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ASP GUIDANCE NOTES (GN2015-1)

Implementation Guidelines of Life Reserve Valuation Standards

In accordance with the IC Circular 2014-42-A

Official Release

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2015 Joint Committee on Life Reserve Valuation Standards

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Introduction

The Actuarial Society of the Philippines (ASP) affirms the IC Circular 2014-42-A, Valuation Standards for Life Insurance Policy Reserves, presents a sufficient framework of standards for the valuation of life insurance policy reserves (or statutory reserves) for regulatory reporting to the Insurance Commission.

The ASP also recognizes that the regulatory reporting is primarily for establishing and monitoring of the solvency of life insurance companies. The statutory reserves represents the measure of the company's main liability on inforce policies as at the valuation date. Risk-based capital (RBC), which is an allocation of surplus or net worth, shall be layered on top of the statutory reserves for adequate provisions for solvency.

The purposes, basis and the amounts of statutory reserves may be not fully congruent with those for Philippine Financial Reporting Standards (PFRS) and tax regulations. There are differences in the principles underlying various financial reporting standards or regulations.

Guidance Notes

Guidance Notes serves the following purposes:

- Present the position of ASP on the subject matter
- Clarify certain items in the relevant regulations or standards that may have conflicting interpretations
- Supplement the regulations or standards with additional actuarial practice guidelines
- Establish consistent applications of the standards among Fellows of the ASP
- Expand guidance in order to address utilization of the principles and components of statutory reserves to related items in risk-based capital, Philippine Financial Reporting Standards, reporting of a period's realized/unrealized profit through Profit and Loss Statement (P&L) or Other Comprehensive Income (OCI), asset valuation and others
- Build guidance notes, if necessary, to become Standards of Practice

The ASP issues this Guidance Notes (GN2015-1) for compliance by all Fellows (the Actuary) certifying the basis, calculations and amounts of life insurance policy reserves in accordance with IC Circular 2014-42-A.

SCOPE

1. Discount Rate
2. Consistent Asset Valuation Method
3. Breakdown of Statutory Reserves
4. Non-Guaranteed Benefits
5. Long Term Lapse/Surrender Rates

Possible Scope of Subsequent Guidance Notes

a. Risk-Based Capital
b. Certification of Non-Life Policy Reserves
c. Presentation of Statutory Valuation Results in the Annual Statement (Analysis of Reserves, Exhibits 8 & 8A)
d. Appointed Actuary Framework
e. Cash Value Basis for New Products

1. **Discount Rate**
   IC Circular 2014-42-A Section IV 1., Valuation Assumptions – Discount Rate

Guidance Notes:

The pre-tax rates, gross of any final taxes and other taxes, should be used.

Rationale:

- The discount rate is primarily a market-consistent parameter of a time value measure that is consistent with the market value basis of long term financial instruments.
- Discount rate, for purposes of reserve valuation, does not represent the expected investment income that can be generated from the supporting asset portfolio.
- Provisions for taxes are to be taken up separately in accordance with tax regulations and outside of the scope of regulatory reserve valuation.
- Only the taxes that are fully and directly proportional with the premium or benefit cash flows (such as premium tax and DST) are factored in the projected cash flows.
- Final taxes on investment income may apply only on government bonds. Since there are various asset mixes across companies, provisions for final taxes on investment income from government bonds should be taken up in the deferred tax asset/liability and not in reserve valuation.
- In the same manner, provisions for deferred tax assets/liabilities on corporate income taxes, MCIT, municipal taxes and other assets are to be taken up separately and outside the reserve valuation.

2. **Consistent Asset Valuation**
   Financial Reporting Framework under Section 189 of Republic Act No. 10607, Draft Section 2.11. Section 214 (of The Amended Insurance Code)

Guidance Notes:

For purposes of establishing an appropriate value of Net Worth (Assets – Liabilities) upon adoption of Gross Premium Valuation (GPV) on statutory reserves, the Actuary should strongly recommend to the company the use of the following asset classification for valuation basis on the specified assets supporting actuarial reserve liabilities, RBC and other related surplus reserves:

A. Available-for-sale financial assets (AFS) when the option is allowed under the prevailing PFRS, particularly for:
    a. All bonds or other instruments of indebtedness having a fixed term and rate of interest, except –
        i. Derivatives
        ii. Loans and Receivables (financial assets with fixed or determinable payments that are not quoted in an active market)
    b. Listed stocks in which the insurance company has no significant influence or control
    c. Mutual Funds and Unit Investment Trusts
    d. Other assets similar to the foregoing classes of assets
B. Financial assets at fair value through profit or loss (FVPL) when required under the prevailing PFRS

The GPV method on reserve liabilities and related surplus/RBC allocations reserves renders misleading net worth results when part of the supporting assets are valued based on Held-to-maturity investments (HTM) classification. The Actuary should disclose the carrying amounts and corresponding market values of the supporting assets classified as HTM.

Rationale:

The GPV methodology using market-consistent discount rates in the determination of actuarial reserves is consistent with the AFS valuation of assets, and to a lesser degree, with the FVPL classification of certain assets. The GPV methodology on liabilities will yield counter-intuitive net worth values when a material amount of supporting assets are valued based on HTM. RBC provisions on interest rate risks layered on top of liabilities valued on market-consistent GPV are significantly inconsistent with the HTM valuation of assets.

The basis of the Actuary's recommendation on the asset classification for valuation basis of assets supporting actuarial reserve liabilities and related surplus reserves is the following overarching principle stated in:

Financial Reporting Framework under Section 189 of Republic Act No. 10607
Draft Section 2.11. Section 214 (of The Amended Insurance Code)
Paragraph (h)

"Notwithstanding any provision contained in this section or elsewhere in this chapter, if the Commissioner finds that the interests of policyholders so permit or require, he may permit or require any class or classes of insurers authorized to do business in this country to value their investments or any class or classes thereof as of any date heretofore or hereafter in accordance with any applicable valuation or method."

3. **Breakdown of Statutory Reserves**
IC Circular 2014-42-A Appendix B, Actuarial Valuation Results

Guidance Notes:

The Actuary is also responsible for the demonstration of:

A. The impact on reserves due to changes in:
    a. The insurance policy portfolio over the relevant period,
    b. Valuation methodology
    c. Best-estimate assumptions
    d. Provisions for adverse deviations
    e. Market-consistent parameters
    f. Business models and nature of contractual obligations
B. Components of statutory reserves that may be utilized for financial reporting under PFRS and other local regulations

In the light of these purposes, the Actuary should present the following breakdown of total statutory reserves by line of business using the definitions laid out below:

Acronym	Definition
NPV	Reserves based on net premium valuation methodology
GPV	Reserves based on gross premium valuation methodology
UPR	Unearned Premium Reserves
GwPwCV	GPV Reserves with PAD and with Cash Value Floor, including GPV Reserves of policies whose GwPwoCV < CV, and excluding UPR
GwPwoCV	GPV Reserves with PAD without Cash Value Floor
GwoPwoCV	GPV Reserves without PAD and Without Cash Value Floor
NegGPV	Negative GPV Reserves with PAD
RNonGuaB	GPV Reserves for Non-Guaranteed Benefits and Policyholder Dividends (excluding those payable in the following year)
GPV-NPV	Change in reserves upon transition from NPV to GPV
GwPwCV-GwPwoCV	(or ExCV) Sum of the excess of GwPwCV over GwPwoCV on each policy whose GwPwCV > GwPwoCV
GwPwoCV-GwoPwoCV	(or PAD) Aggregate amount of provisions for adverse deviations
While UPR is presented separately, it is understood that UPR in principle is the GPV reserves for short-term insurance contracts, including those renewable at non-guaranteed premium rates. The UPR should contain, when appropriate, provisions for adverse deviations consistent with other classes of policies.	

During the transition period up to the date of the adoption of GPV, the Actuary should present, but not limited to, the following reserve amounts.

	As of End of Prior Period	As of End of Current Period	Amount Increase
NPV			
GPV			
NPV-GPV			
UPR			
NegGPV			
RNonGuaB			

During and beyond the transition period, the Actuary should present, but not limited to, the following reserve amounts:

Increase in statutory reserves during the current period

	As of End of Prior Period	**As of End of Current Period**					
		Prior to any change in assumptions	Amount Increase	After any changes in assumptions except DR	Amount Increase	Upon change in DR	Amount Increase
Total Reserves							
UPR							
GwPwCV							
GwPwoCV							
GwoPwoCV							
NegGPV							
RNonGuaB							

The following reserve breakdown and changes in reserves may be applied as follows:

Components	Possible Applications
NPV-GPV	Change in valuation methodology, primarily to match or offset impact of any change in asset classification from HTM to AFS or FVPL, and if appropriate, reported through Other Comprehensive Income (OCI) or similar accounts
GwPwCV-GwPwoCV	Equivalent provision for RBC for surrender risk
GwPwoCV-GwoPwoCV	Aggregate amount of reasonable provisions for adverse deviations
NegGPV	Non-distributable surplus allocation
Inc. in GwPwoCV during the period prior to changes in assumptions and DR	* Component of the increase in GPV reserves applicable to determination of current realized profit during the period and reported through Profit &Loss Statement
All other increases in GPV reserves	* Components of changes in GPV reserves representing portions of unrealized future profit/loss, and if appropriate, reported through OCI or similar accounts
Inc. in GwPwoCV during the period due to changes in DR	* Component of changes in GPV reserves due to change in market-consistent parameter and comparable to changes in market value of supporting assets, and if appropriate, reported through OCI or similar accounts

* Related to Financial Reporting Framework under Section 189 of Republic Act No. 10607, Appendix A, Sections 52 & 53

4. **Non-Guaranteed Benefits**
   IC Circular 2014-42-A Section IV 1., Valuation Assumptions – Non-Guaranteed Benefits

Guidance Notes:

The Actuary should determine the value of reserves for non-guaranteed benefits and policyholder dividends using, to the extent possible, consistent and verifiable basis of the following parameters:

1. Current scales of prospective non-guaranteed benefits or policyholder dividends. These shall mean:
   a. On products being marketed during the relevant reporting period, the scales appearing in sales illustrations
   b. On products which are no longer marketed during the relevant reporting period, the scales in the following order of relevance:
      i. Recently approved by the Board of Directors
      ii. Applied as the basis of most recent non-guaranteed benefits or policyholder dividends provided to policyholders
      iii. Currently stored in the administration system of the company
      iv. Used in the last set of the product's sales illustration

2. Discount rate. This shall mean:
   a. The expected future investment income rate which:
      i. Can be extrapolated from the recent levels and trend of earned investment income rates based on current asset holdings supporting the liabilities of products with non-guaranteed benefits or policyholder dividends
      ii. Takes into account investment expenses and applicable final taxes on investment income but not corporate income tax
      iii. Provides for reasonable provision for adverse deviation
      iv. Considers future reinvestment rate
      v. May be a level rate for all future years
   b. The discount rate used for discounting of guaranteed benefits if the Actuary has no adequate basis to establish the expected future investment income rate described in the preceding subsection.

The Actuary should disclose:
- The discount rate used
- The scale of rates of non-guaranteed benefits or policyholder dividends for all prospective years on a policy with issue age 35 (or other representative age) of the product with one of the most significant reserve amounts for non-guaranteed benefits
- Any changes in assumptions and basis from those in the prior year

5. **Long Term Lapse/Surrender Rates**
   IC Circular 2014-42-A Section IV 5., Valuation Assumptions – Lapse and/or Persistency

It is generally recognized that the rates of lapses, surrenders and persistency are largely dependent on macroeconomic factors, policyholder characteristics and parameters internal or specific to the company such as the product (premium term, benefits, non-forfeiture options), distribution channel, service level, etc.

Also, the volume of relevant past experience on long term lapse rates is very slow to develop.

It is therefore difficult to establish a credible basis for long term lapse rate assumptions. The overriding consideration is the consistency of assumption adopted by actuaries in the absence of adequate basis for the assumption.

The Actuary may use a best-estimate long term lapse rate between 2% to 4% p.a. for the following policy characteristics without having to justify with the rationale or establishing credibility from insufficient volume of relevant policy experience:

1. Policies already on paid-up period
2. Policies during the premium payment period but beyond the 5th policy anniversary

The Actuary however may use a best-estimate long term lapse rate outside the 2% to 4% range if the assumption is supported with sufficiently credible experience basis or if the Actuary can make declarations of a strong rationale for doing so.

Provisions for adverse deviation shall be added in accordance with the IC Circular 2014-42-A.

This does not preclude the company in building relevant experience to support the adoption of a more credible long term lapse assumption.