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Actuarial Standard 5.02

COST OF INVESTMENT PERFORMANCE GUARANTEES

Actuarial Standards Board

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INTRODUCTION The Standard

The actuarial standard for the calculation of the cost of investment performance guarantees is established under section 42 of the Life Insurance Act 1995 (the Act).

The Act requires the segregation of business which consists of the provision of Australian investment-linked benefits from the other (non investment-linked) life business of the company. This is achieved through the establishment of a separate statutory fund, and is a recognition of the essentially different nature and risk profile of the two types of business.

Further, the Act provides that the principal objective of an investment-linked contract is the provision of benefits calculated by reference to units the value of which is related to the market value of specified assets.

Within the parameters of this ‘definition’, therefore, it is possible to structure an investment-linked contract that offers guarantees in respect of the investment performance of those underlying assets.

While, in practice, the guarantees provided on investment-linked benefits have generally been insignificant relative to the overall liability, this need not necessarily continue to be the case.

In order that the nature of an investment-linked contract and the requirement to segregate such business are not undermined, the Act requires the identification of, and quantification of the cost of, investment performance guarantees. The extent to which such guarantees can be provided within an investment-linked statutory fund is then subject to prescribed limits within section 42 of the Act.

This actuarial standard, therefore, has a single purpose. It prescribes the principles and methodology for calculating the cost of investment performance guarantees provided in association with investment-linked contracts for the purpose of section 42.

Application to Friendly Societies

The Act was amended in 1999 to extend its application to friendly societies that undertake life insurance business. This standard is applicable to all life companies (registered under the Act) including friendly societies.

Application of the Investment Performance Guarantee Standard.

The Investment Performance Guarantee Standard is made for the purposes of section 42 of the Life Insurance Act 1995.

It applies:

a) in respect of a statutory fund, the business of which:

   (i) consists of the provision of investment-linked benefits and

   (ii) includes provision of Investment Performance Guarantees

b) at all times on and after 30 June 2002.

PART A – PRINCIPLES

SECTION 1 The Cost of Investment Performance Guarantees

Overview

The Act limits the extent to which investment performance guarantees may be provided in an investment-linked fund (a statutory fund which provides investment-linked benefits) by reference to the cost of those guarantees expressed as a proportion of the total policy liabilities of the fund.

This standard is restricted to determining the cost of the investment performance guarantees for this specific purpose.

1.1 The cost of the Investment Performance Guarantee, at a particular time, is determined as the sum of the cost of:

a) providing the guarantee benefit, on a best estimate basis; and
b) providing an amount of capital considered sufficient to secure the provision of that benefit, into the future, under a scenario of adverse experience.

1.2 In calculating the cost of the Investment Performance Guarantee the Actuary must take account of the mix of the assets of the statutory fund supporting the policy liabilities subject to guarantees. In this regard, reference should be made to the principles of paragraph 5.2 of the Capital Adequacy Standard, and their application in the determination of the Resilience Reserve for the purposes of that standard.

1.3 The cost of the Investment Performance Guarantee should be calculated making proper allowance for Reinsurance. In this regard, reference should be made to the principles of paragraph 3.3.1 of the Capital Adequacy Standard.

1.4 The cost of the Investment Performance Guarantee is not affected by the quantum of capital of the statutory

fund. In particular, the injection of capital into the statutory fund does not reduce the cost of the guarantee.

SECTION 2 Compliance with Section 42 of the Act

2.1 Compliance with section 42 of the Act will be secured where, using the prescribed methodology in Part B of the Standard, the Actuary can demonstrate that the cost of the Investment Performance Guarantee represents less than 5% of the total Policy Liabilities at that date.

PART B – METHODOLOGY

SECTION 3 The Calculation of the Cost

Overview

The variety of guarantees currently provided in the market is understood to be fairly limited. The types of guarantees which exist include:

- guarantee that the unit price will not decline;
- guarantee of a return of a stated proportion of premium invested;
- guarantee of a return expressed in terms of the performance of a market index; and
- guarantees as at a future specified point in time (including guarantees on death or maturity).

While it is not appropriate to attempt to anticipate innovation in the market, it is equally inappropriate to prescribe provisions so inflexible as to inhibit such innovation.

Accordingly, a pragmatic and practical methodology for the determination of the cost of investment performance guarantees has been prescribed. The prescribed method uses a deterministic approach which is a simple substitute for a more technical stochastic approach. It adopts as its framework the resilience reserve requirements already existing in the Capital Adequacy Standard. (It is noted that the resilience reserve requirement itself uses formulae derived from an underlying stochastic approach). This method is considered appropriate for the purposes of this Standard, and in accordance with the intent of section 42 of the Act.

3.1 The cost of the Investment Performance Guarantee of a statutory fund is taken as:

50% of X

where:

X is the amount that would need to be held in respect of the policy liabilities subject to those guarantees to

ensure that the company could continue to meet the liabilities after the happening of a prescribed set of changes in the economic environment.

3.2 For the purposes of this Standard, hypothecation of the assets of the statutory fund (or subcategory where assets are already hypothecated to this level) to the policy liabilities subject to Investment Performance Guarantee is considered appropriate.

3.3 The prescribed changes to the economic environment are those applicable to the determination of the Resilience Reserve for the purposes of the Capital Adequacy Standard. (Refer to Section 11 of the Capital Adequacy Standard for more detail.)

3.4 The expression 'policy liabilities subject to guarantees', as it is used in paragraphs 3.1 and 3.2 should, for these purposes, be taken to mean the policy liabilities which would have been applied if the Investment Performance Guarantee did not exist.