



FINAL

**SECTION II
EXPLANATORY NOTES
IN AMPLIFICATION OF CERTAIN
DIVIDEND RECOMMENDATIONS**

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TABLE OF CONTENTS

Section 1	General - Explanatory Note	3
Section 3	The Process of Dividend Determination - Explanatory Note	5
	The Reversionary Bonus Method.....	5
Section 5	Experience Factors - Explanatory Note	6
Section 7	Investment Income Factor - Explanatory Note	7
	A) Policy Loan Utilisation in Determining Dividends	7
	B) The Use of a Portfolio Method or an IYM Method	7
Section 10	Tax and Other Factors - Explanatory Note	8
Section 11	Termination Dividends - Explanatory Note	9
Section 13	Illustrated Dividends - Explanatory Note	10

SECTION 1. GENERAL - EXPLANATORY NOTE

Section 1 discusses the purpose and scope of the recommendations.

The purpose of the recommendations is to provide professional guidance to Fellows of the Canadian Institute of Actuaries in any work related to dividend determination and illustration with respect to participating individual life insurance and annuity policies issued for delivery in Canada.

The recommendations outline “generally accepted principles and practices” involved in dividend work and provide, in detail, items that should be considered and covered in a dividend report to management. The actuary is not restricted from following any principles and practices he chooses, although he has a professional responsibility to ensure that such principles and practices are appropriate, and should be prepared to justify them.

The Committee on Dividend Principles and Practices has given consideration to the question of policy enhancements, and the extent to which they should or should not come within the scope of the recommendations.

Currently there is no generally accepted practice as to the treatment of policy enhancements in relation to the dividend determination and distribution process. However, where an enhancement is considered by the company to be a dividend the recommendations are applicable, in particular Recommendation 16.

The recommendations apply with respect to all participating individual business issued for delivery in Canada. However, Section 1.2 states the opinion of the Institute that for participating business issued by stock companies, it is not possible to follow the contribution principle over the longer term unless:

- a) it is possible to determine the surplus earnings of the participating business, and
- b) there is a limitation on the amount that may be transferred from participating surplus to the shareholders' account.

There must be some systematic method for determining the surplus earnings of the participating business; in the absence of such a method, the limitation on shareholder participation is ineffective. The generally accepted method for determining the surplus earnings of the participating business is the maintenance of separate and distinct accounts for the participating business, as required by Section 83 of the Canadian and British Insurance Companies Act. If separate accounts are not maintained, but instead some other method is used which is applied consistently from year to year, uses sound accounting and actuarial principles, is capable of independent review and gives results similar to those which would be produced by separate accounts, the contribution principle can be followed. The actuary should describe the method in his report and compare it to separation of accounts. If the method does not meet these requirements, the actuary will not be able to say that the contribution principle has been followed in the determination of dividends.

Given that there is an appropriate method for determining the surplus earnings of the participating business, then the equally important requirement of limiting the amount that may be transferred from participating surplus to the shareholders' account must be observed. The degree of limitation on transfers to the shareholders' account which is envisaged is that of Section 84 of the Canadian and British Insurance Companies Act; for smaller companies this permits 10% of distributed participating surplus to go to the shareholders, with the 10% being reduced in steps as the companies become larger, to 2.5% in the case of larger companies.

To take an extreme example, if the shareholders of a company were to consistently receive 85% of the participating business' surplus earnings, it seems very unlikely that the dividends allotted to the company's participating policyholders could be of the same order as those allotted by a company

subject to Section 84 of the C.I.B.C. Act. Therefore, the corresponding products are not really comparable as participating products because of the very wide difference in degree of participation; similarly if the shareholders were to receive percentages of the participating business' surplus earnings which fluctuated widely from year to year. Unless the **degree of participation** is substantially the same as that described in the above paragraph, the actuary will not be able to say that the contribution principle has been followed in determination of the dividends.

Companies which are most likely to be unable to follow the contribution principle are foreign companies (especially companies domiciled in the United States and operating under state laws which place little or no restriction on the shareholders' share of profits) and companies to the law of provinces (e.g. Alberta) which do not impose regulatory constraints comparable to Section 84 of the C.B.I.C. Act.

SECTION 3 THE PROCESS OF DIVIDEND DETERMINATION - EXPLANATORY NOTE

Section 3.3 lists several different methods for determining dividends. Of these, the Reversionary Bonus Method deserves special discussion because it is a method used in Canada by some companies and it generally involves a concept of equity which is different from that of the Contribution Principle.

The balance of this Note discusses the reversionary bonus method and how it is envisaged a member would prepare a report which deals with the determination of illustration of reversionary bonuses, bearing in mind the various Recommendations.

THE REVERSIONARY BONUS METHOD

The reversionary bonus method, as customarily employed by life insurance companies in the United Kingdom, involves a concept of equity which is quite different from the Contribution Principle, although over an extended period of time it may be possible to consider the method as following the Contribution Principle.

For a given block of business and bonus scale, the reversionary bonus is a uniform percentage of the face amount of insurance and (in the case of a compound reversionary bonus scale) the amount of bonuses already allocated. For this reason, the method is known as the **uniform** reversionary bonus method.

Terminal bonuses - also expressed as percentages of the sum assured - may also be provided (they are more common under a reversionary bonus system). Historically they have been a means of reflecting a policyholder's share of capital gains realized on the underlying investments, but of recent years they have also come to reflect part of unrealized capital gains. The level of terminal bonus is expected to fluctuate downwards as well as upwards, and because any estimate of the level of future terminal bonuses is a matter of considerable doubt, some companies refuse to illustrate future terminal bonuses at the point of sale, restricting any illustration to the basic reversionary bonus.

Clearly, with such a difference in concept of equity involved, a member preparing a report concerning allocation or illustration of reversionary bonuses in respect of Canadian policies would find difficulty following exactly the procedure envisaged for a report concerning the application of the Contribution Principle. For example, to do this in a literal fashion would presumably call for a number of disclosures that particular Recommendations were not being followed and for justification of the departures. On the other hand, the Contribution Principle, or variations of it, **are** generally accepted practice in Canada, and, all things considered, it was felt by the Committee on Dividend Principles and Practices that a separate set of recommendations (or its equivalent) for the reversionary bonus method should not be proposed.

Rather, a report was envisaged which would begin by stating (in accordance with Section 2.2) that the Contribution Principle was not followed; that instead the reversionary bonus method was employed. The report would then describe the essential actuarial features of the method - in detail commensurate with that expected in a report dealing with the application of the Contribution Principle. For example, the report is expected to describe how mortality, expenses, policy loans, etc., are taken into account, how the interest rate assumptions are selected, and so forth.

It is anticipated that after members have had one or two years' experience preparing reports involving the reversionary bonus method, they will be able to advise the Committee as to possible changes in the Recommendations and possible additions to these Explanatory Notes. Meanwhile, the member should, at a minimum, follow the Recommendations set forth in Section 1, 2, 3, 11 and 13.

SECTION 5**EXPERIENCE FACTORS - EXPLANATORY NOTE**

This note deals with Section 5.6 of the Dividend Recommendations. Section 5.6 states that in the formation of experience factor classes, a company should “group together policies with similar levels of experience”. Despite this language, contractual guarantees, other legal circumstances, or existing company practices may justify paying the same dividends to policies with differing experience expectations.

An example of such a situation might be the grouping of underwritten new business policies of a particular whole life plan with conversions from term policies to that same plan. Although the company anticipates different mortality and lapse experience from these two sets of policies, it may have established an overriding agreement with the converting policyholders to treat them in all respects identically to those who purchased underwritten whole life policies. This agreement may be explicit; it may be implicit in the wording of the conversion guarantee; or it may be implicit from prior company practice. It may cause the dividend scale to be based strictly on the experience of underwritten policies despite the fact the scale also applies to some non-underwritten policies.

Another example would be the grouping together of coverage obtained through exercise of guaranteed insurability provisions with underwritten coverage. Similar situations can occur with group conversions and other contractually guaranteed options.

While the Recommendations imply that combining such differential expectation groups is contrary to generally accepted practice, such action may be regarded as permissible whenever circumstances similar to those described above are present.

SECTION 7

INVESTMENT INCOME FACTOR - EXPLANATORY NOTE

A) Policy Loan Utilization in Determining Dividends

Recommendation 10 states that it is generally accepted practice to reflect the effect of policy loans in the investment income factors. Recommendation 10 is the only one which makes explicit reference to policy loans; in addition, there is implicit reference to them in Recommendation 7, which is concerned with experience factors.

The Recommendations do not include a recommendation that the actuary should or should not take direct account of policy loan utilization rates, on a policy basis, in determining dividend scales for a particular class of participating business. Such a practice is not common in Canada.

If such a practice is being recommended or followed, the actuary's report should include the following information for the class or classes of business for which direct recognition of policy loan utilization is being considered or made:

1. A description of the methods used to determine dividends for existing policies taking into account policy loan utilization on a policy by policy basis.
2. The methods used to determine the investment income factors underlying the recommended dividend scale.

B) The Use of a Portfolio Method or an IYM Method

Recommendation 11 is as follows:

The use of either the portfolio average approach or the investment generation approach is considered generally acceptable practice. The detailed procedures for implementing either approach should have a sound theoretical basis. The actuary's report should state which approach is used for allocating investment income to the policies covered by the report. Furthermore, if the approach for a given group of policies has been changed, or if a previously unused approach is to be introduced for a new group of policies, the actuary's report should state that fact and should include a full description of the nature, rationale and effect of such new or revised approach.

The interest element is usually a major component in the amount of dividends paid to policyholders for individual life insurance and annuities. The use of a portfolio method instead of an investment year method for crediting interest will generally result in quite a different scale of dividends. However, Recommendation 11 is clear: both methods are generally acceptable.

A basic requirement is that the actuary explain the method used to allocate investment earnings by line of business for dividend purposes. In addition, since the distribution of surplus between different groups of policies is subject to the equity principle, it is important that if both methods are being used (the IYM for some groups of policies, the portfolio method for others), that they are used in a way that treats each group of policies equitably. The actuary should explain the rationale, including the method used to allocate investment earnings to the two different groups of policies.

The different characteristics of the two methods are very important in relation to illustrating future dividends. This aspect is discussed further in the explanatory note on Illustrated Dividends.

SECTION 10**TAX AND OTHER FACTORS - EXPLANATORY NOTE**

This note deals with Section 10.3 of the Dividend Recommendations. This section includes the statement that the charge for shareholder retention “can be a separate factor in the formula for the dividend scale or can be implicitly included as a part of one or more of the other experience factors”. This statement allows (but does not require) a stock company to let the charge for shareholder retention for a block of participating policies vary according to the actual experience of that block.

Take, for example, two companies which expect the mortality savings on their par blocks to be 50 cents per thousand. The first company may earmark 10 cents as shareholder retention, while the second company earmarks 20%. Thus, if actual experience equals expected, both companies will allocate 40 cents to the policyholders and keep 10 cents as profits. If actual mortality savings are double what was expected (\$1.00), however, the first company will retain 10 cents while the second retains 20 cents. Both approaches are in compliance with the Recommendations.

Some companies may provide more complicated sharing formulas, such as those incorporating sliding scales, minima, maxima, etc. In order to be in compliance, such formulas must always provide (and conversely can charge) the policyholders with a substantial share of the deviations from expected experience.

SECTION 11**TERMINATION DIVIDENDS - EXPLANATORY NOTE**

Recommendation 17 is as follows:

The actuary's report should specifically state whether termination dividends equitably reflect the incidence, size and growth of the policy's share of the amounts previously accumulated on behalf of the policies on which such dividends are payable, whether differences in termination dividends among different policies reflect differences in the corresponding amounts accumulated, and whether termination dividends are expected to be recurring and/or for a temporary period. The actuary's report should include a description of the process used to determine termination dividends, the sources of funds or the types of investment gains which are being used to support the dividend, and any changes in practice with respect to the determination of termination dividends since the last report.

A) Termination dividends paid on death, maturity, and surrender generally reflect a policyholder's share of surplus which has not been distributed through the annual dividend. This surplus may be generated by investment in common stocks and real estate, but other types of gains, including gains which do not arise from investments, may also be recognized.

The member should include a description of the source of funds or the type of investment gains which are being used to support the dividend.

The dividend program may represent a one-time distribution, or be part of a recurring process by which such gains are distributed, and the member should indicate which general approach is being followed.

If the termination dividend is expected to be paid for a period such as one to three years, but may or may not be continued thereafter, (depending on expectations at the end of the period), this should be identified in the member's report.

B) Certain deferred annuity contracts provide for annual participation to cease at retirement and a terminal dividend to be payable to reflect anticipated investment and mortality profits during the post-retirement period.

The member should describe the assumptions on which the terminal bonus is based. These assumptions will normally differ significantly from those described for the first type of termination dividend since the member will be taking a prospective view of profits.

SECTION 13

ILLUSTRATED DIVIDENDS - EXPLANATORY NOTE

Recommendation 23 is as follows:

The actuary's primary professional responsibility with regard to illustrated dividends is to ensure that the dividends appropriately reflect the current financial results of the company and are related to paid dividends in an equitable justifiable manner.

This is an important recommendation. Any inequity between new business and old, as evidenced by new business dividend illustrations, is not acceptable. Recommendations 21 and 22 address specific aspects of the problems as follows:

Recommendation 21:

The actuary should conduct tests of illustrated dividends which are adequate to judge whether those illustrated dividends could be paid in the near future. If there is a substantial probability that the illustrated dividend scale will not be supportable in the near future, the actuary's report should include a statement to that effect.

Recommendation 22:

The actuary's report should identify the time period used to determine the portfolio or investment generation rate of return for policies to which the illustrated dividends apply.

The Recommendations are concerned with Dividend Determination and Illustration. They require appropriate disclosure of dividend practices to Management. They do not, however, cover disclosure to regulatory bodies or the consumer.

Nevertheless, since the Recommendations require that illustrated dividends reflect the current financial results of the company and are related to paid dividends in an equitable, justifiable manner, then the report should advise management as to how illustrated dividends are influenced by certain dividend practices. This applies to existing as well as to new business.

Examples of practices that may have a significant impact on illustrated dividends, particularly if there is a substantial difference between treatment of older policies and new policies, are:

1. Policy Loan Utilization

If the dividend determination for a class of policies is based on direct recognition of policy loan usage, the report should explain the impact of policy loan utilization on dividends, and state how dividend illustrations identify the particular assumptions as to the loan utilization rate.

2. Investment Generation Interest Rate

If the dividend determination for a class of policies is based on investment generation interest rates, the report should explain how changes in interest rates will impact dividends, and how dividend illustrations identify the interest rate assumed.

3. Termination Dividends

If termination dividends are provided, the report should explain the terms and conditions under which they are payable, and how these termination dividends are identified in dividend illustrations.

Sections 13.3 and 13.4 of the Recommendations state that if “there is a substantial probability that an illustrated dividend scale will not be maintained in the near future,” the actuary should either reduce the illustrated dividend scale or note the fact in his report.

Such circumstances can arise for a variety of reasons. Obviously, expected future unfavourable events, such as an anticipated drop in interest rates or other anticipated experience deteriorations, could result in such a situation.

It is less obvious, but perhaps equally important, that both current and future **favourable** events could also result in such a situation.

For example, a large temporary increase in distributable surplus could result from such current favourable events as the following: A large capital gain or a large tax reduction or recovery.

As mentioned above, not only current, but **future** favourable events could also imperil a current dividend scale. For example, an anticipated huge growth in future sales could generate future surplus strain that would result in a future temporary decrease in distributable surplus.