Prudential Standard LPS 340

Valuation of Policy Liabilities

Objective and key requirements of this Prudential Standard

The ultimate responsibility for the value of a life company's policy liabilities rests with the Board of a life company.

This Prudential Standard requires that a life company's policy liabilities in respect of life investment contracts are determined in accordance with the requirements of relevant accounting standards to the extent appropriate for the purposes of the Act.

This Prudential Standard establishes a set of principles and practices for the consistent measurement and reporting of policy liabilities for life insurance contracts. The policy liabilities must provide for both a best estimate value of the liabilities and the timely release of profit over the life of the business.

The key requirements of this Prudential Standard are that a life company must:

- generally classify contracts into life investment contracts and life insurance contracts in accordance with relevant accounting standards, except where this Prudential Standard states otherwise;
- in respect of life investment contracts, generally comply with the requirements of the relevant accounting standards in the valuation of the policy liabilities; and
- in respect of life insurance contracts, value the policy liabilities in accordance with the principles and methodology set out in this Prudential Standard.

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Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. This Prudential Standard only applies to the business of an Eligible Foreign Life Insurance Company (**EFLIC**) which is carried on through its Australian statutory funds but not otherwise.[2]

4. This Prudential Standard applies to life companies from 1 January 2013 (**effective date**).

Interpretation

5. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

6. This Prudential 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 Prudential Standard is being applied to overseas business.

Part A – Contract classification and application

Contract classification and application

7. For the purposes of this Prudential Standard, policies issued by a life company must be classified as either life investment contracts or life insurance contracts. The classification of a policy under this Prudential Standard may differ from its classification under Australian Accounting Standard AASB 1038 Life Insurance Contracts (**AASB 1038**).

8. For the purposes of this Prudential Standard, a contract that includes a **participating benefit** or a **discretionary participation feature** is deemed to satisfy the definition of a life insurance contract, even if it is classified as a life investment contract under Australian Accounting Standards. If a contract includes a participating benefit but does not include a discretionary participation feature and it is classified as a life investment contract under Australian Accounting Standards a life company may, under subsection 15(4) of the Act, request that APRA declare the benefit to be non-participating, to allow the treatment under this Prudential Standard and the treatment under Australian Accounting Standards to be aligned.

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[1] Refer to subsection 21(1) of the Act.
[2] Refer to section 16ZD of the Act.

9. Some life insurance contracts contain both an insurance component and a deposit component.[3] AASB 1038 permits contracts to be unbundled into separate insurance and deposit components if (and only if) the deposit component can be measured separately. To unbundle a life insurance contract, the insurance component must be treated as a life insurance contract. The deposit component must be treated as a separate life insurance contract if it includes a discretionary participation feature. Otherwise, the deposit component must be treated as a life investment contract. However, a life company is not required to unbundle, and may therefore treat the entire contract as a life insurance contract if it so wishes.

10. For the purposes of this Prudential Standard, the following contracts must not be unbundled:

    (a) reinsurance contracts; and

    (b) participating contracts with insurance riders, where the profits on the riders are deemed to be in respect of participating business and so allocated between policyholders and shareholders.

11. For the purposes of this Prudential 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.

12. If not in conflict with paragraph 9 of this Prudential Standard, a contract must be unbundled if it can be split for the purpose of recognising premium revenue and claims expense under AASB 1038.

13. If not in conflict with paragraph 9 of this Prudential Standard, where a contract contains both investment-linked and non-investment-linked benefit options, they must be unbundled as separate deposit components, with the associated service components apportioned between them.

14. If not in conflict with paragraph 9 of this Prudential Standard, an option to make future investments into a discretionary investment benefit option must be unbundled and, if necessary, separately valued.

15. After allowing for any unbundling, the policy liability in respect of a life investment contract must be determined in accordance with the requirements of Part B of this Prudential Standard

16. 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 C and D of this Prudential Standard.

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

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[3] Deposit component is defined in AASB 1038.

Part B – Policy liabilities in respect of life investment contracts

18. For the purposes of this Prudential Standard, 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.

19. Life investment contracts consist of at least one **financial instrument element**, 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.

20. 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.

21. 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 Prudential Standard.

22. 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; and

    MSE = the net liability (asset) in respect of the management services element.

23. The life investment contract liability, being the component of the policy liability that arises under a life investment contract 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 Australian Accounting Standards (whether or not the financial instrument element is measured on that basis under the Australian Accounting Standards).

24. 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 Australian Accounting Standards.

25. 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 Australian Accounting Standards (whether or not they are reported on that basis under the Australian Accounting Standards).

Part C - Principles for the valuation of policy liabilities in respect of life insurance contracts

The principles of the valuation

26. This Prudential Standard does not prescribe a single methodology for the valuation of policy liabilities in respect of life insurance contracts. The principles of the Prudential 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.

27. The principles are paramount in determining the policy liability; methodology is incidental to the principles. Projection or accumulation methodologies may be appropriate provided the life company can demonstrate that the principles have been met.

28. 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**.

29. 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.

30. 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.

31. 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.

32. 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.

33. 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.

34. Subject to circumstances covered by paragraph 33, 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).

35. In determining the best estimate liability and best estimate assumptions, the life company 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.

36. 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.

The valuation of policy liabilities

37. The policy liability is equal to the sum of:

    (a) the **best estimate liability**;

    (b) the value of future **best estimate bonuses**; and

    (c) the value of future **best estimate shareholder profits**.

38. Where **non-participating benefits** are provided, profit is entirely the entitlement of the shareholder. In that case, the policy liability is equal to the sum of:

    (a) the best estimate liability; and

    (b) the value of future best estimate shareholder profits.

39. 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

40. Friendly society benefits are neither participating nor non-participating. For the purpose of applying this Prudential 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 there is no provision for distribution of unallocated surpluses to policy owners are to be valued as if they were non-participating.

Participating benefits

41. 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**.

42. 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.

43. 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.

Non-participating benefits

44. 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.

45. 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

46. 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 life company must make appropriate adjustments to the policy liability.

Reinsurance of life insurance contracts

47. 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**.

The best estimate liability

48. 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. This best estimate liability is equal to:

    (a) the value of expected future benefit payments; plus

    (b) the value of expected future expenses; less

    (c) the value of expected future receipts.

49. 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.

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

    (a) investment earnings;

    (b) inflation;

    (c) taxation;

(d) expenses;

(e) mortality and morbidity; and

(f) policy discontinuance.

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

51. 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.

Valuing liability options

52. The best estimate liability and best estimate assumptions must have regard to any options or asymmetrical distribution of liability outcomes.

53. 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.

54. However, the life company 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.

55. 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.

56. The requirements throughout this Prudential Standard in respect of best estimate assumptions and best estimate liabilities are to be interpreted in this context.

Investment earnings

57. 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.

The discount rate

58. 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 discount rate (or rates) that the life company considers to be risk free, based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows is to be used.

59. 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**.

Taxation

60. 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.

61. 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 58.

Servicing expenses

62. 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.

63. 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 58.

64. 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

65. 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 life company considers to be ‘one-off’ in nature.

    Both must be consistently adjusted for tax in accordance with paragraphs 60 to 61.

Other assumptions

66. The best estimate assumptions in respect of all other assumptions used in the valuation of policy liabilities, must be assumptions about future experience which:

    (a) are made having regard to the advice of the Appointed Actuary;

    (b) are made having regard to reasonably available statistics and other information; and

    (c) are neither deliberately overstated nor deliberately understated.

Profit carriers and profit margins

67. 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. This is achieved by setting the profit margin as:

    (a) the value of the future best estimate shareholder profits;

    (b) divided by the value of the profit carrier(s)

    where the profit carrier is a financially measurable indicator of either:

    (c) the expected cost of the services provided to the policy owner; or

    (d) the expected income item relating to the services.

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

    (a) insurance of mortality, morbidity (or similar risks);

    (b) generation of investment income;

    (c) setting up the policy (selling or acquisition);

    (d) ongoing administration;

    (e) investment management; and

    (f) provision of bonuses.

Profit margins

69. In accordance with the principles of paragraphs 26 to 36, 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.

70. A profit margin must be expressed, explicitly or implicitly, as a uniform proportion of one or more appropriate profit carrier(s).

Profit carriers

71. The appropriate profit carrier(s) must be related to the services provided to policy owners by the company. The life company, in selecting the appropriate profit carrier(s), must consider:

    (a) the services and income items applicable to the benefit;

    (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.

72. Provision of capital to meet the requirements of *Prudential Standard LPS 110 Capital Adequacy* is not a service for this purpose.

73. Acquisition is a service for this purpose only when explicit establishment fees are received.

74. Profit carrier(s), once chosen, must be used consistently for a related product group unless in the life company's judgement the profit carrier(s) are no longer appropriate.

75. 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.

Acquisition expenses

76. The principles for the allocation of expenses to acquisition expenses are set out in Part E. 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.

77. 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.

78. 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.

79. Appropriate allowance must be made in this process for tax on both establishment fees and acquisition expenses.

80. 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 paragraphs 115 to 121.

81. 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.

82. 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 D – Methodologies for determining policy liabilities in respect of life insurance contracts

83. 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.

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

New business - calculation of profit margins and acquisition expense recovery components

Profit margins

85. 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).

86. The value at commencement of expected future profits must be determined on the basis of best estimate assumptions.

87. 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;

    (b) the date of commencement of the business; or

    (c) the end of the reporting period.

88. The acquisition expense assumption is determined at the end of the reporting period.

Treatment of losses

89. If the projection reveals a value of expected future profits 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 90. 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 paragraphs 115 to 121).

90. 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.

91. The approach used by the life company for treatment of losses on new business must be applied consistently over time.

Acquisition expense recovery components

92. 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).

93. 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.

94. 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 must have regard to acquisition expenses accrued or deferred in the accounts.

Reporting date recalculations - benefits providing no discretionary entitlement to share in the investment experience of assets backing them.

Recalculation of profit margins

95. Where profit margins are determined at commencement, the principles of this Prudential Standard 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.

96. The methodology detailed below produces results in accordance with the principles of this Prudential Standard. Other methods may be appropriate where the life company can demonstrate that the principles have been met.

97. 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:

        (i) the best estimate liability (on basis 1); plus

        (ii) the value of expected future profits (on basis 1); less

        (iii) the best estimate liability (on basis 2); and

    (b) recalculate the profit margins as:

        (i) the value of expected future profits (from (a));

        (ii) divided by the value of the profit carrier(s) (on basis 2)

    (c) where:

        (i) 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 98 and 99 below; and

        (ii) basis 2 uses the best estimate assumptions at the current reporting date.

Discount rate

98. 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.

99. 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.

Recalculation of acquisition expense recovery components

100. Where acquisition expense recovery components are determined at commencement the principles of this Prudential Standard require a recalculation of those components at each subsequent reporting date to ensure that future expected profits are neither released prematurely nor deferred inappropriately.

101. The methodology detailed below produces results in accordance with the principles. Other methods may be appropriate where the life company can demonstrate that the principles have been met.

102. 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:

        (i) the acquisition expense recovery components;

        (ii) multiplied by the value of the acquisition expense recovery carrier(s) (on basis 1); and

    (b) recalculate the acquisition expense recovery components as:

        (i) the value of the expected future acquisition expense recoveries (from (a));

        (ii) divided by the value of the acquisition expense recovery carrier(s) (on basis 2)

    (c) where

        (iii) basis 1 uses the best estimate assumptions at the previous reporting date, except for the discount rate and related economic assumptions - see paragraphs 98 and 99; and

        (iv) basis 2 uses the best estimate assumptions at the current reporting date.

Reporting date recalculations - benefits providing a discretionary entitlement to share in the investment experience of assets backing them

103. 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.

104. 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;

    (a) 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.

    (b) operating profit includes shareholder profit and policy owner profit. It comprises:

(i) 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

(ii) non-investment experience profit.

105. 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. This 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.

106. 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 this Prudential Standard.

Recalculation of profit margins

107. Where profit margins are determined at commencement, the principles of this Prudential Standard 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.

108. The methodology detailed below is deemed to produce results in accordance with the principles of this Prudential Standard. Other methods may be appropriate where the life company can demonstrate that the principles have been met.

109. 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:

(i) the value of supporting assets;

(ii) less the best estimate liability (on basis 2);

(iii) less the value of current period bonuses and shareholder profits (on basis 2); and

(b) recalculate the profit margins as:

   (i) the value of future profits (from (a)) less the value of future best estimate bonuses (on basis 2);

   (ii) divided by the value of the profit carrier(s) (on basis 2);

(c) where:

   (i) value of supporting assets is calculated according to paragraphs 110 to 111;

   (ii) basis 2 uses the best estimate assumptions at the current reporting date;

   (iii) value of current period bonuses is determined as the cost of bonus according to paragraphs 112 to 114; and

   (iv) The relationship between bonuses and shareholder profits must be in accordance with paragraph 43.

Value of supporting assets

110. The value of supporting assets is determined as:

   (a) the policy liability at the end of the previous reporting period;

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

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

   (d) less the expected shareholder profits emerging over the period and the non-investment experience profit.

111. The value of supporting assets must be calculated so as to attribute no value of assets to terminated benefits.

Cost of bonus

112. 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.

113. 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 life company, in determining the cost of bonus, must allow an appropriate value for that unvested bonus.

114. 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.

Loss recognition

115. 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 this Prudential Standard 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.

116. 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.

117. Cumulative losses may be run-off in accordance with the run-off of the business of the relevant related product group.

118. 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

    (b) then to the extent available, in producing profit margins in excess of the adequacy threshold.

119. 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 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 all separate related product groups.

120. 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 the discount rate described in paragraph 58 is not used) is equal to the difference between:

    (a) the best estimate liability on basis 2 (either in accordance with paragraph 97 or paragraph 109, whichever is applicable), but using the discount rate described in paragraph 58); and

    (b) the best estimate liability on basis 2.

121. For all other related product groups the adequacy threshold is zero.

Reinsurance

122. 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.

123. The principles of this Prudential 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 126.

124. 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 paragraphs 115 to 121 of this Prudential 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 paragraphs 115 to 121 of this Prudential 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.

125. In undertaking the allocation described in paragraph 124 regard must be had for a diligent assessment of:

    (a) the purpose of the company in entering the reinsurance; and the contribution of that reinsurance to the business of the company;

    while retaining the integrity of the principles of this Prudential Standard.

126. 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 E – General requirements for all forms of policy and the Appointed Actuaries statement

Allocation of expenses

127. 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.

128. 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 Prudential Standard.

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

130. 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.

131. 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.

132. 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 paragraphs 141 to 142. Total expenses for this purpose are total operating expenses as disclosed in the financial statements.

133. 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.

134. 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.

135. 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 life company, may be reflected in the final allocation of expenses provided transparency of the allocation process is retained.

136. 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.

137. In undertaking the allocation described in paragraph 136 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 this Prudential Standard.

Apportionment process

138. 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.

Service agreements

139. 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 life company must determine an alternative allocation applying the principles of this section on a 'look through' basis.

140. 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.

One-off expenses

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

    (a) material in accordance with the provisions of paragraphs 147 to 148; and

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

    (c) not regularly recurring in nature.

142. 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 Prudential Standard.

Friendly societies

143. 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.

144. 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.

145. 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 131, the provisions under paragraphs 139 to 140 in relation to service agreements are applicable.

146. 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.

Materiality

147. A life company may take into account materiality when valuing its policy liabilities. Particular values or components are considered material to the overall result of a calculation if misstating or omitting them would produce results likely to be misleading to the users of the information.

148. The policy liability determined in accordance with this Prudential Standard is subject to materiality standards applied at a statutory fund level.

Adjustments and exclusions

149. APRA may, by notice in writing to a life company, adjust or exclude a specific requirement in this Prudential Standard in relation to that life company.

Determinations made under previous prudential standards

150. An exercise of APRA's discretion (such as an approval, waiver or direction) under a previous version of this Prudential Standard continues to have effect as though exercised pursuant to a corresponding power (if any) exercisable by APRA under this Prudential Standard. *Prudential Standard LPS 1.04 Valuation of Policy Liabilities* may be regarded as a previous version of this Prudential Standard.