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Educational Note

Guidance on Fairness Opinions Required Under the Insurance Companies Act Pursuant to Bill C-57 (2005)

Task Force on Bill C-57

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Memorandum

To: All Fellows, Affiliates, Associates and Correspondents of the Canadian Institute of Actuaries

From: Phil Rivard, Chair
Practice Council

Nick Bauer, Chair
Task Force on Bill C-57

Date: December 14, 2011

Subject: **Educational Note: Guidance on Fairness Opinions Required Under the Insurance Companies Act Pursuant to Bill C-57 (2005)**

With the changes made to the Insurance Companies Act as a result of Bill C-57 (2005) there are new governance requirements for boards of directors with respect to dividend policies, management of participating accounts and changes to adjustable policies at the sole discretion of the company. The same legislation imposed on appointed actuaries the requirement to opine on the fairness of those policies and management practices. The purpose of this Educational Note is to assist the actuary in forming these fairness opinions.

This Educational Note contains a general section, and sections dealing with management of participating accounts, dividends and adjustable policies.

In accordance with the Institute's Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice, this Educational Note has been prepared by the Task Force on Bill C-57, and has received final approval for distribution by the Practice Council on December 8, 2011.

As outlined in subsection 1220 of the Standards of Practice, "*The actuary should be familiar with relevant Educational Notes and other designated educational material*." That subsection explains further that a "practice which the Educational Notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation." As well, "Educational Notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them."

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1. GENERAL

1.1 Purpose and Scope

With the changes made to the Insurance Companies Act (ICA) as a result of Bill C-57 (2005) there are new governance requirements for boards of directors on establishing policies respecting participating policyholder dividends and bonuses and the management of participating accounts and criteria that the company will follow when making changes to adjustable policies. The same legislation imposed on appointed actuaries the requirement to opine on the fairness of those policies and management practices. The purpose of this Educational Note is to assist the actuary in forming these fairness opinions and, in fulfilling that purpose, is not restricted to a discussion of the changes in the Insurance Companies Act and the Policyholder Disclosure Regulations.

After this General section, the following three sections of the Educational Note will consider fairness opinions required in respect of the management of participating accounts, dividends and adjustable policies.

1.2 Background

The Parliament of Canada adopted Bill C-57 (2005), amending the ICA, in November 2005. Certain sections amended by Bill C-57 (2005) dealing with corporate governance were not proclaimed at that time because supporting regulations had not yet been registered. The regulations were necessary for compliance with, and proper administration of, those sections.

The relevant sections of the ICA, introduced or amended by Bill C-57 (2005), apply only to federally licensed Canadian life insurers and deal with

- management of participating accounts,
- determination of dividends and bonuses, and
- criteria for making changes to adjustable policies.

These sections introduce the requirement that the "company's actuary", that is, the Appointed Actuary (AA), must opine on the fairness of the policies and practices adopted by the board of directors with respect to these matters. (There are also new and existing requirements for the board of directors to adopt and maintain such policies.)

In November 2010 the new Policyholders Disclosure Regulations, which support the ICA on the subject of participating and adjustable policies, were enacted with an effective date of June 1, 2011.

1.3 Applicability

The participating and adjustable policies requirements referred to in the ICA apply to Canadian incorporated life insurance companies, including any branch operations outside of Canada. These requirements of the ICA do not apply to provincially-incorporated insurance companies, to fraternal benefit societies, to foreign subsidiaries of a Canadian insurance company or to the Canadian branch business of a foreign insurance company. Nevertheless this Educational Note may be a useful reference for actuaries doing work related to participating and adjustable business not falling within the scope of Bill C-57 (2005).

For companies with no existing participating or adjustable business in force as of June 1, 2011, the required policies must be in place before any such insurance policies are issued after that date.

For companies that have participating or adjustable policies in force as of June 1, 2011, the effective date of the amendments is, in respect of both in-force and newly-written policies, six months after the regulations have been registered, i.e., December 1, 2011. The only exceptions are the requirements with respect to dividend policy, which become effective on June 1, 2011. The reason for the earlier date is that the dividend policy was mandatory under the ICA prior to the adoption of Bill C-57 (2005) and is, therefore, effective immediately.

The effective date for all fairness opinions, including the one on the policy for determining dividends and bonuses, is December 1, 2011.

1.4 Summary of Changes and Sources of Guidance

The following list summarizes those sections of the ICA that have been changed by Bill C-57 (2005) that would be of primary interest to the actuary in the context of fairness opinions relating to participating and adjustable policies.

> Section 165 (2)(e), which specifies the duties of directors to establish a policy for determining dividends and bonuses, has been expanded to require a policy for the management of the participating accounts and the establishment of criteria for changes made to adjustable policies.
>
> Section 165 (3) has been expanded to require several reports and opinions from the Appointed Actuary.
>
> Section 165 (4) is new and specifies notification requirements to the Superintendent and disclosure requirements to shareholders and policyholders.
>
> Section 464 (2) has been amended to require a fairness opinion concerning the declaration of participating dividends.
>
> Section 464.1 has been added to require a fairness opinion for adjustable policy adjustments and to require notification of adjustments to policyholders.

The Policyholder Disclosure Regulations provide additional guidance on what is required to comply with the ICA changes.

1.4.1 ICA Requirements

The table below provides a short summary of the new or revised ICA requirements for a company that already has participating or adjustable business in force as of June 1, 2011.

ICA Reference	Board Policies	Fairness Opinions (required annually)	Communication
Policy for determining dividends and bonuses (for participating products) 165(2)(e) 165(3)(1) 464(2)	Policy for determining dividends and bonuses ***(Revision)***	▪ AA opinion that policy is fair and continues to be fair ***(New)*** ▪ AA opinion that dividend actions are fair and in accordance with policy ***(Revision)***	▪ Communication of policy to participating policyholders ***(Revision)*** ▪ Make policy available to policyholders and others ***(New)***
Participating Fund Management Policy 165(2)(e.1) 165(3.2)	Policy documenting how participating funds are managed ***(New)***	▪ AA opinion that policy is fair and continues to be fair ***(New)***	▪ Annual meeting information to include financial data and summary of policy ***(New)*** ▪ Make policy available to policyholders and others ***(New)***
Adjustable Policy (for adjustable products) 165(2)(e.2) 165(3.3) 464.1(1)	Policy documenting adjustment criteria ***(New)***	▪ AA opinion that policy is fair and continues to be fair ***(New)*** ▪ AA opinion that adjustments are fair ***(New)***	▪ Communicate adjustments to policyholders within 30 days of policy anniversary ***(New)*** ▪ Make policy available to policyholders and others ***(New)***

In addition, the following existing requirements are continued,

an opinion that the [proposed] payment to shareholders or transfer to the shareholders' account would not materially affect the company's ability to comply with its dividend or bonus policy or to maintain the level of dividends or bonuses paid to the company's participating policyholders (ICA subsection 461(c)),

an opinion that the method of allocation of investment income is fair and equitable to the participating policyholders (ICA section 457),

an opinion that the allocation of expenses, including taxes, is fair and equitable to the participating policyholders (ICA section 458), and

a report to the directors on the fairness of the method used for allocating investment income and losses and expenses to a participating account (ICA section 460).

1.4.2 Standards

The insurance-specific Standards of Practice (subsection 2460) have been updated to provide standardized wording for the new, unqualified, opinions required of the Appointed Actuary. If the opinion must be qualified for any reason, the actuary would amend the wording to reflect that qualification.

In addition, though not yet part of the Standards of Practice, the existing standard, Recommendations: Dividend Determination and Illustration (CIA: amended March 1986) and Section II Explanatory Notes (CIA: amended March 1986 and June 1987), are still applicable.

1.4.3 OSFI Guidance Note

In addition to the regulatory requirements and Standards of Practice changes outlined above, OSFI has promulgated guidelines setting out its expectations with respect to the implementation of the requirements of the ICA and Regulations regarding the management of participating accounts, determination of dividends and bonuses, and changes to adjustable policies. The OSFI guidance also sets out OSFI's requirements with respect to the operation of closed blocks resulting from demutualization.

1.5 General Considerations of Fairness

1.5.1 Definition/Description of Fairness

At a high level, fairness balances the interests of the company with the interests of the policy owners, and, further, the policy owners' interests among each other, although any material threat to company solvency may take precedence over all other considerations.

This Educational Note does not attempt to provide a precise definition of fairness. Fairness is neither unique nor immutable. For example, more than one method of allocation or adjustment can be fair, and changing circumstances may in turn change what is perceived to be fair.

There are, however, a number of general principles that, if followed in establishing and applying policies, would be expected to result in policies and practices that would be considered to be fair.

Experience factor classes[1] would be established at issue. These classifications would not be expected to change to the detriment of a class or group except as justified or required as a result of external circumstances arising after issue. An example might be post-issue changes in taxation affecting only some policies or affecting different classes differently. Justification would be documented and

[1] The OSFI guideline and other actuarial literature refers variously to "cohorts, policy classes, dividend classes" or similar expressions. Consistently with the Recommendations—Dividend Determination and Illustration, this Educational Note uses the expression "experience factor classes".

supported, and would be free from arbitrary bias against any particular group or class.

Policies would be applied consistently over time.

The method for determining dividends and changes to adjustable policies would be based on objective quantifications, to the extent practicable.

Actual dividends and changes to adjustable policies would be consistent with policy contracts, communications with policy owners, policies and criteria established by the board, and applicable law.

Pooling experience beyond policy owner reasonable expectations or arbitrary cross-subsidization across classes would be avoided to the extent practicable. See section 1.5.6 for additional considerations.

The remainder of this section discusses several more considerations that might apply in forming fairness opinions with respect to both the policies related to dividends and participating accounts and the criteria for making changes to adjustable policies.

1.5.2 Consistency

The policy for determining dividends and bonuses, the policy regarding participating account management and, where applicable, any operating rules adopted upon the creation of closed blocks (on demutualization or otherwise) would be internally consistent. The structure of the participating accounts, including the methods for allocation of expenses, taxes and investment income, would be aligned with and support these policies.

1.5.3 Completeness

The policies and criteria would address all the items that are required to be addressed in the Policyholders Disclosure Regulations. The actuary would refer to the guidance from OSFI and the CIA in assessing their completeness.

1.5.4 Verification

Appointed actuaries would satisfy themselves that the policies related to participating products and the criteria for changes to adjustable policies are being applied appropriately. They would

satisfy themselves that verifiable processes are established,

satisfy themselves that documentation of the related controls is in place, and

normally rely on internal and external audit to validate the effectiveness and completeness of these controls, but bring any perceived shortcomings to their attention.

They would also satisfy themselves that the results of experience studies and other objective data used in the setting of dividends and bonuses and changes to adjustable policies are documented. Both the policies and criteria would be reviewed on an ongoing basis and the actuary would verify that they have been updated as appropriate.

1.5.5 Materiality

The concept of materiality is important in assessing fairness. Materiality would generally be judged from the policy owners' perspectives, but subject to practical constraints in terms of applying the policies and criteria. While such constraints may, for example, alleviate the need to incur unreasonable expenses to ensure fairness to small groups of policy owners, practical expedients and approximations would be used to accomplish fairness objectives while keeping expenses of dividend determination or changes to adjustable policies at reasonable levels, to the benefit of both participating and non-participating policy owners. The actuary would review, and ensure the appropriateness of, those practical expedients and approximations.

1.5.6 Volatility Management and Cross-Subsidization

Section 1.5.1 describes concepts of fairness generally. In applying them, some averaging of experience to manage volatility in setting dividends and bonuses and making changes to adjustable policies would be allowed, and may even be desirable, consistent with policy owner reasonable expectations.

Any such mechanism necessarily entails some degree of cross-subsidization, for example in portfolio rate crediting.

The following considerations are therefore suggested with respect to these mechanisms.

> A documented approach would be established in advance, and not altered thereafter (absent "force majeure"), or altered only in ways that are demonstrably not unfair to or among affected policy owners. For example, if the experience of an experience factor class is adverse to the point that the permitted adjustments are insufficient to reflect experience pursuant to the company's normal practice, then it is unfair to try to cover the loss through adverse adjustments of others.
>
> The approach would respect relevant contractual terms of insurance policies, and would be consistent with policy owner reasonable expectations and with communications to policy owners.

Different considerations might apply to adjustable and participating products because of the prospective versus retrospective natures of the two blocks. More specific detail with regard to adjustable products is included in subsection 4.5.2.

1.5.7 Policy Owner Reasonable Expectations (PRE)

In addition to the above general principles on fairness, policy owner reasonable expectations (PRE) would be an important consideration in assessing fairness. PRE may be described as policy owners' reasonable expectations of the company's exercise of discretion in matters concerning their policies. PRE arises from the company's communications in marketing materials, from information provided, from its administration practices and from general standards of market conduct.

> Significant transactions such as corporate reorganizations, acquisitions and divestitures of participating blocks of business would be structured to protect PRE, and any changes in practice resulting from the coming together of different approaches should be considered from the perspective of the policy owners affected by the change.

The Standards of Practice, Practice-Specific Standards for Insurance (paragraphs 2320.28 through 2320.34) are an important reference with respect to PRE.

1.6 Documentation

In addition to the policies and criteria themselves, it is suggested that documented support of the fairness opinions include

- a description of areas where judgment has been applied in the application of the policies and criteria, and support for the conclusions, and
- controls that are in place to apply the policies and criteria appropriately.

1.7 Classification

The regulations define an adjustable policy as "an individual life insurance policy, other than a participating policy, that is issued by a life company and for which the company may, at its sole discretion, directly or indirectly change the premium or charge for insurance, the amount of insurance or the policy's surrender value".

If a policy that is structured like a non-participating adjustable policy is contractually issued as participating, then the company would comply with the ICA requirements governing participating policies. For such policies, there is no requirement to comply with the ICA requirements governing adjustable policies.

Classification is discussed in greater detail in the Adjustable Policies section of this Educational Note.

The actuary should solicit advice, as appropriate, in reviewing policy classification decisions.

1.8 Transition

This is an issue if, and to the extent that, the changes to the ICA as a result of Bill C-57 (2005) and/or the regulations necessitate a non-trivial change compared to current practices.

The actuary would assess historical practice against the new requirements and, where inconsistencies exist, a reasonable transition plan to comply with the new requirements would be developed. Fairness would be judged on a prospective or go-forward basis.

1.9 Changes to Policies

There are a number of situations that might result in a need to review the policies related to participating products or the criteria for changes to adjustable policies, including

- acquisition of a block of participating or adjustable business,
- change in company structure,
- decision to enter or exit a particular market, and
- change in the regulatory environment.

2. MANAGEMENT OF PARTICIPATING ACCOUNTS

2.1 General

The ICA was amended, and regulations were promulgated, to deal with the management of the participating accounts. This section is intended to expand on areas that the actuary would consider with respect to developing an opinion on the fairness of the management of participating accounts, including allocation of expenses (including taxes) and of investment income to the participating account(s).

2.2 Applicable Law and Regulations

Sections 456 through 464 of the ICA govern the operations of the participating accounts. Bill C-57 (2005) did not amend these sections except for section 464, where revisions were made to subsection 464(2) relating to the dividend policy.

2.2.1 Insurance Companies Act

The pertinent portions of the Act as amended to be effective from June 1, 2011, are presented here.

> 165. The directors of a company shall
>
> (2)(e.1) establish a policy respecting the management of each of the participating accounts maintained under section 456,
>
> (i) if the company has participating policyholders on the day on which this paragraph comes into force, within six months after that day, and
>
> (ii) in any other case, before issuing a participating policy.
>
> (3.2) The company's actuary shall report to the directors in writing on the fairness to participating policyholders of any policy to be established or amended under paragraph (2)(e.1) and report at least once during each financial year on its continuing fairness.
>
> (3.4) The directors shall consider the report prepared under subsection (3.2) before establishing or amending a policy under paragraph (2)(e.1).
>
> (3.5) The report of the actuary shall be prepared in accordance with generally accepted actuarial practice with such changes as may be determined by the Superintendent and any additional directions that may be made by the Superintendent.
>
> (4) The company shall, within 30 days after a policy is established or amended under paragraph (2)(e.1), send a copy to the Superintendent.
>
> (4.1) The company shall on request and free of charge send a copy of a policy established or amended under paragraph (2)(e.1) to a shareholder or participating policyholder and on payment of a reasonable fee to any other person.

In addition to the amended sections of the act, sections 457, 458 and 460 continue to apply and require opinions of the actuary.

> 457. There shall be credited to, or debited from, a participating account maintained pursuant to section 456 that portion of the investment income or losses of the company for a financial year, including accrued capital gains or losses, whether or not realized, that is determined in accordance with a method that is

(*a*) in the written opinion of the actuary of the company, fair and equitable to the participating policyholders;

(*b*) approved by resolution of the directors, after considering the written opinion of the actuary of the company.

458. There shall be debited from a participating account maintained pursuant to section 456 that portion of the expenses, including taxes, of the company for a financial year that is determined in accordance with a method that is

(*a*) in the written opinion of the actuary of the company, fair and equitable to the participating policyholders;

(*b*) approved by resolution of the directors, after considering the written opinion of the actuary of the company.

460. The actuary of a company shall annually report in writing to the directors on the fairness and equitableness of the method used by the company for allocating its investment income and losses and expenses to a participating account maintained pursuant to section 456.

2.2.2 Regulations Respecting Management of the Participating Accounts

The pertinent portions of the associated Regulations to be effective from June 1, 2011, are presented below.

3. A participating account management policy established under paragraph 165(2)*(e.1)* of the Act shall include the following information:

(a) a description of the participating account and its associated policies,

(b) a description of the investment policy for the participating account,

(c) a description of the method, under section 457 of the Act, for allocating investment income to the participating account,

(d) a description of the method, under section 458 of the Act, for allocating expenses, including taxes, to the participating account,

(e) a description of the company's approach in respect of managing and using the surplus, if any, in the participating account,

(f) the principal factors that might cause the board of directors of the company to change the policy,

(g) if the company does not accept new business in the participating account, information on how the company would manage and dispose of the surplus, if any, in the participating account,

(h) in the case of a converted company under section 237 of the Act, the measures taken by the company to ensure fairness to participating policyholders whose policies form part of a closed block, and

(i) the percentage that the amount that the company intends to transfer to shareholders or a shareholder account of the company out of the company's participating accounts in a financial year in accordance with section 461 of the Act represents of the total amount that the company intends to transfer to shareholders or a shareholder account of the company and participating policyholders from those participating accounts in that year in accordance with that section.

2.3 Comments on the Regulations

2.3.1 Participating Account and Sub-Account Definition

While companies typically have only one participating account per jurisdiction, in some cases a company may also have participating sub-accounts. A sub-account may arise as a result of

- a demutualization (the closed fund, open fund and ancillary fund are such sub-accounts),
- part of a past agreement to take over/acquire/merge a block of business from another company, and
- the company's internal tracking in its accounting for use in setting dividends.

The participating account management policy would cover each participating account, and may differ among sub-accounts if the reasons for the creation of those sub-accounts, or the circumstances of those sub-accounts, make such differences necessary or desirable.

2.3.2 Allocations

An important consideration in management of the participating accounts is the various allocations made to the accounts of the company (participating and non-participating).

This includes the allocation of items such as investment income and expenses, including taxes.

Regardless of the allocation method used for these items the actuary must be satisfied that the end result of the allocation is fair, since the actuary will be opining specifically that the allocations are fair and equitable[2].

Combinations of the following approaches can be used to assess fairness.

Understand the allocation process

Know where it should produce similar results on different products and where it should not.

Reconcile differences between product lines

Suppose Product A has a lower cost per 1,000 than Product B. A possible explanation for this would be that Product A has a larger average size than Product B.

Develop reasonableness checks

Develop rules of thumb to approximate the allocation independently. These rules can include comparing the expense allocation to volumes of business in each product line, observing trends and exceptions, ensuring consistency with activity levels required to administer the product line, etc. Investment rates can be

[2] The law requires that the actuary opine that the allocation methods are "fair and equitable" while for dividend policy, participating account management and criteria for adjustable policies it requires that the actuary opine that they are "fair". The task force is not aware of why the distinction and was in any event unable to discern any material difference between the meanings of "fair" and "equitable".

compared between accounts. Growing accounts should have a rate closer to the new money rates than accounts that are not growing (unless both are part of the same portfolio average fund). Accounts with little turnover would have a rate closer to the previous year's rate.

Directly supervise the allocation work

Perform various tests and have checks built in to the process.

2.3.3 Investment Policy—Participating Account(s) Investment Policy

In taking note of the investment policy the actuary would verify that

- investment policy is clearly documented and reviewed regularly,
- process for changing the investment policy is documented, and
- investment policy is followed consistently and controls are in place to ensure target mixes by type of asset, quality, and term are maintained within a defined tolerance.

2.3.4 Allocations of Investment Income to the Participating Account(s)

Section 460 of the ICA requires an annual fairness opinion on the method used by the company for allocating its investment income and losses and expenses to a participating account.

The actuary would consider the section 460 opinion in forming the fairness opinion on the participating account management policy. In forming the opinion with respect to the fairness of the allocation of investment income the actuary would consider

- where assets are separately allocated to the participating account(s), whether individual assets being allocated to the participating account(s) are appropriate and conform to the investment policy applicable to the participating account(s),
- where investment policies differ between the participating and non-participating accounts, that their application does not result in unfair allocation to the participating account(s),
- where the company maintains separate sub-accounts, the allocation of investment income across sub-accounts could be accomplished by
  - establishment of separate asset segments, each with its own investment policy, or
  - application of an allocation process with clear criteria governing the allocation of investment income across sub-accounts, and
  - recognition of how allocations would need to differ based on the nature of the policies in the different sub-accounts.

Whatever method is adopted, the actuary would verify that it is applied consistently and fairly to each account or sub-account.

Following are some examples of these methods.

Allocation of Specific Assets

Each asset segment is assigned specific investments in an amount equal to its total liabilities and surplus. Asset segments may be shared between participating and

non-participating accounts. Such sharing can be fair, indeed advantageous to both, so long as the investment policies and strategies of the experience classes sharing the segment are consistent.

The investment income credited to each segment is a function of the earnings of assets allocated to that segment. Where segments are shared between participating and non-participating accounts, the allocation would reflect their proportional interests in the segment.

Mean-Fund Method

The company manages assets in a single pool and allocates investment income in proportion to the liabilities, or liabilities and surplus, in each of the funds.

Investment Generation Method

The company uses an investment generation approach to allocate investment income between its participating and non-participating accounts. The same method can also be used to allocate investment income among the participating sub-accounts, if applicable.

Combination Approaches

It is possible and acceptable to use a combination of approaches for allocating investment income. The general principle is that participating account(s) should not be disadvantaged by these methods. For example,

- allocate specific assets for the larger pools of assets using a mean fund approach for smaller pools within the company,
- allocate specific assets for new money products using investment year methods for portfolio average products, both participating and non-participating, and
- share assets between accounts in proportion, which can be fair when the asset would otherwise form too large a proportion of the account or exceed risk or other policy limits.

2.3.5 Allocations of Expenses, including Taxes, to the Participating Account

Section 458 of the ICA requires an annual fairness opinion on the method used by the company for allocating its expenses, including taxes, to a participating account.

As with investment income above, the actuary would consider the section 458 opinion in forming the fairness opinion on the participating account management policy. In forming the fairness opinion with respect to expenses and taxes the actuary would consider the following matters.

For expenses

- the allocation is supportable by expense analysis,
- there is an appropriate allocation of overhead, and
- the allocation of expenses related to investment in new business is appropriate, i.e., the amount to be absorbed by shareholders compared with that to be absorbed by different generations of participating policyholders.

For taxes

- where appropriate, taxes are allocated directly (e.g., premium tax, investment income tax),
- income taxes are based on the earnings of each account and, where applicable, each sub-account,
- future tax assets/liabilities are treated consistently between participating and non-participating accounts and, where applicable, between sub-accounts and across accounts, e.g., components of FTA/L considered to support liabilities rather than surplus, and
- overall company tax planning has been considered, including the appropriate reflection of any benefits to the participating accounts, except that allocation to the closed blocks would follow the tax allocation rules adopted on their formation.

2.3.6 Management of Surplus

Considerations for the actuary regarding the fairness of the management of surplus for the participating account(s) include

- a consistently applied approach to managing the level of surplus, including among participating accounts and sub-accounts,
- for accounts closed to new business, ensuring that the management of surplus will not create a tontine effect, and
- for accounts open to new business, ensuring that the extent to which existing business is financing new business is appropriate and in conformity with PRE.

2.3.7 Changing a Participating Account Management Policy

The factors to be considered in deciding whether to change a participating account management policy will be more general and at a higher level than those which lead to a change in current policyholder dividends. Changes in participating account management policy are expected to be infrequent. They may include such things as changes in

- legislation,
- regulation of participating accounts,
- taxation,
- accounting rules, or
- fundamental changes in circumstances.

2.3.8 Disposal of Surplus in a Closed Account

If the company does not accept new business in a participating account, the policy must provide information on how it will manage and dispose of the surplus in that account. Companies operating under a permanent contribution to surplus philosophy would explain how this surplus may be used by the company.

2.3.9 Closed Blocks of a Converted Company under Section 237

Account structures and operating rules were established for these blocks at demutualization and were approved by the voting (participating) policyholders and the regulator. Any subsequent changes would have to conform to the demutualization document and have to be approved by the regulator.

A report on these blocks is filed annually with the regulator by the Appointed Actuary and it contains an opinion that the blocks are being maintained consistently with the commitments made at the time of demutualization and any subsequent changes.

The actuary's fairness opinion would rely on that report.

2.3.10 Transactions with the Participating Account(s) or Among Participating Accounts

The method of calculating the transfer under section 461 of the ICA from the participating account(s) to the shareholders' account would be described in the participating account management policy. The actuary would verify that the transfers to the shareholders' account conform to applicable law and to the participating account(s) management policy with respect to surplus levels.

Where assets are allocated to each product line companies may exchange assets between the participating and non-participating accounts from time to time and/or, subject to certain limits, exchange notes between participating and non-participating accounts which have a demonstrably beneficial effect on both accounts (or a beneficial effect on one without disadvantaging the other) in order to meet liquidity needs and maintain a matching of assets and liabilities. The actuary would consider the fairness of such transactions and ensure that note transactions comply with Guideline E-12 on Inter-segment Notes. More generally, the actuary would review all transactions between the participating accounts and other accounts and among the participating accounts to be satisfied they are appropriate and fair.

3. DIVIDENDS

3.1 General

This section is intended to expand on areas that the actuary would consider with respect to developing an opinion on the fairness of the dividend policy and of dividend determination. It also outlines the requirements with respect to the content of the dividend policy. Some items that are closely related to dividend determination (e.g., expense allocation) are covered in the Participating Account Management section, and these would also be reviewed with respect to the dividend policy and dividend determination.

The policy for determining dividends and bonuses, the policy regarding participating account management and, where applicable, any operating rules adopted upon demutualization, would be internally consistent.

The determination of aggregate divisible surplus for any particular year is the prerogative of the board of directors of the company. That determination is made in the context of the participating account management policy considered in section 2 of this Educational Note. Section 3 deals with the allocation of that aggregate among participating policy owners.

3.2 Applicable Law and Regulations

3.2.1 Insurance Companies Act

The ICA was amended, and regulations were promulgated, to deal with the determination of dividend/bonus scales. The pertinent portions of the Act as amended to be effective from June 1, 2011, are presented here.

165. The directors of a company shall

(2)(e) in the case of a company that issues participating policies, establish, before issuing any participating policies, or in the case of a former-Act company, within six months after the coming into force of this Part, a policy for determining the dividends and bonuses to be paid to the participating policyholders;

(3.1) The company's actuary shall report to the directors in writing on the fairness to the participating policyholders of any policy to be established or amended under paragraph (2)(e) and report at least once during each financial year on its continuing fairness. In the case of a policy established before the day on which this subsection comes into force, the actuary shall within six months after that day report on its fairness to participating policyholders and at least once during each financial year on its continuing fairness.

(3.4) The directors shall consider the report prepared under subsection (3.1) before establishing or amending the criteria under paragraph (2)(e).

(3.5) The report of the actuary shall be prepared in accordance with generally accepted actuarial practice with such changes as may be determined by the Superintendent and any additional directions that may be made by the Superintendent.

(4) The company shall, within 30 days after the criteria are established or amended under paragraph (2)(e), send a copy to the Superintendent.

(4.1) The company shall on request and free of charge send a copy of a policy established or amended under paragraph (2)(e) to a shareholder or participating policyholder and on payment of a reasonable fee to any other person.

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(2) The company's actuary shall, in writing, report to the directors on the fairness to participating policyholders of a proposed dividend, bonus or other benefit and whether it is in accordance with the policy. The directors shall consider the actuary's report before declaring the dividend, bonus or other benefit.

(2.1) The report of the actuary shall be prepared in accordance with generally accepted actuarial practice with such changes as may be determined by the Superintendent and any additional directions that may be made by the Superintendent.

3.2.2 Regulations Respecting Dividend Policy

The pertinent portions of the associated Regulations to be effective from June 1, 2011, are presented below.

2. A policy respecting participating policy dividends and bonuses established under paragraph 165(2)(e) of the act shall include the following information:

(*a*) a statement indicating

(i) that the dividends or bonuses are declared at the discretion of the board of directors of the company; and

(ii) that the company's policy respecting participating policy dividends and bonuses may be amended from time to time at the discretion of the board of directors of the company;

(*b*) the frequency with which experience and dividend and bonus scales are examined and, if necessary, adjusted, and the principal factors that, in the opinion of the board of directors of the company, would be expected to affect the amount of the dividends and bonuses declared under section 464 of the Act;

(*c*) the principal factors that might cause the board of directors of the company to review its policy respecting participating policy dividends and bonuses;

(*d*) a description of the basis upon which dividends and bonuses are allocated among different classes of participating policies;

(*e*) a description of the principal sources of income considered for the purpose of declaring dividends and bonuses and, in the case of a mutual company, if income other than income derived from the participating business of the company is not considered, the use to which that other income is put; and

(*f*) a description of how specific policyholder behaviour is reflected in the dividend or bonus scale.

3.3 Comments on the Regulations

References below are to sections of regulation 2 above.

(a) Frequency of review.

The frequency of the dividend scale review would be disclosed. If the review frequency differs by segment or block or is less frequent than annual this would be explained.

(b) Considerations regarding the principal factors that would affect the dividend scale are outlined below.

Principles of Participating Fund Surplus Distribution to Policy Owners

The dividend policy governs the distribution of divisible surplus among eligible policy owners. The policy would clearly state whether the Contribution Principle is being followed. There are many different methods which can follow the Contribution Principle of dividend determination that can be used, including but not limited to

Source of Earnings Method (or "Contribution Method"),

Asset Share Method,

Fund Method,

Experience Premium Method,

Percentage of Premium Method, and

Reversionary Bonus Method.

It is the application of a particular method, by means of the experience factors, rather than the method itself, that determines whether or not it follows the Contribution Principle.

Participation in the Participating Account

The policy would make clear that policyholders are participating in the results of the participating account to which a particular policy belongs if the policy has a dividend mechanism. It would also state that the mechanism for this participation is the dividend scale. In some cases, policies can be participating but do not share in the experience of a participating account. How the experience of these policies is handled would be disclosed.

Terminal Dividends

If terminal dividends are paid or credited, then the difference between these dividends and regular periodic dividends would be explained clearly and the dividend policy would encompass the approach to the determination of terminal dividends.

Contribution to Surplus Philosophy

This policy, and/or the participating account management policy, would discuss the contribution to surplus philosophy that is being followed. The surplus philosophy being followed would be explained and supported. The policy would also discuss the proportion of gains, or the method used to determine the amount of annual gains, from the participating account which are intended to make up the contribution to surplus.

(c) Policy review.

It is expected that there are relatively few circumstances that would cause a board to review the dividend policy. Factors that may cause such a review include closing, splitting or combining participating accounts, completing an acquisition or divestiture, adopting a change in an allocation method, or dealing with a fundamental change in external circumstances such as applicable law or taxation.

(d) Principal sources of income for dividend declaration.

The material factors that enter into the dividend scale calculation would be clearly described. It is important to disclose that dividends arise from the difference between actual experience and a less favourable guaranteed level of experience. Since actual experience cannot be known in advance, dividends cannot be guaranteed and must be reviewed on a periodic basis.

Sources of dividend experience are generally identified in contract and marketing materials. Common primary sources include interest, mortality and expense.

Dividend scales often include explicit factors for primary sources of experience. Secondary sources may not have a direct component but may be reflected through

adjustment of one of the primary factors. Secondary sources may include policyholder behaviour risks, such as lapse, exercise of dividend options and policy loan usage. In general, how policyholder behaviour risks are handled in the dividend scale would be explained.

In the case of a mutual company, the disposition of profits from policies or coverages that are not themselves participating, and whether such profits are used to support participating policy dividends, would be discussed. This discussion would include a description of the company's policy and practice in this area.

These factors and others are discussed at length in the CIA Recommendations—Dividend Determination and Illustration document. This document, though not yet integrated into the Standards of Practice (after review some portions may be dealt with in Educational Notes), is, nevertheless, considered to have the same weight of importance and would be reviewed for further detailed guidance.

3.4 Other Considerations

The reader is reminded that the following considerations, already discussed in the General section of this Educational Note, are pertinent to the adoption of dividend policies and practices,

establishment of dividend classes,

averaging to manage volatility, and

policyholder reasonable expectations.

4. ADJUSTABLE POLICIES

4.1. General

This section is intended to expand on areas that the actuary would consider with respect to developing an opinion on the fairness of criteria for changing adjustable policies and on their application in making such changes.

4.2 Applicable Law and Regulations

The ICA was amended, and regulations were promulgated, to ensure the fair treatment of adjustable policies. The pertinent amendments to the Act, which have an effective date of June 1, 2011, are as follows.

4.2.1 Insurance Companies Act

165(2) The directors of a company shall

(e.2) establish criteria for changes made by the company to the premium or charge for insurance, amount of insurance or surrender value in respect of its adjustable policies,

(i) if the company has adjustable policyholders on the day on which this paragraph comes into force, within six months after that day, and

(ii) in any other case, before issuing an adjustable policy.

(3.3) The company's actuary shall report to the directors in writing on the fairness to adjustable policyholders of the criteria to be established or

amended under paragraph (2)(e.2) and report at least once during each financial year on their continuing fairness.

(3.4) The directors shall consider the report prepared under subsection (3.3) before establishing or amending the criteria under paragraph (2)(e.2).

(3.5) The report of the actuary shall be prepared in accordance with generally accepted actuarial practice with such changes as may be determined by the Superintendent and any additional directions that may be made by the Superintendent.

(4) The company shall, within 30 days after the criteria are established or amended under paragraph (2)(e.2), send a copy to the Superintendent.

(4.2) The company shall on request and free of charge send a copy of the criteria referred to in paragraph (2)(e.2) to an adjustable policyholder and on payment of a reasonable fee to any other person.

464.1(1) The actuary of a company that has adjustable policyholders shall, annually and in writing, report to the directors on whether the changes that the company made in respect of its adjustable policies during the preceding 12 months are in accordance with the criteria established under paragraph 165(2)(e.2) and are fair to the adjustable policyholders.

(1.1) The report of the actuary referred to in subsection (1) shall be prepared in accordance with generally accepted actuarial practice with such changes as may be determined by the Superintendent and any additional directions that may be made by the Superintendent.

(2) A company that made changes in respect of its adjustable policies during the preceding 12 months shall within the prescribed period send the prescribed information to the policyholder.

(3) In the case of a renewal of an adjustable policy, the company shall within the prescribed period send the prescribed information to the policyholder.

4.2.2 Regulations respecting Adjustable Policies

Section 6 of the Regulations defines "adjustable policy" as an individual life insurance policy, other than a participating policy, that is issued by a life company and for which the company may at its sole discretion directly or indirectly change the premium or charge for insurance, the amount of insurance or the policy's surrender value, but does not include

(a) a policy under which the premium or charge for insurance, amounts of insurance and surrender values are stated in the policy or a schedule to the policy, or can be determined under the terms of the policy or a schedule to the policy;

(b) a group insurance policy including a creditor's group insurance policy;

(c) an annuity contract, including a deferred annuity or a savings, investment or capital accumulation plan under which the life company has undertaken to provide an annuity; or

(d) a reinsurance policy.

The specific reference to "life insurance policies" results in the adjustable policy disclosure not being required for accident and sickness policies.

In addition, section 7 of the Regulations defines the prescribed period under ICA 464.1(2) as

> "For the purpose of subsection 464.1(2) of the Act, where a change has been made in an adjustable policy in the preceding 12 months, the company shall, no later than the end of the 30-day period following the policy anniversary that falls immediately after the 12-month period, send a notice to the policyholder containing a brief summary of the change."

4.3. Classification

A policy would be considered for classification as being adjustable in terms of this legislation only if it is non-participating and is so classified in the accounts of the company. All participating policies (even those that would otherwise qualify as adjustable) are covered under the legislation concerning participating policies.

4.4. Considerations in Determining Whether a Policy is Adjustable

Whether a policy is an adjustable policy or not is determined based on the terms of the policy. The policy is adjustable when those terms provide the company with unilateral discretion—directly or indirectly—to change the premium or charge for insurance, the amount of insurance or the surrender value of the policy. This determination is made by the company at issue and does not depend on a company's administrative practices.

The OSFI guideline interprets the concept of "adjustable" broadly, to classify the policy as adjustable unless any change made in the premium or charge for insurance, the amount of insurance or the surrender value of the policy can be determined by the policyholder by reference to the contract terms.

The existence of features such as interest-bearing accounts, loan rates and market value adjustments that vary over time, do not, by themselves, make a policy adjustable. On the other hand, any determination of credited interest that does not link to market rates, indices or other measures determinable by policyholders would, according to the OSFI guideline, make the policy adjustable. The guideline also notes that daily interest accounts would not, per se, make a policy adjustable. Logical extension of that exclusion would result in not classifying policies as adjustable if the sole features that the company may change are credited interest rates, provided doing so is consistent with contract terms and all other disclosures made to the policyholder.

Prima facie, policy terms guaranteeing that any change will follow terms, prices or benefits then being granted on newly-issued policies would result in classifying a policy as not adjustable. However, if the company has ceased issuing such policies, or if their pricing is materially influenced by in-force policies to which those terms apply, then the company may need to review the classification.

Similarly, a unilateral right to adjust policy variables such as cost of insurance charges and expense charges would make the policy adjustable under the OSFI guidelines.

The existence of contractual limits on the degree of adjustment does not exclude a policy from consideration as an adjustable product.

Strict interpretation of section 464.1(1) of the ICA would not require the AA to opine when no changes have been made to adjustable policies. However, OSFI's guideline asserts that not making a favourable change when the underlying experience would so permit would not normally be considered fair. This point is academic for contract types that are "one-way". A policy would be considered "one-way" where the policyholder reasonable expectations are that only increases to premiums or charges, or decreases to benefits, would be expected. The determination of whether a policy is "one-way" or "two-way" would, like all decisions as to classification, be made by the company and would involve assessing the contract, marketing material, past practices regarding the policies and any other relevant information.

For two-way contracts, it would be good practice for the AA to opine that a decision not to adjust conforms to the criteria adopted by the board and is fair to policyholders, even if not, strictly speaking, legally required. There would be no need to modify the wording of the standard unqualified opinion set out in subsection 2460 of the insurance-specific standards.

Most segregated fund contracts with maturity and/or mortality guarantees are annuities and are therefore not adjustable insurance policies. If the death benefit guarantees significantly exceed the maturity guarantees then they may be variable life insurance policies, and could then fall within the definition of adjustable policies, depending on their terms.

A feature of a product which is an accessory that has no material effect on the policy's premium or charge for insurance, the amount of insurance or the policy's surrender value, that the insurer has the option to adjust at their sole discretion but where the policy owner has the option to exercise or not (e.g., premiums or dividends on deposit or policy loans), would not on its own make a policy an adjustable policy.

4.5 Concepts of Fairness

4.5.1 Definition of Fair for Adjustable Policies

Since the company has unilateral control over the drafting of contracts and the post-issue adjustments, "not fair" is to be interpreted as "favouring the company". An adjustment favouring the policyholder at the expense of the company may, in this sense, be fair to the adjustable policyholder affected by the change if it satisfies the other considerations for fairness.

Desirable pre-conditions to the ability to determine reliably whether an adjustment is, or is not, fair are

elements that may be adjusted are clearly set out in the policy contract,

the sources of, or reasons for, adjustment are clearly set out in the policy contract, and

the sales and other illustration materials are clear and do not conflict with the policy contract.

It is recognized that the desirable preconditions may not exist, or may exist only partially, especially in the case of policies issued prior to the effective date of the law. It then falls to the judgement of the actuary to determine how to decide whether any proposed adjustments are fair.

Considerations to determine if an adjustment is fair would include

review that the board established the policy and criteria governing adjustments, and that those criteria

do not permit post-issue changes in policy classifications, except as justified or required as a result of external circumstances arising after issue, e.g.,

post-issue changes in taxation that affect only some policies or affect different classes differently (note that justification would be recorded and supported, and free from arbitrary bias against any particular group or class),

statutorily or regulatorily imposed changes, e.g., a change in required surplus,

are applied consistently both over time and as respects different (classes of) policyholders,

rely on policy characteristics and expectations of future experience, though past experience is relevant to the extent that it serves as the basis for establishing future expectations,

do not permit adjustments (or increases in adjustments) to recover losses incurred prior to the adjustment date, and

are based on objective quantifications.

In some cases, the terms of the policy and/or long-standing practice of the insurer might support adjustments to recover past losses, but such instances are likely to be infrequent and would need solid support. The actuary would exercise caution in accepting such practices to recover past losses as fair.

The need for sound judgement is evident in the application of the criteria, but would be documented and supported.

Actual adjustments would conform to the terms of the policy contracts, the criteria established by the board and applicable law. No adjustment (that is, an adjustment of zero) would be considered an adjustment requiring a fairness opinion just as much as a non-zero adjustment.

Justification for adjustments would be supported, documented and free of arbitrary bias against any group(s).

A useful perspective for AAs who must opine on fairness is the question: “As a reasonably informed policyholder, would I find the proposed adjustment fair?”

Periodic external review would assist AAs in performing their duties optimally with respect to fairness. They would also assist defence of the AA's opinion on the fairness of the company's adjustments in court, should that become necessary. The scope of the external review should be determined by the Appointed Actuary, subject to any OSFI guidelines or requirements.

4.5.2 Managing Volatility (i.e., averaging of experience)

Managing the variation of (expected) experience is permitted to prevent undesirable (from the perspective of the policyholder, as well as the company) short-term fluctuations in price or benefits.

Any averaging mechanism necessarily entails some degree of cross-subsidization, yet averaging is desirable. The adjustable pricing policy should be established in advance and not altered thereafter (absent "force majeure"), or only altered in ways that are demonstrably not unfair to, or among, affected policyholders.