

## Institute of Actuaries of India

### GUIDANCE NOTE (GN) 6: Management of participating life insurance business with reference to distribution of surplus

**Classification: Recommended Practice**

**Compliance:**

Members are reminded that they must always comply with Professional Conduct Standards and that Guidance Notes impose additional requirements under specific circumstances

**Legislation or Authority:**

- a) The Insurance Act 1938 and amendments thereto (hereinafter referred to as the Act).
- b) Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2000 ((hereinafter referred to as the Actuarial Report Regulations)
- c) Insurance Regulatory and Development Authority (Assets, Liabilities and Solvency Margin of insurers) Regulations, 2000 (hereinafter referred to as ALSM regulations).
- d) Insurance Regulatory and Development Authority (Appointed Actuary), Regulations 2000 (hereinafter referred to as AA Regulations)
- e) Actuarial Practice Standard 1 - Appointed Actuary and Life Insurance Business, issued by Actuarial Society of India, (hereinafter referred to as APS1)
- f) Actuarial Practice Standard 2 - Additional Guidance for Appointed Actuaries and other Actuaries involved in Life Insurance, issued by Actuarial Society of India, (hereinafter referred to as APS2)
- g) Insurance Regulatory and Development Authority (Distribution of Surplus Regulations), 2002 (hereinafter referred to as Distribution of Surplus Regulations)
- h) The Income Tax Act, 1961, including Schedules attached and amendments thereto.

We do not quote or summarise the individual provisions of the above statute, regulation and practice standards. The Actuary should however be familiar with their requirements, inasmuch as they affect the subject of this Guidance Note, as they are updated from time to time.

**Application**

This Guidance Note is applicable to an Appointed Actuary, referred to hereinafter as the Actuary, appointed in accordance with provisions contained under AA Regulations.

**Status**

Issued under Due Process in accordance with the “Principles and Procedures for issuance of Guidance Notes (GNs) {ver. 3.00/27TH June, 2009}”.

Version	Effective from
1.0	31/03/2014

## **A: Purpose**

This document has been prepared as a guidance note for Appointed Actuaries advising direct life insurance companies on the declaration of bonus rates. Since the guidance note has the classification of 'Recommended Practice', there is an implicit understanding that the adoption of asset shares is also 'Recommended Practice'.

## **B: Grouping**

The Appointed Actuary should consider whether it is appropriate to group policies for the purpose of determining bonus rates. In general, policies can be grouped according to their major product features e.g. policies with similar bonus structure, date of issue, policyholder age, bonus earning capacity or the extent to which guarantees are in or out of the money, and type of plan.

The grouping of policies should not materially disadvantage one group of policyholders at the expense of another group of policyholders.

The policy grouping will also be influenced by any risk sharing rules that the insurer has, either explicit or implicit, such as views on policyholders reasonable expectations, equity and due balance between risk and reward. For example, if the risk sharing rules dictate that the investment experience will be shared differently between single premium and regular premium policies, the asset share will be determined separately for single and regular premium policies.

Asset shares, where calculated, should be separately determined for each policy grouping.

The more homogeneous the policy groupings are, the less is the extent of cross subsidies between policyholders. The Appointed Actuary has to balance the need to ensure equitable treatment between classes of policyholders with the practical constraints of having too fine a grouping.

Older or smaller groups of policies may be grouped together with other policies judged to have similar characteristics in order that a practical and equitable approach to the sharing of experience could be achieved.

## **C: Method and Assumptions**

### **Definition of Asset shares**

#### **Uses of asset shares**

Asset shares are commonly adopted by actuaries to guide them in the determination of bonus rate by:

- a) Setting the bonus scale such that the ratio of the asset share to the surrender value or maturity value lies within a certain specified range, at each policy grouping level
- b) Setting the bonus scale such that the ratio of the asset share to the gross premium valuation lies within a certain specified range, at each policy grouping level;

#### **Calculation of asset shares**

An asset share for a policy grouping at a given point in time is the accumulation of the

premiums received plus investment income earned from the inception of the policies, less deductions due to benefit payments, commission, expenses, tax, a reasonable cost of capital and of guarantees, contribution from miscellaneous surplus (if considered appropriate) and transfers to shareholders.

The Appointed Actuary should consider the various sources of surplus in the participating fund and should document the company's approach to and treatment of each of these items of surplus or deficit for the purposes of deriving the asset shares. In particular the Appointed Actuary should consider whether the surplus or deficit item forms part of the asset shares or is maintained within the fund's estate.

If there are particular items of surplus or deficit that the Appointed Actuary believes do not belong to participating policyholders and should not be re-distributed to either the current generation or future generations of policyholders, then these items should be explicitly identified.

The asset share formula should also allow for survivorship with the relevant decrements such as mortality, morbidity and possibly surrender. Surrenders may generate profits or losses that may have an effect of increasing or reducing the assets backing the policies.

Miscellaneous surplus could arise from various sources, including profits on account of surrenders. The Appointed Actuary will consider the treatment of miscellaneous surplus and whether it forms part of the asset share or the estate, depending on the bonus philosophy and bonus practices of the company.

Where the asset share is to include the impact of surrender profits, the Appointed Actuary should consider whether to explicitly or implicitly (for example by artificially adjusting the investment return) allow for the surrender profits when carrying out the calculations.

Overall, the Appointed Actuary should satisfy himself or herself that the approach adopted is fair and appropriate and that a consistent method is adopted from year to year. The Appointed Actuary should maintain documentation consistent with this possible requirement.

When deriving the asset share as at the end of the year, the Appointed Actuary will typically roll forward the asset share at the beginning of the year to the end of the year.

It is important for the Appointed Actuary to continually look for ways to refine the way in which the asset share is being determined for each policy grouping, to ensure equity and fairness to policyholders and that the calculation method is robust.

The Appointed Actuary may adopt different approaches in allowing for the cost of guarantees in the derivation of the asset share. The allowance for the cost of guarantees arises from the view that it is prudent for the insurer to hold some buffer to meet the cost of guarantees inherent in all its participating policies, taking into account the types of investment held. For example, the Appointed Actuary may either make an explicit deduction for the cost of guarantees in the asset share formula, or allow for the cost of guarantee implicitly through having a target payout less than the calculated asset share (excluding the cost of guarantees). In coming up with the approach to adopt, the Appointed Actuary should have regard to factors such as policyholders' reasonable expectations and the need to maintain the ongoing financial strength of the fund. The Appointed Actuary should document the justification of the approach to the cost of guarantees adopted.

## Comparison of asset share with gross premium valuation

It was earlier mentioned that insurers will typically compare the asset share with the gross premium valuation for each policy grouping to decide the scale of bonus rates. For this purpose the Appointed Actuary should consider the interaction between reversionary bonuses, terminal bonuses and the level of prudence in the valuation basis.

The Appointed Actuary should also ensure that there is consistency between the asset shares used to determine bonuses and the liability on the balance sheet of the Company.

## Assumption setting

Wherever possible, the Appointed Actuary should make use of actual historical data and cash flows to derive the historical asset share, so that the rigour of the process is not diluted. However, sometimes detailed historical records on actual experience may not be readily available (especially for policies which have been in-force for a very long time). In such cases, and only in such cases, the Appointed Actuary may make use of proxies to the actual historical experience, such as best estimates where it is considered equitable to do so.

The Appointed Actuary would also need to consider the need to calculate investment returns on a marked to market basis and the extent to which smoothing may need to be applied to investment returns.

It is also necessary to consider the level of expenses allocated to asset shares consistent with policyholders' reasonable expectations, having regard to comments made in Section D.

## Shareholders' transfer computation and tax

Shareholders' transfers are calculated as a certain percentage as stipulated in the Distribution of Surplus Regulations.

For the purpose of asset share calculations, shareholders' transfers refer to the shareholders share of the cost of bonus. This can be attributed to the relevant product grouping to determine the asset share for each policy grouping. Asset shares would not typically reflect any transfers into the fund to support new business strain etc

The Appointed Actuary should keep abreast of changes in tax rules, and ensure that derivation of asset shares are consistent with the appropriate tax rules prevailing.

In particular:

- a) It is normal practice for deductions for taxation to be applied to the asset share calculation in order to fund for the taxation on the cost of bonus
- b) Many companies may find that whilst on a standalone basis the participating fund would be generating taxable surplus, when the tax computation is performed at an aggregate company level, tax is not payable due to losses elsewhere in the company. In these circumstances the Appointed Actuary should consider the reasonableness or otherwise of making deductions for taxation from the asset shares, taking into account the regulatory filing, sales literature and other policyholder disclosures and policy wordings.
- c) To the extent that the Appointed Actuary considers it reasonable, the Appointed Actuary should consider the extent to which the participating policyholders should benefit from the any deferred tax asset.

## **D: Fund Management**

### **Operation of smoothing**

Smoothing of total benefits over time is characteristic of participating funds, which may pool business both within and between generations and classes of policyholders. A company will have some discretion in its smoothing of benefits, but the Appointed Actuary should have regard to the following when advising the company:

- whether there is a genuine reduction in the volatility of payouts;
- whether there is a significant increase in the risk of statutory or realistic insolvency; and
- whether all policyholders are treated fairly.

### **Treatment of over or under distribution (relative to reserves)**

The bonus distribution should reflect the performance of the participating fund and ensure that the payouts on policies are fair.

The Appointed Actuary should document the company's approach to setting reversionary and terminal bonuses, covering:

- a) Guidelines on the extent to which reversionary bonuses may be changed from one year to the next;
- b) The proportion of asset share targeted for maturity claim payouts;
- c) The projected financial strength of the participating fund and the bonus strategy assumed in that projection;
- d) Consistency of the assumed strategy with current rates of bonus; and
- e) Any differences in the intended treatment of different categories of policyholder.

The Appointed Actuary should consider whether the treatment of surpluses or deficits arising from the smoothing of maturity values, in particular whether they are shared with the surviving asset shares or with the estate, is in accordance with policyholders' reasonable expectations. The Appointed Actuary should document the company's approach to the treatment of such emerging surplus or deficit.

### **Surrender values**

In making his or her recommendation of bonus rates to the Board, the Appointed Actuary should consider the impact of the bonus rates on surrenders. As well as bonus rates, consideration should also be given to any other factors over which, under the policy terms and conditions, the company has discretion and which form part of the computation of the value which is paid to the policyholder upon surrender.

When considering surrender values, the Appointed Actuary should have regard to the following:

- a) Progression of surrender values over the life of the policy. Consideration should be given to the consistency between surrender values and maturity values.
- b) Policyholders' reasonable expectations in respect of surrender values.

- c) Where future surrenders have not been assumed in the liability valuation, the level of surrender surpluses expected to emerge. Where future surrenders are assumed in the liability valuation, and hence the emergence of surrender surplus has, to some extent, already been anticipated, the total surrender surplus should be considered. The Appointed Actuary should in particular consider whether such surpluses are consistent with the reasonable expectations of those policyholders who surrender.
- d) Whether and to what extent surrender surpluses are being used to support the payouts to policyholders who hold their policies for longer. Where surrender surpluses are being used to support payouts to policyholders who hold their policies for longer, the Appointed Actuary should consider if the method of surplus distribution, either reversionary or terminal bonus, is well-matched to the source of surplus.

The Appointed Actuary should document the company's approach to surrender values and to any surpluses arising from surrenders.

### **Treatment of riders or any non-participating business written in the participating fund**

It is acceptable to write riders or non-participating business in the participating fund. Where such products are written in the participating fund the following conditions should apply:

- pricing should be fair and follow actuarial principles;
- surpluses and deficits from riders or any non-participating business written in the participating fund should be treated consistently, and in accordance with the reasonable expectations of with profits policyholders;
- pricing of these products should not put undue strain on the fund. In particular, the ability to supply capital in support of the investment strategy of the assets backing the participating business should not be expected to be compromised.

The Appointed Actuary should document the company's approach to surpluses and deficits arising from riders or any non-participating business written in the participating fund.

### **Policyholders' reasonable expectations**

These may be assumed to be influenced by, *inter alia*, sales material, benefit illustrations, any other documentation shared with the policyholder that relates to the management of participating business and the company's past practice. Consideration should also be given to the impact of writing new business on existing policyholders to ensure that they would not be expected to be disadvantaged.

### **Expense allocations**

Allocation of expenses should be considered at two levels for participating business;

- 1) The amount of expenses charged to the participating funds versus other non participating and unit linked funds
  - a) While the Appointed Actuary may not be solely responsible for the allocation and apportionment of expenses between funds, he or she should understand the approach being adopted, consider whether it is reasonable and inform the company if, in his or her opinion, it is not.

- b) Expense allocations would be relatively straightforward for certain items that are directly related to the policies, such as commissions, but it is likely that the apportionment of many other items will be subject to some degree of discretion. For example, the expenses of some cost centre may be allocated by reference to, inter alia, policy count, new business received premium, new business weighted received premium, renewal premium, etc. The Appointed Actuary should judge whether the basis of the allocation adopted is reasonable, given the nature of the expense.
  - c) The Appointed Actuary should document the basis of allocation of expenses.
  - d) The basis of allocations should not be subject to arbitrary changes from year to year.
  - e) In coming to a conclusion, the Appointed Actuary should be aware of:
    - o Implications for the revenue account of the policyholders' funds; and
    - o Any reliance placed upon his or her opinion by the statutory auditors.
- 2) The amount of expenses charged to the historical asset share of policies
- a) The Appointed Actuary must consider the consistency of expenses being charged to asset shares with what has and is being illustrated to customers. In particular, the expenses intended to be allocated to the asset shares should be consistent with the bonuses projected in benefit illustrations.
  - b) In respect of renewal expenses, so long as policyholders' reasonable expectations encompass expense risk, the Appointed Actuary, when making the actual allocation to asset shares, may use a degree of discretion in departing from the expenses implicit in any benefit illustration issued at point of sale. However, in respect of acquisition expenses, the level of expense should be known with greater certainty. Hence, the Appointed Actuary will have less scope to depart from the level of expense implicit in any benefit illustration when allocating acquisition expenses to asset shares. The Appointed Actuary should document any such departure.
  - c) Where the expenses allocated to the fund exceed those allocated to the asset shares, the Appointed Actuary should consider the reasons for this, and be satisfied that the approach:
    - i. is sustainable;
    - ii. is not, by its effect on the estate, expected to affect policyholders' reasonable expectations adversely and materially; and
    - iii. is appropriately reflected in the expenses assumed in the statutory valuation of liabilities.

## **E: Reinsurance and Investment**

### **Reinsurance**

The Appointed Actuary (AA) has the responsibility to ensure that reinsurance programmes in place are sufficiently robust, consistent with the policyholders' risk appetite and protect the balance sheet vis a vis the insurer's risk appetite and capital strength. For example, if non-participating protection business is written in a participating fund, and participating policyholders' share in the surplus or deficit generated by this protection business, the reinsurance programme put in place will affect the participating business's exposure to risk and reward. Therefore, the reinsurance programme should be consistent with the policyholders' risk appetite.

## Investment

As per the 'Corporate Governance Guidelines for Insurance Companies' (Circular No. IRDA/F&A/CIR/025/2009-10 dated 05th August, 2009), wherever an AA is employed, the AA must be a member of the Investment Committee. The Committee is responsible for laying down an overall investment policy and operational framework for the investment operations of the insurer. The policy should cover Asset Liability Management (ALM) supported by robust internal control systems.

The AA should evaluate the appropriateness of the investment policy with regard to the nature and term of liabilities, the investment environment and take into consideration the interests of policyholders.

### Investment management of participating funds and treatment of costs of guarantees

The AA should consider the likely investment management approach for the participating funds operated by the company and the implications this has on whether policyholders' reasonable expectations (PRE) are being appropriately set through sales literature and illustrations.

- The AA should refer to GN5 for guidance on benefit illustrations and any related disclosures in this regard.
- In certain circumstances the guaranteed benefits provided to a group of participating policies may be in excess of the underlying asset shares of the policies. In these circumstances the Appointed Actuary should clearly document the approach taken to dealing with these guarantee costs and in particular whether this cost will be borne by estate or charged directly to some or all participating policies.
- The Actuary should document the approach and method for determining the investment returns to be credited to asset shares including
  - How the calculation is performed and whether an amortised cost or market value return or smoothed market value return is credited to the asset share
  - Where differential credits are applied to different policy groups, the rationale for the differences and the asset hypothecation logic

## F: Segregation and Merging

The participating fund may be segregated into sub-funds either formally or notionally to manage different risks, e.g. a reason for segregating the participating portfolio into sub funds would be to segregate risk exposures. Two or more participating funds may also be merged, e.g. to achieve better diversification benefit on a risk capital basis across funds.

Prior to the segregation or merger of two or more participating funds, the Appointed Actuary should consider:

- clear allocation of expenses and investment income to each of the funds
- the bonus outlook for all affected policyholders
- pre and post financial condition of the participating funds, wherever appropriate, including but not limited to the security of benefits for all affected policyholders
- the pre and post diversification benefits on a risk capital basis
- whether there is any material impact on the affected policyholders' interests
- appropriate disclosures are made to existing and prospective policyholders

The AA should document the structure and rationale of the sub-funds and the risks that are shared within each sub-fund for experience pooling and the rules should be consistent from

year to year and not subject to arbitrary changes. Any changes should be clearly justified and documented.

Where there is significant weakening of these factors listed above or deviation from pre-merger investment strategy, the AA should inform the Board and document the reasons to proceed with the merger.

The AA should adhere to all legislation and regulatory requirements in this regard. Further, the AA should be aware that the factors listed above are not exhaustive. If there are any other factors that would significantly affect the policyholders, the Appointed Actuary should document the company's approach to their treatment.

## **G: Documentation**

Wherever references are made to the required documentation in the above, the Appointed Actuary should be prepared to share the documents with the Board or the Regulator.