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canadian institute of actuaries institut canadien des actuaires

July 23, 1981

To: All Members of the
Canadian Institute of Actuaries

From: The Committee on Dividend Principles and Practices

Re: Recommendation on Dividend Principles and Practices

At the June, 1981 meeting of the C.I.A. Council, the Committee on Dividend Principles and Practices presented a report outlining the development of proposed Recommendations on dividend principles and practices. The Council approved the principle of issuing Recommendations on this subject and also approved the distribution of the proposed Recommendations as an exposure draft to the membership for consideration and comment.

The exposure draft of such Recommendations is attached as well as a copy of the Committee's report to Council. Also attached is a draft Opinion CIA-7 which the Recommendations would support. This will be submitted to the Committee on Professional Conduct for their comment.

It is hoped that the Recommendations can be applied to dividend scales adopted in 1983 and later. In order to provide adequate time for members to structure their dividend work in accordance with such Recommendations, it will be necessary that such Recommendations be adopted by the general membership at the November, 1981 meeting of the Institute. The Committee therefore requires that any comments on this exposure draft of the Recommendations be received by them no later than September 15, 1981.

The following comments regarding the proposed Recommendations should be noted:

(1) The Recommendations are not intended to limit the actions of any dividend actuary in determining the manner in which divisible surplus of any company is distributed to its participating policyholders. Rather, the Recommendations outline in detail the information which should be disclosed in the dividend actuary's report. For example, one of the Recommendations requires that the actuary's report should include a statement that the Contribution Principle has been followed, or, if it has not been followed, the report should explicitly state any deviations and their rationale. Actuaries recommending the use of methods of distribution such as the Reversionary Bonus Method would have to provide specific comment if they felt that the application of such methods did not follow the Contribution Principle. In this connection, however, Section 3.3 of the Recommendations should be noted. This section

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points out that it is the application of a particular method, not the method itself, which determines whether the Contribution Principle has been followed.

(2) It is not envisaged that the Recommendations would remain static but rather it is anticipated that changes will be required as new forms of surplus distribution emerge. The Committee expects to maintain an on-going role to ensure that the Recommendations remain current with changes in dividend practices which may emerge. However, it feels it would be appropriate to adopt these Recommendations at this point to provide uniformity with the Recommendations already adopted by the American Academy in the United States.

Please submit any comments on this exposure draft of the Recommendations to the Chairman of the Committee, in writing, no later than September 15, 1981.

COMMITTEE ON DIVIDEND PRINCIPLES AND PRACTICES

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Attachments.

May 21, 1981.

Report to the Council of the C.I.A.

From: The Committee on Dividend Principles and Practices

Our committee was appointed in November 1978. The charge to the committee was as follows:

> "To study the underlying actuarial principles and practical problems relating to the calculation and illustration of policyholder dividends, including related matters of philosophy, and to develop guidelines concerning appropriate standards of practice for the practicing actuary. The committee should coordinate its work with the Society of Actuaries' Committee on Dividend Philosophy and the American Academy of Actuaries' Committee on Dividend Principles and Practices."

The appointment of the committee stemmed from a request by the Board of Governors of the Society of Actuaries, following receipt of the August 1978 Report of the Society Committee on Dividend Philosophy. The Board requested that the Canadian Institute of Actuaries and the American Academy of Actuaries be asked to set in motion implementation of appropriate standards of practice as called for by the Society committee's current and future work.

In June 1980, the Society Committee developed and distributed for comment Draft 11 of the "Recommendations Concerning Dividend Principles and Practices in Connection with Dividend Determination and Illustration for Individual Life Insurance". The current work of the Society Committee, in addition to consideration of comments received by Society members on Draft 11, is directed towards the development of guidelines applicable to the participating business of stock companies as well as consideration of non-participating policies featuring non-guaranteed premiums and/or benefits and participating annuity policies.

In January 1981, the American Academy of Actuaries published its Recommendations of the Committee on Dividend Principles and Practices as adopted by its board of directors in October 1980. Due to the broad range of concerns expressed on U.S. stock company issues, the Recommendations are applicable specifically to mutual companies, for dividend scales adopted for policy anniversaries in 1982 and lat The current work of the Committee, in addition to considering responses to comments

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received, is directed towards (a) the development of guidelines applicable to stock companies, as well as for dividends on annuity policies (b) consideration of possible disclosure in the statutory statement and possible changes in the Life Insurance Buyer's Guide and (c) the preparation of a checklist concerning mandatory and optional items contained in the Recommendations.

The consumerist and regulatory pressure exerted in the U.S. actuarial profession regarding dividend matters does not exist to the same degree in Canada. However, it is not difficult to visualize the underlying concerns intensifying in Canada as well. For example, the recent report of the Ontario Select Committee on Company Law outlined a number of recommendations regarding the practices of life insurance companies with respect to the illustration and payout of dividends.

The Declaration of Guiding Principles of the Canadian Institute clearly anticipates that guidance will be given to members on important professional matters.

The Guides to Professional Conduct provide that the member will exercise his best judgement to ensure "that the methods employed are consistent with the sound principles established by precedents or common usage within the profession". The Guides contain two supporting opinions on specific subject matters, namely actuarial principles and practices in connection with pension plans, and actuarial principles and practices for the valuation actuary. In both of these subject areas, an actuarial certification is required by statute, and this actuarial certificate is relied upon by members of the public other than the client who commissioned the actuarial report. Both of these subject areas are complex, and the actuarial profession has agreed that guidance to the practicing actuary is needed for the public interest. Although there is currently no requirement that an actuary certify to the dividend determination practices of an insurance company, this fact should not prevent the Institute from recognizing the need for some guidance to the practicing actuary in this important area.

It is, therefore, recommended that the attached draft set of recommendations, dated May 21, 1981, be distributed to the membership as soon as possible, with a view to the possible adoption of the Recommendations at the November 1981 meeting of the Institute.

The committee would ask that the membership of the C.I.A. give their comments on this exposure draft to members of the committee by September. If it then appears that any changes which should be made are not material, a revised draft of the Recommendations incorporating these changes would be presented at the November meeting for adoption by the membership. The Recommendations would be applicable to 1983 and later dividends. If it appears that material changes are needed, an exposure of revised Recommendations would be made before presenting them at a C.I.A. meeting.

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In view of the considerable amount of drafting already done by both the Society and Academy committees, the attached Recommendations are quite similar to the corresponding Recommendations produced by those bodies. This is particularly true of the Recommendations adopted by the Academy. Therefore, it may be helpful to the membership to summarize the differences between the draft C.I.A. Recommendations and the Academy Recommendations.

1. The title of the Recommendations indicates that the Recommendations are applicable to participating annuity contracts as well as to participating insurance policies. Several detailed changes in the text of the Recommendations are required for this purpose. It is felt that participating annuity contracts in Canada would normally follow the contribution principle.

2. The Academy Recommendations do not apply to stock companies because many U.S. stock companies are not required to separate their par and non-par accounts, nor do they have limits on the amount that may be transferred from par surplus to the shareholders' account. The situation is different in Canada where federally registered Canadian stock companies (as well as provincially registered Ontario and Quebec stock companies) do have these requirements. Therefore, we have specified in Section 1.2 that the Recommendations apply to such companies.

   This means that the Recommendations do not apply in the case of stock companies which are foreign companies or which are provincially registered in one of the other provinces. It may be that there are very few companies issuing participating business who would be excluded by this limitation. Furthermore, actuaries for such companies may feel that they could nonetheless comply with the Recommendations. The committee would appreciate comments from the membership concerning whether the limitation could, or should, be removed.

3. These Recommendations have been changed from the Academy version in several places to emphasize the Canadian viewpoint:

   e.g. - in Section 1.7 concerning references in actuarial literature, to mention C.I.A. journals

   - in Section 5.1 on policy loans, to refer to the loan situation in Canada

   - in Section 10.1 on taxes, to eliminate reference to U.S. taxes

4. The Recommendations include some additional wording in Section 3.3, in the second last paragraph, which has applicability to methods, such as the reversionary bonus method, which are not always thought of as following the contribution principle.

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5. Where no useful purpose would be served by using slightly different wording than in the Academy Recommendations, we have used the identical wording. Nonetheless, we have made a few relatively minor changes because we felt the changes were merited. For example, we have defined the business to which the Recommendations apply as "participating policies issued for delivery in Canada". The Academy Recommendations use the wording "... apply to dividends distributed under the provisions of participating policies issued in the United States". Also, we have added material from the Opinion on Transmittal of Actuarial Reports to remind the member of the importance of underlying data to an actuarial report.

6. The Academy Recommendations are not tied to an Opinion of the Academy because the general usage of such Opinions is undergoing change in the Academy. The attached material does include a draft Opinion CIA-7. The wording of this draft Opinion was developed by our Committee - it will be submitted to the Committee on Professional Conduct.

The committee's current feeling is that it is not appropriate to make recommendations in connection with statutory or public disclosure of dividend determination and illustration. However, it intends to study these matters further. Comments from the membership in this connection would be welcomed.

COMMITTEE ON DIVIDEND PRINCIPLES AND PRACTICES

David R. Johnston, Chairman

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| Robert M. Astley | Leon Mondoux |
| Paul C. Butler | Andrew Muirhead-Gould |
| J. Stewart Cunningham | Owen Reed |
| David Millar | D'Alton S. Rudd |

Attachments

D R A F T

RECOMMENDATIONS CONCERNING ACTUARIAL PRINCIPLES AND PRACTICES IN CONNECTION WITH DIVIDEND DETERMINATION AND ILLUSTRATION FOR PARTICIPATING INDIVIDUAL LIFE INSURANCE AND ANNUITIES

and

OPINION CIA-7

May 21, 1981

Opinion CIA-7: Actuarial Principles and Practices in Connection with Dividend Determination and Illustration for Participating Individual Life Insurance and Annuities

This Opinion is intended to interpret and amplify the application of the Institute's Guides to Professional Conduct for a member making recommendations regarding the determination and illustration of dividends for participating individual life insurance and annuities. This work will be referred to as "dividend recommendations" below.

The work of the actuary making dividend recommendations requires the exercise of professional judgment. Council believes that it is desirable to adopt principles of general application which do not prevent the member from making valid professional judgments and which the member can apply to the particular circumstances of the company.

It is the opinion of Council that Guide 4 requires that the actuary making dividend recommendations take into consideration the Recommendations Concerning Actuarial Principles and Practices in Connection with Dividend Determination and Illustration for Participating Individual Life Insurance and Annuities of the Canadian Institute of Actuaries. A member whose conduct does not conform to these Recommendations should be prepared to justify his or her departure from them to the members of the Institute appointed by Council to consider his or her conduct.

However, when the actuary makes dividend recommendations for policies in a jurisdiction which is not within the scope of the Recommendations, the actuary should take cognizance of the actuarial principles and practices in such jurisdiction.

# RECOMMENDATIONS CONCERNING ACTUARIAL PRINCIPLES AND PRACTICES IN CONNECTION WITH DIVIDEND DETERMINATION AND ILLUSTRATION FOR PARTICIPATING INDIVIDUAL LIFE INSURANCE AND ANNUITIES

## Section 1. General

1.1 These Recommendations are intended to support Opinion C.I.A.-7 in describing the basic responsibilities of the actuary in the application of sound actuarial principles and practices to the determination and illustration of dividends under participating individual life insurance and annuity policies.

1.2 These Recommendations apply to participating policies issued for delivery in Canada by:

(a) a mutual life insurance company,

(b) a stock life insurance company subject to Section 83, with respect to separate and distinct accounts, and Section 84, with respect to limitations on the distribution of participating profits to shareholders, of the Canadian and British Insurance Companies Act, and

(c) a stock life insurance company subject under provincial laws to provisions substantially the same as those of subparagraph (b).

1.3 The determination of the aggregate amount of dividends to be distributed in any year is a decision to be made by company management in light of many factors, the most significant being the continuing solvency of the company and its ability to fulfill all contractual obligations. This determination is not the subject of these Recommendations.

1.4 These Recommendations address both the determination of currently payable dividends for policies in force and the closely related process of determining illustrated future dividends for both in-force business and new business.

1.5 Opinion C.I.A.-3, Transmittal of Actuarial Reports, includes the following statements:

(a) "An actuarial report is essentially a statement of actuarial findings, conclusions or recommendations resulting from the actuary's experience and judgment, applied within the framework of a particular set of facts and assumptions."

(b) "Any manner of transmittal of an actuarial report which involves the risk that the underlying facts and assumptions, and the limitations resulting from their use, are not fully communicated to the client involves a corresponding risk that the conclusions or recommendations may be misinterpreted or misapplied. It is important, therefore, that this risk be minimized or eliminated."

(c) "When a member advises an insurance company on premiums, dividends, reserves and related matters, the client is the company, its policy-making executives and in some situations its board of directors, whether or not he is an employee of the insurance company. Thus, in such circumstances, the member should satisfy himself that the persons who requested his report are fully cognizant of the significance of his findings."

(d) "Thus, Guide 4(a) provides for the inclusion in an actuarial report of such underlying data as are essential to the findings or conclusions reported. The key test is whether another actuary, unfamiliar with the situation, would find the information sufficient to appraise the conclusions."

Consequently, these Recommendations elaborate on the requirements expressed in Opinion C.I.A.-3 and the more general provisions of the Guides to Professional Conduct, particularly Guides 2(c), 4(a) and 4(b).

1.6 RECOMMENDATION 1: Whenever an actuary advises an insurance company on dividends, either illustrated dividends or current dividends, he or she should prepare a written report which documents the advice. Such a report should include a statement describing the framework of facts, assumptions and procedures upon which the advice was based. In particular, if an actuary uses assumptions and procedures which deviate materially from those prescribed in these Recommendations, he or she should support the use of such assumptions and procedures and should include in the report an appropriate and explicit statement with respect to the nature, rationale and effect of such deviations.

1.7 "Sound actuarial principles" emerge from the utilization and adaptation of generally accepted concepts described in actuarial literature. The Study Notes for candidates for fellowship in the Society of Actuaries are valuable parts of the literature, but it should be kept in mind that the Study Notes are intended primarily to teach basic principles rather than to specify professional conduct. Furthermore, the professional journals of the Canadian Institute of Actuaries, the Society of Actuaries and other actuarial bodies provide an additional source for the presentation and discussion of actuarial principles and practices. It must also be noted that use of certain procedures related to the distribution of surplus is limited or mandated by regulatory authorities, and that compliance with such regulations must of necessity take precedence over other considerations.

## Section 2. The Contribution Principle

2.1 The basic principle of dividend determination is to distribute the aggregate divisible surplus among policies in the same proportion as the policies are considered to have contributed to divisible surplus. This is said to be the Contribution Principle. In a broad sense, the Contribution Principle provides the essential equity implied by participating business.

2.2 RECOMMENDATION 2: The use of the Contribution Principle in determining dividends is generally accepted practice. The actuary's report should include a statement that this principle has been followed. If it has not been followed, the report should explicitly state any deviations and their rationale.

## Section 3. The Process of Dividend Determination

3.1 The application of the Contribution Principle to the determination of dividends requires two basic types of elements: policy factors and experience factors. Policy factors are those elements which reflect the assumptions inherent in the standard against which experience is measured. In contrast, experience factors are those elements which reflect actual experience. Both of these types of factors are discussed in more detail in subsequent Sections of these Recommendations.

3.2 The process of dividend determination leads to a formulation which is used to calculate specific dividends. This process always requires the use of policy and experience factors. However, those factors may or may not appear in the formulation actually used to calculate the dividends.

3.3 Methods of dividend determination described in actuarial literature include:

(a) The Source of Earnings Method (Or "Contribution Method");

(b) The Asset Share Method;

(c) The Fund Method;

(d) The Experience Premium Method;

(e) The Percentage of Premium Method; and

(f) The Reversionary Bonus Method.

Other methods, including combinations and modifications of the methods above, are also described in the literature. Some methods, such as the Percentage of Premium Method, refer primarily to the formulation used to calculate dividends. Other methods, such as the Asset Share Method, refer primarily to the process used (as opposed to the wide variety of mathematical formulations which may be employed under that method).

It is the application of a particular method, by means of the experience factors, which determines whether or not it follows the contribution principle - not the method itself. C

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Also, it may be that a particular method which does not of itself satisfy the contribution principle will do so when termination dividends (see section 11) are taken into account.

3.4 RECOMMENDATION 3: The actuary's report should include a description of the process used to determine dividends as well as the manner in which the policy and experience factors are reflected in that process. The report should also describe the formulations used to calculate dividends.

3.5 Dividend determination is a process subject to practical constraints. The application of these Recommendations may reasonably be limited by the cost of calculation, the size of a particular group of policies, the cost and practical difficulty of making a dividend scale change and other similar conditions and circumstances.

3.6 RECOMMENDATION 4: When it would be impractical to apply these Recommendations directly to all policies and benefits, the actuary may continue a dividend scale or use approximations or simpler processes and formulations. When such actions are taken, their rationale and impact should be disclosed in the actuary's report.

## Section 4. Policy Factors

4.1 Policy factors are those elements which reflect the assumptions inherent in the standard against which experience is measured. Policy factors are elements which are based on the guarantees or underlying actuarial structure of the policy. Examples of policy factors are: cash values, reserves and their associated net premiums, gross premiums, policy loan interest rate, and the rates of interest and mortality used in calculating cash values and reserves.

4.2 In calculating dividends for a particular policy, the policy factors may be the actual factors of that policy or they may be reasonable approximations to the actual factors when practical considerations indicate the need for such approximations.

For example, the actual gross premium per unit of coverage may vary with mode of premium payment, size of policy, sex of insured, rating classification or other items. Often dividends are calculated using a gross premium which may be the annual mode premium for a particular size of policy of an insured of a particular sex who is classified as a standard risk. The differences between such a gross premium and the actual gross premium are intended to provide for the variations in cost associated with the items generating such differences.

4.3 RECOMMENDATION 5: The use of actual or approximate policy factors is generally accepted practice. However, the actuary should include in the report a description of the policy factors and of any changes in practice with respect to their determination for the period covered by the report.

## Section 5. Experience Factors

5.1 Experience factors are those elements which reflect actual experience. A particular experience factor reflects actual experience of a specific type. Examples of experience factors are: investment income rates, mortality rates, termination rates, and expense rates. The experience factor for a given type of experience may have several different numerical values. For example, the experience factor corresponding to investment income may have one numerical value for policies containing a six percent maximum loan rate, and a different numerical value for policies with a different maximum loan rate or no maximum loan rate. Policies may be combined into groups whose dividends are determined by using a common numerical value of a particular experience factor. Such a group will be referred to as an experience factor class with respect to that factor.

5.2 As used in this opinion, actual experience of a factor class means such experience and trends in experience to the extent that they are determinable, available, and statistically credible. When such suitable data are lacking, actual experience is to be interpreted with sound professional judgment based on experience and trends in experience of other similar classes of business either in the same company or other companies or from other sources, generally in that order of preference.

5.3 If any projection of experience trends is made in determining the experience factor value of any factor class, then such trend projections to the same point in time should be made uniformly for all classes. Such projections should be limited to a relatively short time frame (for example, to reflect the average experience expected during a period for which a dividend scale is likely to remain appropriate) and in particular, they should be used in a consistent manner for both current dividends for policies in force and for illustrated future dividends.

5.4 RECOMMENDATION 6: The actuary's report should describe the experience factor values used. If projection has been used, the type and extent of usage should be stated.

5.5 RECOMMENDATION 7: When there is more than one factor class with respect to a particular experience factor, differences in the value of such factor between any two classes should be based on differences in actual experience between those two classes. In the report, the actuary should identify each such difference. The actuary should also be prepared to provide a demonstration necessary to support such differences.

5.6 The placement of a policy within one experience factor class or another should be based on uniformly applied criteria designed to group together policies with similar levels of experience. In regard to claim factor classes, the actual occurrence or non-occurrence of a claim on a particular policy should not be a criterion for class placement of that policy.

5.7 RECOMMENDATION 8: The actuary's report should include an identification for the period covered by the report of all changes in values of experience factors and of any changes in practice with respect to determination of experience factor classes or placement of policies within them.

## Section 6. Claims Factors

6.1 Statistical data demonstrate significant and valid variations in claims rates by age for most coverages subject to these Recommendations. Therefore, an organized set of internally consistent experience factors corresponding to all ages will be considered as one factor in defining a claims factor class.

6.2 Claim rates vary to a significant extent depending on the sex of the insured. When this element is directly reflected in the experience factors, then the set of factors by age and sex will be considered as one factor in defining a claims factor class.

6.3 Another element which is significant for some coverages is the time elapsed since policy issue. When this element is directly reflected in the experience factors, then the entire set of factors by sex, age and duration will be considered as one factor in defining a claims factor class.

6.4 RECOMMENDATION 9: When there is more than one claims factor class, distinctions may be made on the basis of: risk selection class, selection process, marketing method, policy provisions, plan, premium rate, geographic location, size of policy and date of policy issue. If a basis different from any of these is used, such other basis should be stated in the report, along with an explanation of the rationale and effect of such other basis.

## Section 7. Investment Income Factors

7.1 The investment income experience factor generally reflects the investment experience of the individual line of business for which dividends are being determined. This may include not only interest earnings reduced by investment expense, but also the effects of capital gains and losses. Furthermore, the effect of taxation may be reflected as a reduction of before tax investment income. Alternatively, such tax may be treated separately and is addressed on a more general basis in Section 9. The investment income experience factor which results from taking account of the items above, as well as those discussed in the balance of this Section, may have several different numerical values. A group of policies with a common numerical value for this factor constitutes an experience factor class with respect to investment income.

7.2 The investment income for a given group of policies may be directly affected by policy loans. The effect depends on the contractual or actual policy loan interest rate, the corresponding rate after policy loan related expenses, and the utilization rate of loanable funds. The utilization rate may depend on the contractual loan interest rate, the plan and the size of policy.

7.3 RECOMMENDATION 10: It is generally accepted practice to reflect the effect of policy loans in the investment income factors.

7.4 The investment income, excluding the effect of policy loans, for a given group of policies is directly affected by:

(a) the amount and timing of investable cash flow generated by the insurance operations of the group of policies;

(b) the investment income rates initially and subsequently applicable to that cash flow due to investments actually made;

(c) the rate of rollover of those investments, which affects investable cash flow in subsequent periods.

The portfolio average approach for determining rates of investment income averages the effect of these items over all groups of policies. The investment generation approach recognizes the effect of these items separately on various groups of policies. Various mixed approaches are possible. For example, a company may use an investment generation approach to allocate investment income to the various annual statement lines of business, but use a portfolio average approach to allocate investment income within one or more such line of business.

7.5 RECOMMENDATION 11: 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.

## Section 8. Termination Factors

8.1 The termination factors represent annual rates of termination of coverage for reasons other than claim.

8.2 Termination factors display significant variation by the time elapsed since policy issue. Other elements which have a significant impact on termination factors include age at issue, sex, frequency of premium payment, plan and size of the policy. An organized set of internally consistent experience factors corresponding to the preceding elements will be considered as one factor in defining a termination rate factor class.

## Section 9. Expense Factors

9.1 Expenses incurred on behalf of a group of policies may in fact depend on most or all of the various elements present in the policies and on the risks insured. Such elements include, but are not limited to, the items listed elsewhere in these Recommendations which affect claims and interest factors. Some expenses are direct in that they can be specifically related to a particular policy. For example, a portion of marketing compensation is usually a direct expense as are certain costs relating to risk selection and policy issue and maintenance. Other expenses are indirect, such as general overhead costs.

Marketing, underwriting, and other costs connected with acquisition of policies may be allocated to all policies or may be recognized specifically as non-level costs to be charged to a policy and amortized. Select mortality savings may be used as an offset to these costs. To the extent that these costs are specifically recognized and amortized, the period and the pattern of amortization will depend on assumptions as to rates of interest and termination.

9.2 RECOMMENDATION 12: In the determination of unit expense rates for dividend purposes, direct costs should be charged to the groups of policies generating those costs and indirect costs should be allocated using sound principles of expense allocation. To the extent that non-level costs are amortized, the amortization should be based on realistic interest and termination rates appropriate for the groups of policies to which they are applied.

9.3 An expense factor class is defined as a group of policies which share a consistent and uniformly applied approach for assessing expenses among policies within that group. More specifically, such a group of policies share a common set of unit expense rates. Those unit rates may be a combination of amounts which, for example, are applied per policy, termination and claim; per unit of risk, coverage, premium, loading, reserves, cash value and expected claims; and per year of premium paying period and coverage period. Further, any of these unit rates may vary by issue age or policy duration and may be modified for tax status, risk class, policy size or other elements. In addition, when there is amortization of non-level costs, a common approach is necessary for that amortization, as well as a common interest rate and set of appropriate termination rates.

9.4 There is considerable latitude in the possible approaches for allocating indirect costs within various groups of policies. Amortization periods and patterns may also vary widely. Different approaches may have been taken at the inception of various historical blocks of business. These variations make reconciliation of different expense factor classes a complex process. One approach to reconciliation is to consider the total expenses charged to one class in relation to another. Total expenses charged to a class are those based on the unit expense rates for that class with due regard for the amortization of non-level expenses.

9.5 RECOMMENDATION 13: A minimum test of consistency between two expense factor classes is that any difference in the total expense charged to each class should be justifiable and in accordance with sound principles of expense analysis. The actuary should include a statement to this effect in the report.

## Section 10. Tax and Other Factors

10.1 Details of taxation may vary widely depending on the application of law and regulation in various jurisdictions. However, differences in dividends resulting from differences in taxation should reflect the elements addressed in the tax law.

10.2 RECOMMENDATION 14: Variations in tax factors used in determining dividends should reflect corresponding variations inherent in the applicable laws and regulations imposing that tax and should be consistent with other experience factors.

10.3 Adjustments to dividends are frequently made for a variety of special reasons such as:

(a) to reflect unusual gains or losses on certain supplementary benefit riders;

(b) to reflect losses arising from the presence of settlement option guarantees;

(c) to smooth the transition from one dividend scale to another;

(d) to provide consistency in quantity discounts made to varying degrees in the gross premium structure;

(e) to serve as a balancing item so that aggregate dividends equal aggregate divisible surplus;

(f) to distribute gains from extraneous sources such as non-par benefits or lines of business; and

(g) to smooth the incidence of dividends within a dividend scale by policy duration.

10.4 RECOMMENDATION 15: The actuary's report should specifically state any special adjustments which are made to dividends, and the actuary should be prepared to provide demonstrations which support the existence and magnitude of such adjustments.

## Section 11. Termination Dividends

11.1 The preceding Sections have primarily been directed toward the determination of annual dividends. A number of companies also provide for termination dividends payable upon events such as death, maturity and surrender. Such a termination dividend represents the release of an equitable share of surplus and other contingency funds accrued to cover the risks associated with that policy and all others in force at the time of termination of the policy.

11.2 RECOMMENDATION 16: Termination dividends represent in effect the release of amounts previously accumulated on behalf of the policies on which such dividends are payable. The actuary's report should specifically state whether termination dividends equitably reflect the incidence, size and growth of the policy's share of such amounts and whether differences in termination dividends among different policies reflect differences in the corresponding amounts accumulated. The actuary's report should also include a description of the process used to determine termination dividends and describe any changes in practice with respect to the determination of termination dividends since the last report.

## Section 12. Illustrated Dividends

12.1 The methods and procedures stated in these Recommendations are intended to apply equally to currently payable dividends for policies in force and to illustrated future dividends for both inforce policies and new policies. When a factor value different from any value of the same factor applicable to older policies is applied to any new policies, special care and attention is required to ensure that the differences in experience factors are based upon sound data, reasonable expectations and equitable methods.

12.2 The actuary may find it desirable to assume a conservative posture in determining an experience factor value applicable only to new or recent issues, if such value differs from values used for any existing policies. In such a case, it is important to bear in mind the degree of uncertainty that exists when factor variations are based upon limited experience data.

12.3 Circumstances can arise under which there is a substantial probability that an illustrated dividend scale which is consistent with current experience cannot be maintained in the near future because of the expected deterioration of experience. In such a situation, the actuary may find it desirable to have as the illustrated dividend scale a reduced scale which is consistent with the expected experience.

12.4 RECOMMENDATION 17: The actuary should conduct tests of illustrated dividends which are adequate to determine whether those illustrated dividends could be paid, if current experience continues. For this purpose, current experience is that which underlies the current scale of dividends payable.

12.5 RECOMMENDATION 18: If there is a substantial probability that the illustrated dividend scale cannot be maintained in the near future because of the expected deterioration of experience, the actuary's report should include a statement to that effect.

12.6 Recommendation 11 states that both the portfolio average approach and the investment generation approach are considered to be generally acceptable practice. However, the difference in effect of these two approaches on illustrated dividends may be considerable. This difference is essentially due to the difference in time periods over which an investment generation is determined. For the portfolio method, the time period is the age of the oldest outstanding investment. For the investment generation method, the time period may be 1 year but may also be longer or shorter. For long periods, the two approaches become more and more similar regardless of the past pattern of new investment yields available, for short periods, they may become more dissimilar depending on that past pattern.

12.7 RECOMMENDATION 19: 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.

12.8 RECOMMENDATION 20: 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 responsibility must be adequately discharged, despite the actuary's recognition of the important role that illustrated dividends play in product cost comparisons and competition in the marketplace.