30 MARCH 2006

Actuarial Standard 7.02

GENERAL STANDARD

Life Insurance
Actuarial Standards Board

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CURRENT ACTUARIAL STANDARDS

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AS6.03 Management Capital Standard

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1. INTRODUCTION TO THE ACTUARIAL STANDARDS

The Life Insurance Act 1995 (the Life Act) introduced a new financial reporting regime for life insurance companies which reflected principles of realistic valuation, appropriate capital support for risks and transparency of disclosure. An integral component of this new regime was the establishment of the Life Insurance Actuarial Standards Board (LIASB) with its responsibility to make actuarial standards.

The Life Act makes provision for 6 actuarial standards, in respect of:

- the valuation of policy liabilities
- the determination of solvency requirements
- the determination of capital adequacy requirements
- the determination of capital requirements for the management fund or shareholders' fund
- the calculation of minimum surrender values and paid up values
- the valuation of performance guarantees in investment linked funds.

The most significant of these standards in terms of the financial management of the life insurance business, are the valuation and capital standards. These standards are discussed in relatively greater detail below. (The two remaining standards serve an important purpose in protecting policy owner interests and securing equity between different groups of policy owners).

<u>The Valuation Standard</u>

Important in the development and subsequent amendment of the actuarial standards were considerations of:

- methodologies for determining the policy liabilities of a life insurance 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, Capital Adequacy Standard and Management Capital Standard.

The objectives of the Life Act in this regard provided the basis of the philosophy underlying the Valuation Standard.

In the special circumstances of participating business, a realistic valuation approach continues to apply. The integration of the Valuation Standard with the Life Act requirements for profit allocation and distribution are critical to achieving the objectives of priority of policy owner interest, equity amongst generations of policy owners and transparent disclosure of the operations of this business to facilitate policy owner and shareholder understanding.

Implications for 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 has not been extended with effect for reporting periods commencing on or after 1 January 2005. It is therefore appropriate that regulatory financial reporting requirements be similarly aligned for reporting periods commencing on or after 1 January 2005, and that Actuarial Standard 1.04 also applies to Friendly Societies from this date.

Capital Standards for the Statutory Funds

The Life Act establishes a two tier capital requirement on the statutory funds of the life insurance company with each tier considering the capital requirements in a different set of circumstances. The first tier – the Solvency Standard - is intended to ensure, as far as possible, the payment of the liabilities of the company. The second tier – The Capital Adequacy Standard - is intended to secure the financial soundness of the company as a going concern.

Just as there are two tiers of capital requirement, the LIASB in developing these standards proposed two philosophies - discrete and independent; one for each of the standards. The result is that the Capital Adequacy Standard is not necessarily a stronger Solvency

Standard; or more importantly, the Solvency Standard is not necessarily a weaker Capital Adequacy Standard. Each capital requirement stands on its own, serves different purposes and brings its own consequences. This is consistent with the intentions and provisions of the Life Act.

The essential features of the philosophy of the Solvency Standard are as follows:

The Solvency Standard

- considers capital needs in the context of an extended **run off** situation either under judicial management or following transfer of the business to another insurer, at a high level of confidence
- assumes the statutory fund is **closed to new business**
- aims to meet **obligations** to policy owners (and creditors) while the fund withstands **shocks** (adverse experience).

For Capital Adequacy, the essential features are:

The Capital Adequacy Standard

- considers capital needs in the context of an active and viable **ongoing concern**
- assumes the statutory fund **is open to new business**
- aims to meet **reasonable expectations** of policy owners (and creditors) while the fund withstands **larger shocks** (significant adverse experience).

The LIASB acknowledges that, as a consequence of these philosophies, it is possible that in certain circumstances no additional capital is required for capital adequacy purposes over the Solvency Requirement. The circumstances in which this may arise (for example, a slowly growing fund or a declining fund) do not suggest any inconsistency with the underlying philosophies.

The Solvency Requirement is disclosed in the financial statements of the life insurance company and is intended to be used as an indicator of the financial position of the company. To provide certainty of interpretation and facilitate consistency and comparability across the industry, the standard adopts a primarily prescriptive approach to the determination of the Solvency Requirement.

The Capital Adequacy Requirement is not required to be disclosed in the financial statements of the company. It will, however, be disclosed to APRA (on a confidential basis) and will be used as an important indicator of the longer term financial position of the company, and a trigger for closer regulatory monitoring in respect of short term solvency. The Capital Adequacy Standard adopts a less prescriptive

approach to the determination of the Capital Adequacy Requirement in recognition of the differing business strategies of the companies. Reliance is placed on the professionalism of the Actuary for appropriate assessment of the Capital Adequacy Requirement of a company in accordance with the principles of this Standard.

The policy owner protection objectives of the Life Act are again reinforced through these standards – the distribution of retained profits or shareholder capital of a statutory fund is restricted where the Capital Adequacy Requirement is not met. Distributions to policy owners may continue while ever the company remains solvent.

<u>Capital Standard for the Management Fund/Shareholders' Fund</u>

The Management Capital Standard is established under the Life Act and establishes a requirement to hold capital in the management fund/shareholders' fund to ensure the security of that fund and its business activities under adverse operating circumstances. This capital is additional to the capital requirements for the statutory funds.

The Management Capital Requirement is determined by considering the various risks which could impact the security of the company's operations and, by consequence, policy owner entitlements and requiring the provision of a prudent level of reserve against such risks.

The approach to determining the Management Capital Requirement recognises the separate and distinct nature of a life company's statutory funds in respect of its life insurance business and the extent to which the risks associated with undertaking life insurance business are provided for in the Solvency and Capital Adequacy Standards.

Security of the entitlements of policy owners, however, cannot be considered totally isolated from risks associated with operations outside the statutory funds. In the case of friendly societies, the risks associated with the administration and operational support of the life insurance business are borne outside the statutory funds. Further, a life company may operate businesses (other than life insurance related business) outside its statutory funds. The risks incurred in all respects have implications for the overall security of the company and hence of the policy owners.

<u>Other Actuarial Standards</u>

The Life Act also provides for actuarial standards in respect of the calculation of minimum surrender values and the cost of investment performance guarantees.

The principle of protecting the interests of policy owners and ensuring equity as between groups of policy owners (terminating as against

remaining, those with guaranteed entitlements as against those with market related entitlements) underlies these standards.

The Surrender Value Standard serves an important purpose in the determination of solvency requirements, by providing a floor for the value of the solvency liabilities. The principle which prevails in this case is that the minimum value of the liabilities for solvency purposes (before adding margins for other risks relating to expenses and assets) must be sufficient to secure the minimum entitlement of all policy owners at that time.

2. APPLICATION OF THE STANDARDS TO FRIENDLY SOCIETIES

The Life Act was amended in 1999 to extend its application to friendly societies that undertake life insurance business. In June 1999, the LIASB released a set of actuarial standards relevant to friendly societies. It was acknowledged at the time of release that these standards were transitional, largely reinstating the requirements of the pre-existing Australian Financial Institutions Commission regulatory regime. In 2002 there was a harmonisation of the Friendly Society standards with the life insurance standards. Following the adoption of the International Financial Reporting Standards and the lapse of the ASIC Class Order, there has been further alignment such that the Valuation Standard, AS 1.04, now applies to both life insurance companies and friendly societies.

Harmonisation of Actuarial Standards

In developing a set of actuarial standards to apply commonly to friendly societies and life companies, regard must be had for the differences that exist between the two sectors of the industry.

Terminology

At the simplest level, there are differences of terminology used within the industry sectors – for instance, benefit fund in a friendly society and statutory fund in other life companies. The actuarial standards adopt the same approach to terminology as taken in the Life Act. The following table provides linkages between the terminology adopted in the Life Act and actuarial standards, and that commonly used in practice by friendly societies.

Life Act Concept	**Friendly Society Concept**
Statutory fund	Benefit fund
Life company, company	Friendly society
Best estimate liability	Value of benefit entitlements
Policy owner	Benefit fund member
Policy document	Benefit fund rules
Life policy, life insurance policy	Interest in a benefit fund
Shareholders’ fund	Management fund

Structure of a Friendly Society

One of the more significant differences is in the structure of the friendly society (compared to other life companies).

Benefit Funds
The friendly society segregates its business through benefit funds, where those benefit funds are single product funds. As a consequence, requirements (in the Life Act and actuarial standards) for the segregation of the business of a statutory fund into classes, categories and/or related product groups are not relevant to a friendly society. The benefit fund of a friendly society is effectively a related product group.

Following the lapse 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.

Management Fund
Friendly societies also operate a management fund. This fund is distinct and separate from the benefit funds, and undertakes operational and administrative functions in respect of the life insurance business of those funds (as well as other business activities) for which the benefit funds pay a management fee.

As a result of this operational structure, certain of the risks associated with the life insurance business – in particular, expense risks - are borne by the management fund in the friendly society.

Therefore, in applying the provisions of the actuarial standards to a friendly society, reference to expenses of the statutory fund, whether actual or expected, should be taken to mean the contracted management fees in respect of the business of that fund.

Expense risks related to the life business of a friendly society are provided for in the management fund through the Management Capital Standard. The same risks for other life companies will be provided for in their statutory funds through the Solvency and Capital Adequacy Standards.

3. HOW TO USE THE ACTUARIAL STANDARDS

The actuarial standards are made by the LIASB under prescribed powers in the Life Act. In developing the standards the LIASB follow a defined due process for exposure to, and consultation with, the industry and other stakeholders.

The standards are disallowable instruments and will have been through the parliamentary processes, with notice of the making of the standards being published in the Commonwealth Government Notices Gazette.

The legislative requirements prescribed in the actuarial Standard are shown in bold type.

Most sections of the standard are preceded by an overview - shown in normal print - intended as a plain English introduction to the principles which are developed in greater detail in the relevant section. The overview facility can be used as an aid to interpretation, and to the intent of the Standard.

Newsletters, released periodically, provide background to, and an insight to the considerations of the LIASB in, the development of the standards. The most recent changes to the Standards have also been accompanied by an Explanatory Memorandum at the Discussion Draft, Exposure Draft and final issue stages.

Defined terms are Capitalised in the standards, and the definitions of those terms can be found in the consolidated dictionary at section 5 of this General Standard.

<u>Change in Style</u>

The style of the actuarial standards was modified as part of the process for harmonisation of actuarial standards (March 2002 version of standards).

Pre March 2002 versions of the standards incorporated a significant amount of commentary to guide in the interpretation of the principles. Further, a please note facility was used as a means of emphasising special messages to the practitioner readers.

The benefit of this commentary is available, if required by the practitioner, by accessing these earlier versions of the standards.

It is also noted that the Institute of Actuaries of Australia (IAAust) has issued guidance material on the interpretation and/or practical application of certain aspects of the LIASB's actuarial standards.

4. HISTORY OF THE DEVELOPMENT OF THE ACTUARIAL STANDARDS

9 October 1996	The Valuation Standard version AS1.01 was made.
15 November 1996	The following actuarial standards were made: - The Solvency Standard version AS2.01 - The Capital Adequacy Standard version AS3.01
13 October 1997	The following actuarial standards were made: - The Surrender Value Standard version AS4.01 - The Investment Performance Guarantee Standard version AS5.01
24 June 1999	An Instrument of Variation was made, varying the following actuarial standards to apply only to life companies that are not friendly societies: - The Valuation Standard version AS1.01 - The Solvency Standard version AS2.01 - The Capital Adequacy Standard version AS3.01. - The Surrender Value Standard version AS4.01 - The Investment Performance Guarantee Standard version AS5.01 **AND** The following actuarial standards were made: - The Friendly Society Valuation Standard version ASFS1.01 - The Friendly Society Solvency Standard version ASFS2.01 - The Friendly Society Capital Adequacy Standard version ASFS3.01 - The Friendly Society Investment Performance Guarantee Standard version ASFS5.01 - The Friendly Society Management Capital Standard version ASFS6.01 - The Management Capital Standard version AS6.01

20 September 1999	An Instrument of Variation was made to prescribe a completion date for the following actuarial standards: - The Valuation Standard version AS1.01 - The Solvency Standard version AS2.01 - The Capital Adequacy Standard version AS3.01 **AND** The following actuarial standards were made: - The Valuation Standard version AS1.02 - The Solvency Standard version AS2.02 - The Capital Adequacy Standard version AS3.02
28 March 2002	An Instrument of Variation was made to prescribe a completion date for the following actuarial standards: - The Valuation Standard version AS1.02 - The Solvency Standard version AS2.02 - The Capital Adequacy Standard version AS3.02 - The Surrender Value Standard version AS4.01 - The Investment Performance Guarantee Standard version AS5.01 - The Management Capital Standard version AS6.01 - The Friendly Society Valuation Standard version ASFS1.01 - The Friendly Society Solvency Standard version ASFS2.01 - The Friendly Society Capital Adequacy Standard version ASFS3.01 - The Friendly Society Investment Performance Guarantee Standard version ASFS5.01 - The Friendly Society Management Capital Standard version ASFS6.01 **AND** The following actuarial standards were made: - The Valuation Standard version AS1.03 - The Friendly Society Valuation Standard version ASFS1.02 - The Solvency Standard version AS2.03 - The Capital Adequacy Standard version AS3.03 - The Management Capital Standard version AS6.02 - The Surrender Value Standard version AS4.02 - The Investment Performance Guarantee Standard version AS5.02 - The General Standard version AS7.01

5 December 2005	An Instrument of Revocation was made to revoke the following actuarial standards and to determine the completion date from which the requirements under those actuarial standards would cease to apply:

- The Valuation Standard version AS1.03
- The Friendly Society Valuation Standard version ASFS1.02
- The Solvency Standard version AS 2.03
- The Capital Adequacy Standard version AS3.03
- The Management Capital Standard version AS6.03
- The General Standard version AS7.01

The following actuarial standards were made:

- The Valuation Standard version AS1.04
- The Solvency Standard version AS 2.04
- The Capital Adequacy Standard version AS3.04
- The Management Capital Standard version AS6.03
- The General Standard version AS7.02

5. DICTIONARY

5.1 Application

The Dictionary is made under section 101(2) of the Life Insurance Act 1995 and is applicable to the interpretation of all actuarial standards made under that section.

It applies at all times from 31 December 2005.

Terminology used in the actuarial standards, to the extent it is not specifically defined in the Dictionary, takes the same meaning as that in the Life Insurance Act 1995.

5.2 Definitions

AASB: Australian Accounting Standard Board

Acquisition Expenses: The fixed and variable expenses of the company to the extent they are, either directly or indirectly, referable to those activities of the company related to the acquiring of that new business expected to derive from the expenditure.

Acquisition Expense Recovery Carrier: A financially measurable indicator of the element of a Related Product Group designed or intended to recover Acquisition Expenses.

Acquisition Expense Recovery Component: A uniform margin of an Acquisition Expense Recovery Carrier, determined in accordance with section 6 of the Valuation Standard.

Actuarial Gains and Losses: For the purposes of recognising the value of obligations arising in respect of a defined benefit superannuation fund in the accounts of the employer sponsor, actuarial gains and losses comprise

- **experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and**
- **the effects of changes in actuarial assumptions.**

Actuary: An appointed actuary as defined under the Act.

Adequacy Threshold: The Adequacy Threshold is the minimum value for Profit Margins of a Related Product Group under the Valuation Standard - i.e. it is the level at which losses must be recognised. The Adequacy Threshold is to be determined in accordance with Section 11 of the Valuation Standard.

Admissible Assets: The total assets of the statutory fund or Fund as appropriate excluding those assets, or the parts of those assets, prescribed as inadmissible for the purposes of the Solvency, Capital Adequacy or Management Capital Standard.

Approved Country: An overseas country having capital requirements in respect of life insurance business comparable to those in the Act. The business of such countries, when written in a separate statutory fund, is excluded from the capital requirements of the Act.
The Approved Countries are UK, USA, Canada.

Approved Subordinated Debt: The quantum of debt under an instrument of subordinated debt that, in accordance with approval processes of the Australian Prudential Regulation Authority, can be used in meeting the capital requirements of a statutory fund.

Best Estimate Assumptions: Assumptions about future experience determined in accordance with section 3 of the Valuation Standard.

Best Estimate Liability: The amount expected on Best Estimate Assumptions to be required to the end of the benefit period to meet future benefits and expenses related to past transactions for the business in force. The calculation process will take into account all factors which are known to be material, including future investment earnings, taxation, any options under the policies and future premiums, where relevant to the calculation.

Best Estimate Bonus: The maximum level of Bonus which (on Best Estimate Assumptions and taking into account the company's profit distribution philosophy, including shareholder entitlements) can be added to a Participating Benefit over its benefit life without supplementary income from other sources, including policy owner retained profits.

Best Estimate Discretionary Addition: The level of discretionary addition which (on Best Estimate Assumptions and taking into account the company's crediting philosophy) can be added to a Non-Participating Benefit over its benefit life without supplementary income from other sources, including policy owner retained profits.

Best Estimate Shareholder Profit: The maximum level of Shareholder Profit which (on Best Estimate Assumptions and taking into account the company's profit distribution philosophy, including policy owner entitlements) can be attributed to

shareholders without supplementary income from other sources, including shareholders' retained profits.

Bonus: An amount of profit added at the discretion of the company (including additions in respect of investment experience) to the benefits due under a Participating Benefit, but excluding any guaranteed rate of addition also applicable to the benefit.

Capital Adequacy Assumptions: Assumptions about future experience made in the context of the more adverse experience prescribed for the purposes of capital adequacy.

Capital Adequacy Liability: An intermediate component in the determination of the Capital Adequacy Requirement, which reflects the assessed liabilities in respect of policies on the basis of Capital Adequacy Assumptions.

Capital Adequacy Requirement: The capital requirement calculated in accordance with the Capital Adequacy Standard, as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 70 of the Act.

Capital Adequacy Standard: An actuarial standard for the capital adequacy of a statutory fund as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 70 of the Act.

Claims Cost Liability: The Claims Cost Liability for disability income policies is the component of the liability for active lives in respect of claims.

Commencement: The inception of a policy being the point as at which Profit Margins or Acquisition Expense Recovery Components are, or would be, first determined.

Contractual Minimum Value: The lowest Termination Value the company is obliged to pay in accordance with the policy documentation and promotional material.

Counterparty Grade: The Counterparty Grade of an investment is the Grade reflected under the first column of the table in Attachment 1 of this standard for the equivalent Standard and Poor's, Moody's, AM Best or Fitch rated investment.

Current Termination Value: The Termination Value of a policy at the reporting date.

Date of Commencement: A date used in the determination of minimum surrender values in the Surrender Value Standard. Refer to paragraph 4.2.4 of that standard.

Discretionary Addition: An amount added to a Non-Participating Benefit, at the discretion of the company, to reflect the investment experience of the assets backing the benefit, but excluding any guaranteed rate of addition also applicable to the benefit. For this definition an amount added to a benefit is defined to mean any change to the previously applying contractual conditions that is beneficial to the policy owner.

Discretionary Participation Feature: A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:
- that are likely to be a significant portion of the total contractual benefits;
- whose amount or timing is contractually at the discretion of the issuer; and
- that are contractually based on:
  - the performance of a specified pool of contracts or a specified type of contract;
  - realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - the profit or loss of the company, fund or other entity that issues the contract.

Education Bond Business: A form of Unbundled Investment Business where the policies provide for the payment of a defined benefit for the specific purpose of contributing towards the expenses of and incidental to the education of the beneficiary.

Equity: All investments categorised as Equities for the purpose of reporting under Prudential Rules No. 26 plus:
- all listed trusts except those where the Actuary adopts a 'look through' approach; and
- the equity exposure of convertible notes; and
- other investment assets, unless the Actuary can justify including the asset in Property, Interest Bearing Securities or Indexed Bonds.

Establishment Fee: A fee received at the Commencement of a policy which is intended to, at least partially, cover Acquisition Expenses. It does not include contingent entitlement to exit fees or surrender penalties.

Expense Category: A grouping of the expenses directly or indirectly referable to life business. For the purposes of actuarial standards, three categories of expense are defined: Acquisition

Expenses, Maintenance Expenses and Investment Management Expenses.

Expense Driver: A quantifiable measure in relation to which the relevant expenses of the company are expected to vary.

Expense Reserve: A component of the determination of the Solvency Requirement and Management Capital Requirement, which reflects capital requirements arising from expense risks in a closed fund scenario.

Experience Profit: The profit arising in a period from the difference between actual experience during that period and expected experience on the basis of Best Estimate Assumptions at the beginning of the period.

Financial Risk: The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Financial Services Entity: A Financial Services Entity includes:

- **A life company (within the meaning of the Life Insurance Act 1995), general insurer (within the meaning of the Insurance Act 1973), health insurance institution (being a registered organization within the meaning of Part VI of the National Health Act 1953), ADI (within the meaning of the Banking Act 1959), foreign equivalent of any such company, or a Group containing one or more such companies;**
- **A mortgage lender, leasing company or Group containing one or more such companies;**
- **A superannuation trustee or administrative services company administering financial services business for third parties or the Group's own business;**
- **A financial advising distribution company providing financial advice and distributing products of third parties or the Group's own products;**
- **An investment management entity (such as a funds manager, property manager, asset custodian, trustee company, etc) managing the assets of third parties, or those of the Group;**
- **An investment servicing company (such as a property maintenance company, property developer or share registry) providing services to the Group's own investment assets or other third parties.**

Financial Instrument Element: The activities and associated cash flows of a Life Investment Contract that relate directly to the establishment of a financial asset or financial liability.

Fixed Term/Rate Business: Policies which provide for guaranteed investment returns at a disclosed rate for a specified period. The guaranteed returns may be paid in the form of income or as capital at maturity. The specified period of the guarantee may be the full term of the policy, or may be to an interim point at which the option exists to 'roll' the policy for a further specified period at a new guaranteed return.

Functional Activity: A group of activities of a company consistent with the operational structure of the life business. The functional groupings facilitate the processes of expense recording, accounting and apportionment in the company.

Funeral Bond Business: Policies providing continuous insurance against the contingency of death on terms and conditions agreed at the commencement of the policy, where:

a) the primary purpose of the benefit is to meet the expenses of and incidental to the funeral of the policy owner, their spouse or children; and

b) the amount of the benefit (excluding any entitlement to bonus) is no greater than $15,000.

Funeral Bond Business includes any business written prior to 30 June 2002 which is classified as traditional friendly society sick and funeral business and where no surrender value is payable on withdrawal.

General Fund: A term used in the Management Capital Standard to refer to the management fund for a friendly society or the shareholders' fund for other life companies.

Inadmissible Assets Reserve: A component of the determination of the Solvency Requirement, Capital Adequacy Requirement and Management Capital Requirement, which reflects the capital requirements arising from holding assets qualifying as inadmissible under these standards.

Indexed Bonds: All investments categorised as Index Linked Interest Bearing Securities for the purpose of reporting under Prudential Rules No. 26 but excluding listed trusts where the Actuary does not adopt a 'look through' approach.

Insurance Contract: A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a

specified uncertain future event (the insured event) adversely affects the policyholder.

Insurance Risk: Risk, other than financial risk, transferred from the holder of a contract to the issuer.

Interest Bearing Securities: All investments categorised as Non-index linked Interest Bearing Securities for the purpose of reporting under Prudential Rules No. 26, plus loans, convertible notes exposed to interest rates, and cash but excluding listed trusts where the Actuary does not adopt a 'look through' approach.

Investment Management Expenses: The fixed and variable expenses of the company to the extent they are, either directly or indirectly, referable to those activities of the company related to the management of the investment portfolio.

Investment Performance Guarantee: An investment performance guarantee in accordance with section 42 of the Act.

Liability Component: A component of the determination of the Management Capital Requirement.

Life Insurance Contract: An Insurance Contract, or a financial instrument with a Discretionary Participation Feature, regulated under the Life Insurance Act.

Life Investment Contract: A contract which is regulated under the Life Insurance Act 1995 but which does not meet the definition of a Life Insurance Contract.

Long Term Risk Business: Policies providing continuous insurance against the contingency of death, other than solely by accident, on terms and conditions agreed at the commencement of the policy, where:

a) a level premium is paid through the term of the policy; and

b) the term of the policy is:

- **i) greater than or equal to 15 years; and**
- **ii) such that the policy owner is aged greater than 70 at the expiry of that term; and**

c) the amount of insurance (excluding any entitlement to bonus) is greater than $15,000.

Maintenance Expenses: The fixed and variable expenses of the company to the extent they are, either directly or indirectly, referable to those activities of the company related to the administration of:

a) policies subsequent to their sale, including policies subject to claim; and

b) the general operations, including maintenance of the overall health, of the company.

Maintenance Expenses include all operating costs and expenses other than Acquisition Expenses and Investment Management Expenses.

Management Capital Requirement: The capital requirement calculated in accordance with the Management Capital Standard, as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 73B of the Act.

Management Capital Standard: An actuarial standard for the capital of the shareholders' fund as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 73B of the Act.

Management Services Element: All activities and cashflows arising from the full range of management services provided under a Life Investment Contract, including investment management, financial planning and advice. This will equal all the activities and cashflows of the Life Investment Contract excluding those in respect of the Financial Instrument Element.

Minimum Surrender Value: The surrender value determined in accordance with the Surrender Value Standard.

Mid Swap Rate: The Mid Swap Rate is 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.

Minimum Termination Value: The greater of, at the reporting date:
a) the lowest Termination Value that the company is obliged to pay; and
b) the amount calculated in accordance with the Surrender Value Standard.

Minimum Paid-up Value: The paid-up value determined in accordance with the Surrender Value Standard.

National Government Guaranteed Securities: Securities secured by the national government of the country in whose currency the liabilities of the statutory fund are denominated.

Net Policy Liability: The Policy Liability calculated after allowing for outward reinsurance premiums as an expense and reinsurance recoveries as income.

New Business Capital: Capital recognised within the context of the Capital Adequacy Standard or Capital Management Standard as an appropriate offset against the new business capital requirements of the statutory fund or management/shareholders' fund respectively.

New Business Reserve: A component of the determination of the Capital Adequacy Requirement and Management Capital Requirement, which reflects any additional capital requirements arising from future new business.

Non-Participating Benefit: A non-participating benefit in accordance with section 15 of the Act.

Normal Investment Earnings: A component of the determination of minimum surrender values in the Surrender Value Standard. (Refer to section 4.4 of that standard for more detail).

Normal Ongoing Charges: A component of the determination of minimum surrender values in the Surrender Value Standard. (Refer to section 4.3 of that standard for more detail).

OECD Government: In the context of determining credit risk factors, OECD Government refers to assets that are guaranteed by an Australian state or Federal government or by a national government of another OECD country.

Offset Statutory Capital: Statutory Capital to the extent it has actually been utilised in offsetting components of the statutory fund capital requirements – either the Expense Reserve under the Solvency Standard or the New Business Reserve under the Capital Adequacy Standard.

The Offset Statutory Capital of a company should reflect the aggregate of amounts of Statutory Capital so utilised in each statutory fund and in respect of both Expense Reserve and New Business Reserve components. The Offset Statutory Capital of a company, by definition, may not exceed the Statutory Capital of that company.

Operating Profit: Operating profit in accordance with section 58 of the Act.

Operating Surplus: **Operating surplus in accordance with section 58 of the Act as modified by Regulation in its application to friendly societies.**

Other Liability: **A liability according to general accounting concepts, which is referable to the statutory fund, other than a Policy Liability or Approved Subordinated Debt.**

Participating Benefit: **A participating benefit in accordance with section 15 of the Act.**

Policy Liability: **A liability calculated in accordance with the Valuation Standard.**

Policy Owner Profit Share: **The entitlement of the policy owner to share in the profits emerging from the benefits.**

Prescribed Account Value: **A component of the determination of minimum surrender values in the Surrender Value Standard. (Refer to section 4.2 of that standard for more detail).**

Profit Carrier: **A financially measurable indicator of the provision of a service or related income.**

Profit Margin: **A percentage of a Profit Carrier, determined in accordance with the Valuation Standard.**

Property: **All investments categorised as Investment Property for the purpose of reporting under Prudential Rules No. 26 plus owner occupied property, but excluding listed property trusts where the Actuary does not adopt a 'look through' approach.**

Regular Premium Business: **Life business where:**

a) there exists a contractual obligation on the policy owner to make subsequent premium payments after the first premium payment; or

b) the scale or level of charges levied against the policy distinguishes between first and subsequent premiums.

Reinsurance: **Refers to all arrangements where some part of individual or aggregate insurance risks are ceded to another company or companies and include cessions of direct writing companies to reinsurance companies or other direct writing life companies and parent companies as well as retrocessions of Reinsurers to their parent companies or other Reinsurers.**

Reinsured Best Estimate Liability: **The component of the Reinsured Policy Liability, being the Best Estimate Liability in respect of outwards reinsurance business.**

Reinsured Policy Liability: The Policy Liability calculated by considering as premiums only reinsurance premiums and considering as benefits only reinsurance recoveries.

Reinsurer: Any company providing reinsurance cover, whether a parent life company, direct writing company or reinsurance company.

Related Product Group: A grouping of products where those products are considered by the Actuary to exhibit benefit characteristics and pricing structures sufficiently similar as to justify grouping for the purposes of profit margin calculation, loss recognition or reporting. A Related Product Group must not extend over subcategories, where a subcategory is defined in the Act.

Resilience: The ability of a statutory fund to withstand shocks to the economic environment in which it operates and which are likely to cause a sudden reduction in asset values or a requirement to assess liabilities using reduced investment earning rates.

Resilience Reserve: A component of the determination of the Solvency Requirement, Capital Adequacy Requirement and Management Capital Requirement, which reflects the capital requirements that need to be held before the happening of a prescribed set of changes in the economic environment, such that after the changes the company is able to meet the policy owner and other liabilities of the statutory fund, including the assessed liability risks in accordance with these standards.

Retail Business: Life business which is not Wholesale Business.

Risk Business: Life business which does not include any investment component.

Risk Free Discount Rate: The rate (or rates) based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows.

Servicing Expenses: The combination of Maintenance and Investment Management Expenses.

Shareholder Profit Share: The entitlement of the shareholder to share in the profit emerging from the benefits.

Shareholder Profits: An amount of profits attributable to the shareholder.

Single Premium Business: Life business which is not Regular Premium Business.

Solvency Assumptions: Assumptions about future experience made in the context of the more adverse experience prescribed for the purposes of solvency.

Solvency Liability: An intermediate component in the determination of the Solvency Requirement, which reflects the assessed liabilities in respect of policies on the basis of Solvency Assumptions.

Solvency Requirement: The capital requirement calculated in accordance with the Solvency Standard, as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 65 of the Act.

Solvency Standard: An actuarial standard for the solvency of a statutory fund as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 65 of the Act.

Specialist Reinsurer: A registered life company under the Act, the predominant business of which is Reinsurance business.

Statutory Capital: Assets of the General Fund to the extent available to be utilised in offsetting components of the statutory fund capital requirements; either the Expense Reserve under the Solvency Standard or the New Business Reserve under the Capital Adequacy Standard. In determining the availability of assets for this purpose, regard must be had for any implications for capital requirements on the General Fund under prudential standards of the Australian Prudential Regulation Authority.

Surrender Value Standard: An actuarial standard for the minimum surrender value in respect of a policy as prescribed by the Life Insurance Actuarial Standards Board, in accordance with sections 65, 207 and 209 of the Act.

Termination Value: The Termination Value of a policy is either:

a) the amount that would be paid on the basis used in practice from time to time in the event of voluntary termination; or
b) where no amount would be paid, the discounted present value of the unexpired risks, future payments and/or contractual premium refunds.

Traditional Business: Life business containing an investment component but excluding Unbundled Investment Business, Fixed Term/Rate Business and income stream business. Traditional Business includes whole of life and endowment policies. Long

Term Risk Business and Funeral Bond Business is, for the purposes of the Surrender Value Standard, Traditional Business.

Transition End Date: 31 December 2007, or such other date as is agreed to by APRA for the particular life company.

Transitional Materiality Limit: The Transitional Materiality Limit for the purpose of the Solvency Standard and the Capital Adequacy Standard, is the lesser of:

a) 5% of the excess of the Solvency Requirement (determined prior to allowing for any Transitional Adjustment - i.e. after step 6.1(h) in the Solvency Standard) over the sum of:
- **the Minimum Termination Value; and**
- **Other Liabilities;**

where those amounts are the same as applied in the calculation of the Solvency Requirement; and

b) 5% of the excess of the Capital Adequacy Requirement (determined prior to allowing for any Transitional Adjustment - i.e. after step 7.1(h) in the Capital Adequacy Standard) over the sum of:
- **the Minimum Termination Value; and**
- **Other Liabilities;**

where those amounts are the same as applied in the calculation of the Solvency Requirement.

The Transitional Materiality Limit for the purpose of the Management Capital Standard is 5% of the excess of the Management Capital Requirement (determined prior to allowing for any Transitional Adjustment - i.e. after step 6.1(e) in the Management Capital Standard) over the total of the realistic value of liabilities of the General Fund, where the realistic value of liabilities is the same as applied in the calculation of the Liability Component in accordance with the Management Capital Standard.

Unbundled Investment Business: Life business containing an investment component, where that and the other components of service provided under the policy are unbundled (separately disclosed and costed). Unbundled Investment Business includes investment account and investment-linked business (including allocated annuities and deferred annuities during the period of deferment) and Education Bond Business.

Unrecognised Actuarial Gains (losses): That portion of Actuarial Gains and Losses in respect of a defined benefit superannuation fund for which the life insurance company, or an associated entity,

is the employer sponsor, that has not been recognised as income or expense in the company's accounts.

Value of Supporting Assets: The value of assets determined in accordance with the Valuation Standard as being available to support benefits entitled to bonuses or discretionary additions.

Valuation Standard: An actuarial standard for the valuation of policy liabilities as prescribed by the Life Insurance Actuarial Standards Board, in accordance with section 114 of the Act.

Wholesale Business: Superannuation business where the effective purchasing decision is made by a trustee or company except that where the number of members has always been less than 5 it is retail business.

ATTACHMENT 1 – COUNTERPARTY GRADE

The Counterparty Grade for investments that have been publicly rated is determined from the following table:

	Short Term Ratings				Long Term Ratings			
Grade	**Standard & Poor's**	**Moody's**	**AM Best**	**Fitch**	**Standard & Poor's**	**Moody's**	**AM Best**	**Fitch**
1	A1+		AMB-1+	F1+	AAA	Aaa	aaa	AAA
2	A1	P1	AMB-1	F1	AA+ AA AA-	Aa1 Aa2 Aa3	aa+ aa aa-	AA+ AA AA-
3	A2	P2	AMB-2	F2	A+ A A-	A1 A2 A3	a+ a a-	A+ A A-
4	A3	P3	AMB-3	F3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	bbb+ bbb bbb-	BBB+ BBB BBB-
5					BB+ BB BB-	Ba1 Ba2 Ba3	bb+ bb bb-	BB+ BB BB-
6	B	NP Vulnerable	AMB-4	B	B+,B, B-	B	b+, b, b-	B+,B, B-
7	C	NP Currently Vulnerable		C	CCC or below	Below B	Below b	CCC or below

Investments that have not been publicly rated, and cannot be shown by the use of appropriate methods to have equivalent credit risk characteristics to other rated assets, should be treated as follows:

1. **Secured or mortgaged assets:**

A secured or mortgaged asset is an investment with collateral that is either an existing residential property or such other asset for which a substantive valuation has been obtained within the preceding 3 years.

The Counterparty Grade for secured or mortgaged assets is determined from the following table:

Counterparty Grade	Standard Residential Mortgage		Other Secured Asset	
Loan to Value Ratio	No LMI	>40% LMI	No LMI	>40% LMI
<=60%	2	2	3	2
>60% but <=80%	2	2	4	3
>80% but <=90%	3	2	5	4
>90% but <=100%	4	3	5	4
>100%	5	4	5	5

Loan to Value Ratio is the ratio of the value of the asset (i.e. loan) to the market value of the collateral. The market value of the collateral is the value at inception or, where a substantive valuation has subsequently been carried out, this subsequent valuation.

A standard residential mortgage is a mortgage on existing residential property which is marketable, and where the insurer has a documented lending policy and procedures manual specifying:

- **the process for assessing the ability of the borrowers to meet repayment obligations;**
- **verification procedures to substantiate critical application data provided by borrowers;**
- **the criteria used to justify the value of the collateral where a formal valuation is not obtained;**
- **procedures for determining whether a formal valuation, or revaluation, of the collateral is required; and**
- **procedures for assessing the marketability of the collateral.**

LMI refers to lenders mortgage insurance. ">40% LMI" refers to mortgages where insurance cover has been obtained for all realised losses up to at least 40 per cent of the original loan amount. Such insurance must be with an acceptable lenders mortgage insurer, being an insurer that is authorised for that purpose by APRA or domiciled in a country that APRA considers to have comparable prudential regulation of LMIs in accordance

with criteria established for the purpose of ADI regulation under AGN 112.1.

2. Investments that are not secured are to have a Counterparty Grade of 6.

Where investments are held via a trust which has itself been separately rated by a recognised rating agency, that rating may be applied to all the investments in the trust in lieu of the ratings of the individual trust assets provided that the trust is treated as a single investment for asset concentration purposes and is not subject to "look-through". When a look-through approach is adopted the underlying assets need to be individually rated. If the trust is separately rated, that overall trust rating cannot be applied to the individual underlying assets.

Insurers should, in general, use the same rating agency for determining counterparty gradings. Where the insurer has counterparties with multiple ratings from two or more of the rating agencies in the table above, the insurer should consistently choose the ratings of a single agency whenever possible. For example, an insurer may have a number of counterparties that are rated by Standard & Poor's and AM Best. In this case, the insurer should choose a single agency that will be consistently used whenever the individual ratings conflict.

APRA's approval must be sought if an insurer wishes to use the rating determined by a rating agency not included in the table above.