwise than as above, the present value of those profits must not be released, but respread to emerge as a uniform proportion of the appropriate Profit Carrier(s).

3.9 In determining the Best Estimate Liability and Best Estimate Assumptions, the Actuary 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.

3.10 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. In particular, the special circumstances of Reinsurers are recognised as warranting approximate methods.

SECTION 4 The Valuation of Policy Liabilities

Overview

Benefits for life companies other than friendly societies are either Participating Benefits or Non-Participating Benefits. Due to the different nature of these benefits, different approaches are required to the valuation of policy liabilities.

Participating Benefits
Where Participating Benefits are provided the policy owner is entitled to share in the profits of the business.

The participation process is managed by the life company, through the declaration of Bonuses. Company practice, and ultimately the requirements of the Act, control the relationship between policy owner and shareholder entitlements to profits.

The profit for Participating Benefits includes provision for:

- Bonuses (policy owner profits); and
- Shareholder Profits.

Policy Liability =	
Best Estimate Liability	
plus	Value of future Best Estimate Bonuses
plus	Value of future Best Estimate Shareholder Profits

Non-Participating Benefits

Where Non-Participating Benefits are provided, profit is entirely the entitlement of the shareholder.

Policy Liability =	
Best Estimate Liability	
plus	Value of future Best Estimate Shareholder Profits

The contractual arrangements in respect of the Non-Participating Benefits may entitle the policy owner to additions to the benefit, at the discretion of the company, reflecting the investment experience of the assets backing the benefit. While this is not a distribution of profit, the determination of the additions may involve similar management processes to the distribution of bonus for Participating Benefits. Accordingly, similar valuation methods may be appropriate.

Friendly Society Benefits

Friendly society benefits are neither participating nor non-participating.

For the purpose of applying the Valuation Standard, benefits provided under benefit funds where there is a provision for distribution of unallocated surpluses to policy owners are to be valued as if they were participating. Benefits provided under benefit funds where is no provision for distribution of unallocated surpluses to policy owners are to be valued as if they were non-participating.

4.1 Participating Benefits

4.1.1 In respect of Participating Benefits, profit must include the policy owners' share of profits. The valuation of the policy liabilities must, therefore, make allowance for the best estimate at the reporting date of:

a) the value of expected future Policy Owner Profit Share; and

b) the value of expected future Shareholder Profit Share.

4.1.2 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.

4.1.3 The relationship between the assumed allocation of profit to policy owners and shareholders respectively must, in respect of each future year, be consistent with:
a) the policy conditions; and
b) the company's practice or stated philosophy.

4.2 Non-Participating Benefits

4.2.1 In respect of Non-Participating Benefits, the valuation of policy liabilities must make allowance for the best estimate at the reporting date of the value of expected future Shareholder Profit Share.

4.2.2 Where a Non-Participating Benefit includes an entitlement, at the discretion of the company, to share in the investment experience of the assets backing the benefits, the valuation of the policy liabilities must make allowance for the best estimate at the reporting date of the present value of current year and expected future Discretionary Additions.

Consistency with Asset Values

4.3 Where the basis of asset valuation used for the regulatory financial statements is not consistent with the basis of asset valuation implicit in the valuation of the liabilities, the Actuary must make appropriate adjustments to the Policy Liability.

Reinsurance of Life Insurance Contracts

4.4 The Policy Liability is determined gross of reinsurance (as defined for the purposes of the Act), although the gross Policy Liability may be calculated by first determining the necessary components on a net of reinsurance basis and then adjusting the result by the amounts of the corresponding components of the Reinsured Policy Liability.

SECTION 5 The Best Estimate Liability

Overview

The Best Estimate Liability is determined as the value of the expected future payments and receipts under the policy, gross of reinsurance, based on obligations at the reporting date.

Best Estimate Liability =	
	Value of expected future benefit payments
plus	Value of expected future expenses
less	Value of expected future receipts

Note that the benefit obligations projected include all contractual benefits. In particular, in the case of Participating Benefits they include Bonuses declared prior to (but not on, or after) the date of valuation.

In projecting the expected future cash flows, the Actuary makes assumptions about the expected future experience, taking into account all factors which are considered to be material to the calculation, including:

- investment earnings
- inflation
- taxation
- expenses
- mortality and morbidity
- policy discontinuance.

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

5.1 In accordance with the principles of section 3, where the valuation of the policy liabilities involves assumptions as to future experience, the assumptions used must be Best Estimate Assumptions.

5.2 In establishing Best Estimate Assumptions, due regard must be had for the materiality of:
a) the benefits being considered; and
b) the effect of particular assumptions on the determined result.

5.3 Valuing Liability Options

5.3.1 The Best Estimate Liability and Best Estimate Assumptions are to have regard to any options or asymmetrical distribution of liability outcomes.

5.3.2 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.

5.3.3 However, the Actuary 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.

5.3.4 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.

5.3.5 The requirements throughout this standard in respect of Best Estimate Assumptions and Best Estimate Liabilities are to be interpreted in this context.

Investment Earnings

5.4 Where the cash flows to be valued depend on future investment earnings, the Best Estimate Assumption for investment earnings must reflect the expected investment earnings applicable to the actual assets on which the cash flows depend.

5.5 The Discount Rate

5.5.1 The gross rate used to discount expected future cash flows must, to the extent the benefits under the policy are contractually linked to the performance of the assets held, reflect the expected investment earnings applicable to the assets backing the benefit being valued. Otherwise, a Risk Free Discount Rate is to be used.

5.5.2 This does not preclude the use of discount rates that 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, taxes or profit margins.

5.6 Taxation

5.6.1 For business where tax is based only on profits, liabilities may be determined gross of tax. Otherwise, appropriate allowance must be made for the effect of taxation.

5.6.2 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 in paragraph 5.5.1.

5.7 Servicing Expenses

5.7.1 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.

5.7.2 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 in paragraph 5.5.1.

5.7.3 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.

Acquisition Expenses

5.8 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 Actuary considers to be 'one-off' in nature.

Both must be consistently adjusted for tax in accordance with paragraph 5.6.

Other Assumptions

5.9 The Best Estimate Assumption in respect of all other assumptions used in the valuation of policy liabilities, must be assumptions about future experience which:

a) are made using professional judgement, training and experience; and
b) are made having regard to reasonably available statistics and other information; and
c) are neither deliberately overstated nor deliberately understated.

SECTION 6 Profit Carriers and Profit Margins

Overview

Policies are written with the expectation of producing profits. Profit Carriers are selected and Profit Margins determined when a policy commences to enable the appropriate emergence of the expected shareholder profit over the term of the benefits. (Policy owner profit emerges through Bonuses.) This is achieved as follows*:*

Profit Margin =
Value of future Best Estimate Shareholder Profits
divided by Value of Profit Carrier(s)

where the Profit Carrier is a financially measurable indicator of either:

- the expected cost of the services provided to the policy owner; or
- the expected income item relating to the services.

The range of services which may be provided to the policy owner, includes:

- insurance of mortality, morbidity (or similar risks)
- generation of investment income
- setting up the policy (selling or acquisition)
- ongoing administration
- investment management
- provision of bonuses

Selection of the profit carrier is critical in determining the magnitude and timing with which profits are released.

6.1 Profit Margins

6.1.1 In accordance with the principles of section 3, the appropriate release of expected future shareholder profits is provided for in valuing the policy liabilities, either explicitly or implicitly, through the incorporation of Profit Margins.

6.1.2 A Profit Margin must be expressed, explicitly or implicitly, as a uniform proportion of one or more appropriate Profit Carrier(s).

6.2 Profit Carriers

6.2.1 The appropriate Profit Carrier(s) must be related to the services provided to policy owners by the company. The Actuary, in selecting the appropriate Profit Carrier(s), must consider:
a) the services and income items applicable to the benefit; and
b) the relative risks of services, or of costs, to the company; and
c) the relative timing of the provision of the services and the receipt or recognition of income for those services.

6.2.2 Provision of capital to meet Solvency and Capital Adequacy Requirements is not a service for this purpose.

6.2.3 Acquisition is a service for this purpose only when explicit Establishment Fees are received.

6.2.4 The practical implications of selecting multiple profit carriers should be considered relative to the materiality of the results. Where multiple Profit Carriers are used, for ease of computation it may be desirable to retain a constant Profit Margin for all but one of the Profit Carriers selected, allowing the Profit Margin in respect of that remaining Profit Carrier to be the only variable.

6.2.5 Profit Carrier(s), once chosen, must be used consistently for a Related Product Group unless in the Actuary's judgement the Profit Carrier(s) are no longer appropriate.

6.2.6 Where Profit Carrier(s) are changed this must not result in a release of profit at the date of change. This is achieved by equating the values of Best Estimate Shareholder Profits before and after the change in determining the new Profit Margins.

SECTION 7 Acquisition Expenses

Overview

A company normally incurs Acquisition Expenses and possibly receives Establishment Fees when it acquires new business.

Where new business is written with the expectation of producing profits, then, if the Establishment Fees are less than the actual Acquisition Expenses, there will be an expectation of receiving future income, part of which goes to meeting the unrecouped Acquisition Expenses.

The principles for the allocation of expenses to Acquisition Expenses are set out in section 13. 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.

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.

7.1 **To the extent that Acquisition Expenses are not recovered by the Establishment Fees, they must be charged against expected future profits, provided that these profits are sufficient to recover them. Any Acquisition Expenses which cannot be recovered from Establishment Fees or expected future profit will emerge as a loss at issue.**

7.2 **Appropriate allowance must be made in this process for tax on both Establishment Fees and Acquisition Expenses.**

7.3 **Where expected future profits for a Related Product Group are insufficient to recover unrecouped Acquisition Expenses, the loss must be recognised in accordance with the processes of section 11.**

7.4 **Where a projection approach is used to calculate the Policy Liability, the expected income which is used to recover Acquisition Expenses is incorporated as a reduction in the Best Estimate**

Liability calculation. Accordingly, Acquisition Expense Recovery Components are an implicit component of the valuation.

7.5 Where an accumulation approach is used to calculate the Policy Liability the value of the unrecouped portion of Acquisition Expenses which is to be recovered from future income must be explicitly allowed for as a reduction in the liability by using Acquisition Expense Recovery Component(s).

PART C – METHODOLOGIES FOR DETERMINING POLICY LIABILITIES IN RESPECT OF LIFE INSURANCE CONTRACTS

Overview

If the Best Estimate Assumptions made at Commencement remain valid through the policy term, and if experience under the benefit exactly reflects those expectations, the methodologies should ensure that profit emerges at each reporting date as:

- investment earnings (net of tax) on any retained profits and shareholder capital; plus
- release of the expected profits (net of tax) in respect of the valuation period.

In reality, actual experience in the valuation period will likely differ from that expected, and to this extent there will emerge an experience profit (or loss).

Further, as experience changes, the Best Estimate Assumptions as to the future may change.

The principles of this standard require that the present value of profit resulting from a change in non-economic Best Estimate Assumptions of the Actuary, must not be released immediately at the reporting date, but rather must be released appropriately over the future life of the benefit.

Appropriate profit emergence is achieved through a methodology which involves recalculation at each reporting date of the expected future profit. Profit Margins and Acquisition Expense Recovery Components are determined as required to ensure the appropriate release of those future profits.

In the case of benefits with an entitlement to share in the investment experience of the assets backing them, the methodology must deal specifically with investment experience profits to allow its release over the future life of the benefit as:

- in the case of Participating Benefits (including friendly society benefits under benefit funds where there is a provision for distribution of unallocated surpluses to policy owners), future Bonuses and Shareholder Profits; or
- in the case of Non-Participating Benefits, future Discretionary Additions.

Note that in this Part, discussions of the detail of the methodologies for calculating policy liabilities will typically be in terms of a benefit. A policy may incorporate multiple benefits. Further, certain processes described in this Part may be performed at a Related Product Group level, which incorporates multiple (like) policies.

While recalculation processes described in this Part will normally be considered for a Related Product Group, the Actuary may group benefits at a lower level where this is supported by company practice or stated philosophy and is done consistently over time.

SECTION 8 New Business - Calculation of Profit Margins and Acquisition Expense Recovery Components

8.1 Profit Margins

8.1.1 Where explicit Profit Margins are required, they are determined by dividing:
a) the value at Commencement of the expected future profits from the benefit; by
b) the value at that date of the appropriate Profit Carrier(s).

8.1.2 The value at Commencement of expected future profits must be determined on the basis of Best Estimate Assumptions.

8.1.3 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; or
b) the date of commencement of the business; or
c) the end of the reporting period.

8.1.4 The Acquisition Expense assumption will be determined at the end of the reporting period.

8.2 Treatment of Losses

8.2.1 If the projection reveals a value of expected future profit at Commencement for new business in a Related Product Group that is below the Adequacy Threshold, then that loss must either be recognised, or dealt with in accordance with the provisions of paragraph 8.2.2. Any losses at Commencement so recognised must be accumulated. If the Related Product Group subsequently generates profits above the Adequacy Threshold, the cumulative losses must be offset (see section 11).

8.2.2 Alternatively, new business may be grouped with existing in force business for the same Related Product Group for the purpose of calculating Profit Margins. Where new business is so grouped, any losses at Commencement for that new business cannot be accumulated or subsequently offset.

8.2.3 The approach used by the Actuary for treatment of losses on new business must be applied consistently over time.

8.3 Acquisition Expense Recovery Components

8.3.1 Where explicit Acquisition Expense Recovery Components are required, they are determined at Commencement by dividing:

a) the Best Estimate Assumption for Acquisition Expenses at Commencement (to the extent not recovered by Establishment Fees); by

b) the present value at that date of the appropriate Acquisition Expense Recovery Carrier(s).

8.3.2 The Acquisition Expense Recovery Carrier(s) must reflect the element of the premium or other income item, including surrender penalties, designed or intended to recover Acquisition Expenses.

8.3.3 Appropriate adjustment to Acquisition Expenses and Acquisition Expense Recovery Components will be needed where Acquisition Expenses are expected to be incurred in a year other than the year of issue. Any adjustment by the Actuary must have regard to Acquisition Expenses accrued or deferred in the accounts.

SECTION 9 Reporting Date Recalculations - Benefits Providing no Discretionary Entitlement to Share in the Investment Experience of Assets Backing them.

Overview

A change in the discount rate (and other related economic assumptions) at the reporting date may occur because of:

- changes in the market conditions; and/or
- other changes (such as a change in the mix of assets backing the benefits that are dependent on investment performance).

The recalculation process described in this section results in the Policy Liability reflecting the effect of changes in discount rates (and other related economic assumptions) due to market conditions only . The

effect of other changes in discount rates or other assumptions is spread over the future benefit term, through the recalculation process.

Where the only change in the Best Estimate Assumptions is a change in the discount rates (and other related economic assumptions) due to a change in market conditions, the recalculation process will result in the Profit Margins and Acquisition Expense Recovery Components being unchanged.

9.1 Recalculation of Profit Margins

9.1.1 Where Profit Margins are determined at Commencement, the principles of section 3 require a recalculation of those Profit Margins at each subsequent reporting date to ensure that future expected profits are neither released prematurely nor deferred inappropriately.

9.1.2 The methodology detailed below produces results in accordance with the principles of section 3. Other methods may be appropriate where the Actuary can demonstrate that the principles have been met.

9.1.3 A recalculation of Profit Margins at the reporting date may be carried out as follows:

a) derive the value of expected future profits at the reporting date as:

	Best Estimate Liability (on Basis 1)
plus	**Value of expected future profits (on Basis 1)**
less	**Best Estimate Liability (on Basis 2);**

and

b) recalculate the Profit Margins as:

Value of expected future profits (from (a))
divided by
Value of the Profit Carrier(s) (on Basis 2).

Where

Basis 1 uses the Best Estimate Assumptions and Profit Margins at the previous reporting date, except for the discount rate and related economic assumptions - see paragraph 9.2; and

Basis 2 uses the Best Estimate Assumptions at the current reporting date.

9.2 Discount Rate

9.2.1 The discount rate (and related economic assumptions) used for calculations on Basis 1 is determined as that used at the previous reporting date adjusted only to the extent that there have been changes in market conditions.

9.2.2 A consistent approach is to be used in respect of economic assumptions related to the discount rate; for example, the investment earnings and inflation assumptions.

9.3 Recalculation of Acquisition Expense Recovery Components

9.3.1 Where Acquisition Expense Recovery Components are determined at Commencement the principles of section 3 require a recalculation of those components at each subsequent reporting date to ensure that future expected profits are neither released prematurely nor deferred inappropriately.

9.3.2 The methodology detailed below produces results in accordance with the principles of section 3. Other methods may be appropriate where the Actuary can demonstrate that the principles have been met.

9.3.3 A recalculation of Acquisition Expense Recovery Components at the reporting date may be carried out as follows:

a) derive the value of the expected future acquisition expense recoveries at the reporting date as:

> **Acquisition Expense Recovery Components**
> ***multiplied by***
> **Value of Acquisition Expense Recovery Carrier(s)**
> **(on Basis 1);**

and

b) recalculate the Acquisition Expense Recovery Components as:

> **Value of the expected future acquisition expense recoveries (from (a))**
> ***divided by***
> **Value of Acquisition Expense Recovery Carrier(s)**
> **(on Basis 2).**

Where

Basis 1 uses the Best Estimate Assumptions at the previous reporting date, except for the discount rate and related economic assumptions - see paragraph 9.2; and

Basis 2 uses the Best Estimate Assumptions at the current reporting date.

SECTION 10 Reporting Date Recalculations - Benefits Providing a Discretionary Entitlement to Share in the Investment Experience of Assets Backing them.

Overview

The recalculation methodology described in this section establishes how the Policy Liability changes and, hence, how profit emerges over the period for discretionary business. The objective of the methodology is to determine Operating Profit in accordance with the framework of the Act.

For a Participating Benefit (including a friendly society benefit under a benefit fund where there is a provision for distribution of unallocated surpluses to policy owners), two important aspects of this framework are;

1. 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 (or unallocated surplus in the case of friendly societies) and shareholders retained profits.

2. Operating Profit includes shareholder profit and policy owner profit. It comprises:

   - 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
   - non-investment Experience Profit.

For Non-Participating Benefits which have an entitlement to discretionary additions, the approaches described in this section may

be applied for recalculating Discretionary Additions and Profit Margins. The section is to be interpreted by substituting “discretionary addition” for “bonus”. It must be recognised that the “discretionary addition” is not a “bonus”, and consequently the cost of any “discretionary addition” in the current period forms part of the Policy Liability at the reporting date, while the cost of any “bonus” in the current period is an allocation and distribution of current period operating profit and does not form part of the Policy Liability at the reporting date.

It is noted that for Participating Benefits (but not Non-Participating Benefits which have an entitlement to discretionary additions), 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. In these specific circumstances, this result is considered appropriate and in compliance with the intent of the principles of section 3.

10.1 Recalculation of Profit Margins

10.1.1 Where Profit Margins are determined at Commencement, the principles of section 3 require a recalculation of those Profit Margins at each subsequent reporting date to ensure that future expected profits are neither released prematurely nor deferred inappropriately.

10.1.2 The methodology detailed below is deemed to produce results in accordance with the principles of section 3. Other methods may be appropriate where the Actuary can demonstrate that the principles have been met.

10.1.3 A recalculation of Profit Margins at the reporting date may be carried out as follows:

a) derive the value of expected future policy owner and shareholder profits at the reporting date as:

	Value of Supporting Assets
less	**Best Estimate Liability (on Basis 2)**
less	**Value of current period Bonuses and Shareholder Profits (on Basis 2);**

and

b) recalculate the Profit Margins as:

	Value of expected future profits (from (a))
less	**Value of future Best Estimate Bonuses (on Basis 2*)***
	divided by
	Value of the Profit Carrier(s) (on Basis 2).

Where

Value of Supporting Assets is calculated according to paragraph 10.2;

Basis 2 uses the Best Estimate Assumptions at the current reporting date;

Value of current period Bonuses is determined as the cost of Bonus according to paragraph 10.3; and

The relationship between Bonuses and Shareholder Profits must be in accordance with paragraph 4.1.3.

10.2 Value of Supporting Assets

10.2.1 The Value of Supporting Assets is determined as:

a) the Policy Liability at the end of the previous reporting period; plus

b) the cost of declared Bonuses at the end of the previous period; plus

c) the actual policy related cash flows and investment experience as reported in the regulatory financial statements; less

d) the expected Shareholder Profits emerging over the period and the non-investment Experience Profit.

10.2.2 The Value of Supporting Assets must be calculated so as to attribute no value of assets to terminated benefits.

10.3 Cost of Bonus

10.3.1 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.

10.3.2 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 Actuary, in determining the cost of Bonus, must allow an appropriate value for that unvested Bonus.

10.3.3 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.

SECTION 11 Loss Recognition

Overview

Where at a reporting date the value of future profits for a Related Product Group falls below the Adequacy Threshold for that Related Product Group, 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 in accordance with the principles of section 3 and is achieved by setting the relevant Profit Margins to an amount such that the value of future profits is equal to the Adequacy Threshold at the reporting date. This process is carried out for each Related Product Group.

A record of cumulative losses is kept for each Related Product Group. Before a Related Product Group 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 Related Product Group it will return to a position of adequate future profits.

11.1 A record of the cumulative amount of losses recognised in accordance with the principles of section 3 must be maintained for each Related Product Group.

11.2 Cumulative losses may be run-off in accordance with the run-off of the business of the relevant Related Product Group.

11.3 If at a reporting date it is established, in respect of a Related Product Group 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 then

b) to the extent available, in producing Profit Margins in excess of the Adequacy Threshold.

11.4 There must be no release of profit as a consequence of the combining of Related Product Groups. Where there is grouping of previously separate Related Product Groups, the Policy Liability of the combined Related Product Group must equal the sum of the Policy Liability of the two separate groups immediately prior to the grouping. Cumulative losses that previously existed in respect

of the separate groups must be extinguished, except in the case where cumulative losses existed for both separate Related Product Groups.

11.5 **The Adequacy Threshold for the Value of Future Best Estimate Bonuses and Shareholder Profits under Related Product Groups in respect of benefits that are contractually linked to the performance of the assets held (i.e. where a risk free discount rate is not used to discount future expected cash flows) is equal to the difference between:**

a) the Best Estimate Liability on Basis 2 (either in accordance with paragraph 9.1.3 or paragraph 10.1.3, whichever is applicable), but using a risk free discount rate (or rates) based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows; and

b) the Best Estimate Liability on Basis 2.

11.6 **For all other Related Product Groups the Adequacy Threshold is zero.**

SECTION 12 Reinsurance

12.1 **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 Profit Margins. For the purpose of this standard, inwards reinsurance is to be treated the same as direct insurance business.**

12.2 **The principles of this standard apply to both the calculation of the gross Policy Liability and the Reinsured Policy Liability. In particular, 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 Profit Margins. However, where losses are expected, these are to be recognised, except as allowed under paragraph 12.5.**

12.3 **If the reinsurance relates directly and solely to the direct insurance business of a single Related Product Group then the reinsurance may be included within that same Related Product Group for the purposes of Section 11 of this standard. If the reinsurance does not relate directly and solely to the direct insurance business of a single Related Product Group then the reinsurance must be**

appropriately allocated to Related Product Groups for the purposes of Section 11 of this Standard. 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 Related Product Groups.

12.4 In undertaking the allocation described in paragraph 12.3 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;

while retaining the integrity of the principles of section 3 of this Standard.

12.5 As a result of the allocation of reinsurance business to Related Product Groups, 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 Profit Margins in respect of the reinsurance must continue to be determined separately from the Profit Margins in relation to the associated direct insurance business.

PART D – GENERAL REQUIREMENTS FOR ALL FORMS OF POLICY AND ACTUARY'S STATEMENT

SECTION 13 Allocation of Expenses

Overview

Allocation of the expenses of the company is integral to the principles of this standard for the determination of the emergence of profit. The methodologies of this standard require the expenses of the company to be allocated both into the expense categories (e.g. acquisition, maintenance and investment management) and into related product groups covering both Life Insurance Contracts and Life Investment Contracts.

For those expenses not able to be directly allocated, a process of apportionment between the expense categories and between product groups is necessary. This section provides a set of principles within which the allocation is undertaken, and against which the mechanics of the apportionment process are assessed. It is not the objective of this section to be prescriptive either in terms of the mechanics of the apportionment process or in the specifics of the allocation of particular types of expenses.

It is acknowledged that the allocation of certain expenses to expense categories or particular products 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.

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 in undertaking the allocation for the purposes of this standard.

The principles described in this section are equally applicable to the circumstances of allocation of the actual expenses and the expected expenses of the company.

In respect of Life Investment Contracts, Acquisition Expenses will need to be further split between those that may be deferred in accordance with relevant accounting standards, and those that are to be

treated as overheads. However, for the purposes of the Solvency Standard, the Capital Adequacy Standard and the Management Capital Standard, Acquisition Expenses in respect of Life Investment Contracts as determined by this expense allocation are to include acquisition overheads.

13.1 Expenses for each Related Product Group are to be allocated to the following Expense Categories:

a) Acquisition Expenses;
b) Maintenance Expenses;
c) Investment Expenses; and
d) One-Off Expenses.

13.2 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 (including acquisition overheads in respect of Life Investment Contracts) other than one-off expenses determined in accordance with paragraph 13.10. Total expenses for this purpose are total operating expenses as disclosed in the financial statements.

13.3 Each Related Product Group must include all relevant expenses whether direct or indirect and in aggregate the Related Product Groups must include the total expenses of the company. It is considered appropriate for this purpose to treat the shareholders' retained profits and capital as if it were a notional Related Product Group.

13.4 To the extent that an expense is directly attributable to a particular Expense Category or a particular Related Product Group, it must be so allocated.

13.5 It is recognised that there are circumstances where arrangements (internal or external) provide for the limitation of the expenses borne by a particular product group. Such arrangements, to the extent substantiated as bona fide by the Actuary, may be reflected in the final allocation of expenses provided transparency of the allocation process is retained.

13.6 An expense which is not directly attributable to a particular Expense Category or Related Product Group must be appropriately allocated. That allocation must reflect:

a) the Functional Activities to which the expense relates; and
b) an appropriate relationship between those Functional Activities and both the Expense Categories and the Related Product Groups.

13.7 In undertaking the allocation described in paragraph 13.6 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 company;

while retaining the integrity of the principles of section 3 of this Standard.

Apportionment Process

13.8 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.

13.9 Service Agreements

13.9.1 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 of this section. Where the service company fees are unreasonable as a basis for the allocation, the Actuary must determine an alternative allocation applying the principles of this section on a 'look through' basis.

13.9.2 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.

13.10 One-Off Expenses

13.10.1 It is appropriate, in the context of expense allocation undertaken for the purposes of this Standard, to recognise one-off expenses. To achieve such recognition an expense must be, of itself:

a) material in accordance with the provisions of section 14; and

b) not incurred as part of the normal ongoing operations of the company; and

c) not regularly recurring in nature.

13.10.2 One-off expenses, while allocated to Expense Categories for financial reporting purposes, need not be explicitly allocated (to Expense Categories or Related Product Groups) for the purposes of this Standard.

13.11 Friendly Societies

13.11.1 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.

13.11.2 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.

13.11.3 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 13.1, the provisions under paragraph 13.9 in relation to Service Agreements are applicable.

13.11.4 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% of the total expenses related to the life insurance business.

SECTION 14 Materiality

Overview

Particular values or components are considered material to the overall result of a calculation when their mis-statement or omission would cause that result to be misleading to the users of the information.

Materiality tests assess the significance of the particular value/component by relating it to the amount of the overall result to which it contributes.

14.1 The Policy Liability determined in accordance with this standard is subject to materiality standards applied at a statutory fund level.

14.2 The base amount for materiality purposes is:
a) in respect of components of the profit and loss statement, the operating profit; and
b) in respect of components of the regulatory balance sheet, the difference between the assets of the statutory fund and the sum of the Policy Liabilities and Other Liabilities of that fund.

14.3 While materiality must be applied at the statutory fund level, so that appropriate values are placed on the policy liabilities of each fund, the materiality of the statutory fund relative to the size of the company overall may be taken into account.

14.4 While assessing materiality will always be a matter of professional judgement, the following quantitative thresholds are generally to be used:
a) variations in amounts of 10% or more of the base amount may be presumed material; and
b) variations in amounts of 5% or less of the base amount may be presumed immaterial.

SECTION 15 Initial Calculation of Policy Liability

Overview

When Policy Liabilities are first calculated in accordance with the latest version of this Standard, the calculation of Profit Margins and/or Acquisition Expense Recovery Components for in force business should have regard to the history of that business. Best Estimate Bonuses should be determined consistently.

Alternative approaches may be appropriate, and the choice of approach will be a matter for professional actuarial judgement. In making that judgement consideration should be given to :

- the available data; and
- the type of benefit; and
- the duration the business has been in force; and
- materiality.

15.1 In first applying the latest version of this Standard to in force Related Product Groups, the Actuary must seek to determine a reasonable estimate of the position, at the beginning of the reporting period, that would have existed had the latest version of this Standard been applied since Commencement.

15.2 Where the valuation of policy liabilities in respect of Life Insurance Contracts, and reporting of profit, has previously been undertaken on a basis consistent with the principles of a then current version of the Valuation Standard it may be appropriate that those previous calculations be acknowledged as satisfying the principles of this section, provided that:

a) **the Value of Future Best Estimate Bonuses and Shareholder Profits that would be determined under this standard exceeds the Adequacy Threshold; and**
b) **the result is not considered to be materially different from that which would arise under a strict application of paragraph 15.1.**

SECTION 16 Statement Relating to the Valuation

Overview

In order to provide transparency of the company's financial statements, it is required that full disclosure be made by the Actuary in respect of the processes employed in accordance with this Standard.

Regard must be had for the disclosure requirements prescribed in the standards of the Australian Accounting Standard Board that are relevant to life insurance business (in particular AASB 1038) and the relevant requirements of APRA through Prudential Rules under the Life Act.

Financial Statements

16.1 At each reporting date the Actuary must provide for inclusion in the regulatory financial statements a summary of the significant elements of the calculation processes and significant assumptions used in deriving the results.

Financial Condition Report

16.2 As at each reporting date the Actuary must provide in the investigation report required by section 113 or 115 of the Act, details of the calculation processes and the assumptions used in deriving the results.