



EXPLANATORY MEMORANDUM TO PRACTICE GUIDELINE 199.03: ECONOMIC VALUATIONS

March 2011

About this Explanatory Memorandum

This Explanatory Memorandum has been prepared to assist Members in understanding Practice Guideline 199.03 (Economic Valuations) ("PG 199.03"). PG 199.03 replaces the existing Guidance Note 552 (Economic Valuations) ("GN 552") last issued in July 2004.

Introduction

In July 2006, the Institute issued a Policy for Drafting and Developing Practice Guidelines (the "PG Policy") which was subsequently amended in August 2008. The Policy – developed in conjunction with the Policy for Drafting Professional Standards ("PS Policy") – is designed to ensure that all Practice Guidelines are drafted and developed in a consistent manner and in consultation with relevant and interested members of the Institute (and, where necessary, external parties). A Practice Guideline is issued to formally capture and document generally accepted actuarial practices and techniques.

Following the introduction of the PG Policy, all existing Guidance Notes are to be re-drafted in accordance with such, either as a Professional Standard or Practice Guideline (as relevant).

PG 199.03 was developed to convert and update GN 552 in accordance with the PG Policy.

Review process and consultation

In late 2009, an Economic Valuations Taskforce ("Taskforce") (which reported to the Life Insurance and Wealth Management Practice Committee) was formed, the objective of which was to update GN 552 and Guidance Note 252 (Economic Valuations of Life Insurance Business) ("GN 252") for changes in market practice (including the impact of the global financial crisis) and emerging changes, and also to take account of changes to the Code of Professional Conduct. The Taskforce was also to consider whether a separate life insurance guidance note was required or whether a single note could be prepared.



The members of the Taskforce were:

Rob Daly (Convenor)
Michelle Cater
Trang Duncanson
David Goodsall
David Minty
Anne Peters (Institute representative)
Ian Robinson

As part of the development of an Exposure Draft of PG 199.03, the Taskforce conducted a survey of Members to enhance its understanding of, *inter alia*, the utility of both GN 552 and GN 252 and the need for separate guidance. Seventy Members responded to the survey.

After further deliberation, the Taskforce decided to first release the Exposure Draft of PG 199.03, before consulting on the conversion of GN 252. As PG 199.03 set out the general framework for economic valuations, the Taskforce considered that it would be more efficient to deal with the general framework initially, before proceeding to consult on supplementary guidance such as GN 252. Three submissions were received in response to the Exposure Draft.

Amendments made to PG 199.03 in response were to:

- ▶ make clear that PG 199.03 does not apply to valuations performed under a Professional Standard or to liability-only valuations performed under another Practice Guideline;
- ▶ expand the definition of 'Economic Asset' to make it clear that PG 199.03 does apply to liability-only valuations (unless the specific exclusions apply);
- ▶ incorporate an additional circumstance in clause 1.3 where an economic valuation may be carried out;
- ▶ specifically include transaction costs in the transaction-specific factors set out in clause 4.4.2;
- ▶ specifically deal with the issue of averaging results through amendment of clause 5.3.4; and
- ▶ better cater for the variety of discounted cash flow valuation methods which may be applied, through amendments of clauses 5.5.1 and 5.7.1.

During the consultation process, it was also clarified that PG 199.03 would not generally apply to calculations and advice in respect of individuals such as superannuation transfer values, equitable apportionments, pension commutations and conversion of



defined benefits to accumulation form, or to advice in respect of capital items such as risk reserves.

Key changes to GN 552

The key changes to GN 552 reflected in PG 199.03 are:

- ▶ updates to reflect the language, structural and other requirements laid down in the Policy;
- ▶ re-ordering of a number of the provisions to provide a more logical structure, including shifting much of the background and general information to an annexure for ease of reference;
- ▶ the inclusion of additional material on distressed and illiquid markets;
- ▶ updating for recent developments in the “fair value” debate; and
- ▶ changes to the reporting provisions to reflect recent changes to the Code of Professional Conduct and the development of PG 199.01 (Prescribed Actuarial Advice Reporting).

Choice of language

As Members will be aware, the PS Policy provides that only Professional Standards set out mandatory duties and requirements. Such mandatory duties and requirements are denoted by the use of the word “must”. The PS Policy also requires that the words “should” and “shall” are not to be used in a Professional Standard.

The PG Policy reflects the PS Policy and states that Practice Guidelines do not set out mandatory duties for Members and that the words “must” and “shall” are not to be used in a Practice Guideline.

The word “should” – as used in the Practice Guideline – needs to be viewed in this context. Notwithstanding some dictionary definitions of the meaning of “should”, in the present context (as the above policies make clear) the word does not denote a mandatory requirement; rather, as emphasised by clause 1.4 of PG 199.03, the term is used to reflect what are considered to be generally accepted practices and techniques. This reading of the word “should” is given further emphasis by clauses 1.2.2 and 1.2.3 of PG 199.03 (being clauses required to be included in a Practice Guideline under the PG Policy).



GN 252

GN 252 (which was developed as a supplement to GN 552) has been withdrawn. However, it will remain available in the relevant archive section of the Institute's website.

There were several reasons for withdrawing GN 252, including:

- ▶ member feedback in a survey;
- ▶ the fact that the reasons as to why GN 252 was developed originally – that there were a variety of approaches for determining embedded values and appraisal values – was no longer relevant as such values no longer form part of the financial statements of life companies;
- ▶ there was no clear evidence that the investor community was aware of the existence of the Guidance Note nor evidence of disparate industry practice occurring which might otherwise confuse users of the relevant information;
- ▶ the relevant principles to be adopted, and guidance, was available through other means; and
- ▶ the considerable administrative and compliance costs associated with retaining any Guidance Note.

Commencement

PG 199.03 commences on 1 October 2011.

END OF EXPLANATORY MEMORANDUM