ACTUARIAL SOCIETY OF HONG KONG

# Appendix A to Actuarial Guidance Note 9 – Participating and Universal Life Business Benefit Illustration Assumptions

## 1. BACKGROUND

1.1 This Appendix A to Actuarial Guidance Note 9 (AGN 9) provides specific and supplementary considerations when setting assumptions for benefit illustrations for participating and universal life policyholders. It also supplements Actuarial Guidance Note 5, *Principles of Life Insurance Policy Illustrations.*

1.2 According to Section 3.3 of ASHK Professional Standard 1 (PS1);

> *"it is part of the Hong Kong Appointed Actuary's continuing responsibility to advise the company of his interpretation of its policyholders' reasonable expectations.*
>
> *When a significant change is likely to take place, the Hong Kong Appointed Actuary should take all reasonable steps to ensure that the company appreciates the implications for the reasonable expectations of its policyholders. It is also incumbent upon the Hong Kong Appointed Actuary to take all reasonable steps to ensure that the company's incoming policyholders should not be misled as to their expectations."*

Appropriate development of Benefit Illustrations (BIs) is an important component of an Appointed Actuary discharging his/her responsibility under this requirement as BIs provide policyholders with a company's best estimate expectations under the current circumstances with respect to future policy values which steer policyholders' benefit expectations.

1.3 Insurers are generally required to present a BI to a prospective policyholder at the point of sale. The main purpose of a BI is to provide the prospective policyholder with information showing guaranteed and non-guaranteed benefits that he/she could reasonably expect to receive should certain conditions, particularly investment return assumptions, be met. The BI is provided to assist the prospective policyholder in making an informed purchase decision.

In addition, insurers might provide refreshed BIs at later points during the policy lifetime (e.g. annually, following a change in expectation of future non-guaranteed benefits, or following a customer request) with up-to-date information to the policyholders to inform them of their potential future non-guaranteed benefits reflecting the most recent economic conditions, market outlook and operating experience.

1.4 The ASHK believes it is critical for the sustainability and credibility of the industry and the actuarial profession that the BIs are produced based on realistic and achievable assumptions, especially investment return assumptions.

1.5 This appendix has been prepared on the basis that best estimate assumptions are used in respect of base BIs, and for the sake of generality the derivation of base BIs has been described with reference to best estimate assumptions. However, it is noted that there are circumstances when it may be appropriate for the actuary to use assumptions that are not equal to best estimate to prepare a BI. Examples of such circumstances are provided in section 4 of this appendix. In such cases the actuary shall clearly document and explain the reasons why base BIs are not derived from best estimate assumptions and why they remain appropriate.

## 2. SCOPE

2.1 The guiding principles documented in this appendix are intended to be generic and should be applied for the following range of products and scenarios:

i) Traditional participating products with non-guaranteed benefits payable in the form of annual / terminal dividends or reversionary and terminal bonuses; and universal life products with non-guaranteed crediting interest rates. For the avoidance of doubt, non-guaranteed crediting interest rates for any form of deposit are also in scope;

ii) BIs generated at the point of sale and any inforce BIs provided to policyholders over the lifetime of their policies; and

iii) Base BIs as well as any sensitivity scenarios.

## 3. CONSIDERATIONS FOR BENEFIT ILLUSTRATION ASSUMPTIONS

3.1 Being an important policyholder communication for helping to guide policyholders' reasonable expectations (PRE), one of the core objectives of a BI is to facilitate a prospective policyholder's understanding of what future policy values may be reasonably expected and what are the risks of not achieving them. Various types of BI are commonly provided:

<u>New Policy at the point of sale</u>

- Base BI – with non-guaranteed benefits derived from projections based on best estimate; and
- Sensitivity BIs – additional sensitivity projections should be in place to illustrate to policyholders the risks and volatility surrounding the base illustration when necessary.

<u>Life-time PRE management process for Inforce Policies</u>

- Inforce BIs might be provided at dates after the point of sale, such as annually, following a change in expectation of future non-guaranteed benefits, or following a customer request. These are provided to policyholders to manage PRE by reflecting actual experience to date and updated assumptions going forward.
- The updated assumptions underlie base and sensitivity BI's in a similar manner to point of sale illustrations.

For the sake of clarity, BIs prepared using assumptions that are in aggregate more conservative than the combined effect of assumptions described in this document are considered to be in compliance with this appendix.

### 3.2 Base illustrations

3.2.1 The projection of base non-guaranteed benefits should be based on best estimate assumptions that reflect company-specific and product-specific circumstances as discussed in section 3 of AGN 9.

3.2.2 Owing to different bonus/dividend philosophies (e.g. experience sharing and smoothing bases), ownership structures, management philosophies, investment strategy, expertise, sophistication, experience, risk capacity and risk appetite, two products with very similar policy provisions could be managed very differently between insurers, including different supporting investments. This may result in material differences in the projected non-guaranteed values and the risks inherent in the non-guaranteed benefits. An appropriate BI should reflect the expectations and risks consistent with the insurer's approach to product management for consideration by prospective policyholders. Such illustrations are intended to assist potential customers to select insurance products that fulfil their unique needs and risk profiles.

3.2.3 The base BI may be accompanied by certain relevant information provided by the company; for example, historical investment performance. This information should however be treated with care as historical information is retrospective in nature and may not reflect prospective developments.

3.2.4 Specific considerations required in deriving best estimate assumptions include but are not limited to:

i) Economic assumptions – Given the core objective of the BI in managing PRE, as opposed to merely demonstrating average financial outcomes, the actuary should pay special attention to the impact of adopting mean or median returns in generating BIs. In general, if there is a significant difference between the result derived with the mean return and that derived with the median return, the actuary should exercise professional judgement and prudence in choosing the assumption reflecting the more likely outcome.

ii) Expense assumptions –The expense assumptions underlying the illustration should be marginal expense assumptions only if the actuary believes, based on professional judgement, that the actual non-guaranteed benefits are and will continue to be based on a marginal expense approach and that such approach is sustainable. In general, the illustration should be consistent with the company's actual practice in managing non-guaranteed benefits. The actuary should also reflect agent commissions, commission overrides, and other direct compensation.

iii) Persistency assumptions – For certain types of contracts, the company may experience a gain upon policyholder surrender. Depending on the company's philosophy, such surrender gains may or may not be shared with the remaining policyholders. If they are shared, the surrender gain could be reflected in the BI as an uplift to the policyholder benefits since it is considered that a best estimate lapse assumption is a realistic assessment of future experience. However, the actuary shall describe and explain in the notes to the BI how and why future non-guaranteed benefits might vary from those illustrated if there are more or fewer than expected lapses. In particular, the company has a responsibility to consider the best interests of all of its clients, and the actuary should be mindful of the challenges of potentially explaining to a policyholder's non-guaranteed benefits might be lower than previously illustrated because fewer than expected of the other policyholders lapsed. This practice should be applicable to both BIs generated at the point of sales and refreshed BIs for inforce policyholders.

### 3.3 Risks and sensitivities

3.3.1 Owing to different product features and risk profiles, the underlying investment strategy of different products may differ leading to different levels of investment return and volatility. Different companies may offer a range of products with similar best estimate projected values but with different levels of guarantee and risk in their investment strategy. These should be reflected in the BI via BI sensitivities to allow potential policyholders to differentiate and understand the risk/reward trade-off of different products before arriving at an informed decision.

3.3.2 The assumptions for the sensitivities should cover a reasonable range of potential outcomes and should reflect the underlying risks of the product in accordance with the company's management practice, including its investment strategy and experience sharing mechanism.

3.3.3 For traditional participating products with non-guaranteed benefits, the sensitivities should cover a scenario for each of favourable and unfavourable experience compared with the best estimate assumptions underlying the base BI. These two sensitivity tests should cover all assumptions that could materially impact the BI including but not limited to investment assumptions. The actuary should consider whether sensitivities are also appropriate for universal life policies. For the avoidance of doubt, any illustration required under regulation must also be provided. For example, if regulation requires that sensitivities based on investment assumptions only be provided, such regulation must be complied with and may result in additional two illustrations being provided in cases where assumptions other than investment assumptions are significant based on Appointed Actuary's judgement.

### 3.4 Lifetime PRE management process

To help manage PRE, it is good practice to prepare regular updated BIs for inforce policies. These provide policyholders with up-to-date information with respect to the policy value projections, reflecting the most recent economic conditions and operating experience and help to manage PRE with respect to non-guaranteed benefits. This minimises the risk of last-minute surprises for policyholders when the non-guaranteed benefits become payable.

## 4. OTHER PRACTICAL CONSIDERATIONS

4.1 *Use of prudent assumptions other than best estimate* - There are a number of circumstances under which an actuary may decide to use assumptions that are more prudent than best estimate assumptions for BIs. Examples of situations under which such an approach may be appropriate are provided below.

(i) Assumptions without credible experience

Two approaches should be considered in the event that the non-guaranteed benefits illustrated are materially impacted by a non-economic assumption for which the information available has relatively low credibility. The actuary may include a margin for prudence in the assumption to avoid a situation where PRE may not be met should emerging experience adversely affect policyholder benefits.

Alternatively, if the actuary decides not to include prudence in the assumption, he/she should be satisfied that there is adequate communication to policyholders that there is a significant possibility that their non-guaranteed benefits may be materially lower than the base illustration (for reasons other than investment experience). The actuary should also ensure that the considerations underlying his/her decision are adequately documented and communicated to the management team and the board of directors.

(ii) Lapse supported products

For products under which there is a material level of support to bonus rates from lapsation profits, the actuary should be mindful of the challenges of explaining to policyholders that their non-guaranteed benefits are lower than previously illustrated because fewer than expected of the other policyholders lapsed. As a result it might be appropriate to use assumptions that are more conservative than best estimate.

(iii) Critical Illness Products

For participating critical illness products where morbidity experience is material to policyholder bonus rates, consideration should be given as to whether future medical developments may have a material impact on diagnosis and therefore future claims experience. This may result in the actuary setting assumptions that contain some allowance for deterioration in claims experience over time.

4.2 *Illustration of benefits higher than projected purely from underlying cash flows based on best estimate assumptions* – There may also be circumstances under which an actuary may decide to illustrate benefits higher than that are projected purely based on best estimate assumptions for BIs. Examples of situations under which such an approach may be appropriate are provided below.

(i) Returns subsidisation

In some circumstances insurers may manage policyholder benefits with returns subsidised by assets other than those generated from policyholders' premiums and investment returns, including but not limited to:

a. profits from other lines of business,

b. profits from riders attaching to base policies,

c. direct support from shareholder capital, and/or

d. other assets in a closed fund.

The actuary should be satisfied that the illustrated non-guaranteed benefits are sustainable for all policyholders receiving the subsidised illustrations. If the subsidy is fixed or limited, the actuary is required to determine the maximum business volume supported by this subsidy. Once the maximum business volume has been reached, the actuary should revise the illustration basis accordingly. Under this circumstance, the actuary should manage BIs under a reasonable, sustainable and actuarially sound approach and should justify the approach taken and ensure the level of subsidy is fairly reflected in BIs. For example, the actuary could separate the business into two portfolios, namely with and without subsidisation, in order to determine their bonuses separately.

4.3 *Simplification* – The determination of best estimate assumptions in accordance with AGN 9 can be challenging and can require significant resources. The actuary may adopt a simplified approach in setting the assumptions but such simplification should largely reflect the foregoing overarching principles and should be set in a conservative manner. The resulting BI should in no way steer PRE towards optimism.

4.4 *Frequency* – Given the complexity in producing BIs, it is impractical to continuously refresh the BI assumptions in line with changing economic conditions. Given that insurance contracts are long term in nature and the need to manage PRE, it is generally acceptable practice to refresh BI assumptions no less frequently than annually. The time interval between the regular refreshes should be uniform, and the timing of the refresh should avoid biased selection with respect to economic cycles. Nevertheless, under extraordinary “stressed” economic conditions, it is reasonable to refresh BIs off-cycle where practical.

4.5 *Regulation and compliance* - The actuary should also ensure the BI basis complies with applicable regulations and guidelines.

## 5. GOVERNANCE AND REVIEW PROCESS

The principles and practices, including the model, methodology, assumptions and the associated documentation, for future value illustrations should be maintained by the Appointed Actuary or a senior actuary in a firm who has a similarly responsible standing. The continued appropriateness and reasonableness of the model, methodology, assumptions and documentation should be reviewed at least annually.

## 6. COMMENCEMENT DATE

This Appendix A to AGN 9 shall become effective on 1 April 2016.

***** END OF APPENDIX *****