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EDUCATIONAL NOTE

Dividend Determination for Participating Policies

October 17, 2023

Dividend Determination for Participating Policies

Appointed Valuation Actuary Practice Committee

The Appointed Valuation Actuary Practice Committee would like to acknowledge the contribution of the working group that assisted in the development of this educational note: Trudy Engel, Craig Fyfe, Linda Kerrigan, Josephine Marks (Chair), Ralph Ovsec and Phil Watson.

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Ce document est disponible en français.

The actuary should be familiar with relevant educational notes. Educational notes are not binding; rather they are intended to illustrate the application of the standards of practice. A practice that an educational note describes for a situation is not necessarily the only accepted practice for that situation nor is it necessarily accepted practice for a different situation. Responsibility for ensuring that work is in accordance with accepted actuarial practice lies with the actuary. As accepted actuarial practice evolves, an educational note may no longer appropriately illustrate the application of standards.

Contents

Preamble

Section 2700 of the *Standards of Practice* (SOP) – Policyholder Dividend Determination sets out expectations for actuarial reports on policyholder dividends. An educational note to support this section of the SOP was published in 2014, and this note is now being revised to reflect recent revisions to guideline E-16 (E-16) published by the Office of the Superintendent of Financial Institutions (OSFI). E-16 sets out OSFI's expectations for participating account management and dividend determination, as required under the *Insurance Companies Act* (ICA) and the Policyholders Disclosure Regulations (the Regulations). Although the changes to this educational note were triggered by the changes to E-16, the actuary would note that this guidance material is equally relevant for policyholder dividend determination practices in other Canadian jurisdictions.

Updates to the educational note

Notable updates include:

(a) commentary on issues to be taken into account by the actuary in determining the "contribution to surplus" by various participating policies, and the application of the contribution principle in this regard, in accordance with E-16;

(b) updated commentary on the use of experience factor classes and other contributory factors in determination of fairness opinions (under the contribution principle), in accordance with E-16;

(c) commentary on the reflection of policyholder behaviour in the establishment of dividend or bonus scales, in accordance with E-16; and

(d) other changes required to reflect changes in the SOP since this educational note was previously published in January 2014.

This educational note does not explicitly discuss issues related to the implementation of IFRS 17 for which the actuary is referred to the educational note titled *IFRS 17 Measurement and Presentation of Canadian Participating Insurance Contracts* published in June 2022.

Process

The creation of this cover letter and educational note has followed the Actuarial Guidance Council's (AGC's) protocol for the adoption of educational notes. In accordance with the CIA's *Policy on Due Process for the Approval of Guidance Material Other Than Standards of Practice and Research Documents*, this educational note has been prepared by the Appointed Valuation Actuary Practice Committee and has received approval for distribution by the AGC on October 10, 2023.

Your feedback

Questions or comments regarding this educational note may be directed to the co-chairs of the Appointed Valuation Actuary Practice Committee.

1. General

1.1 Purpose

Subsection 2720 of the SOP contains the following requirements with respect to policy dividend determination on individual life, annuity and health policies:

.01 There should be a written report which documents the advice on policyholder dividend determination, and which describes the framework of facts, assumptions, and procedures upon which the advice was based.

.02 The report should include:

a description of the process used to determine dividends;

the manner in which policy and experience characteristics are reflected in that process; and

the methodology used to calculate dividends, including specific factors used to reflect policy and experience characteristics.

.03 The report should state whether or not the contribution principle has been followed, and, if it has not been followed, the report should describe any deviations and their rationale.

The purpose of this educational note is to provide guidance to the actuary on the application of these standards, with respect to:

- the application of the contribution principle; and
- the contents of the report on the policy dividend determination.

In addition, it provides an overview of other considerations and relevant guidance with respect to dividend determination.

It has been updated to reflect the changes to OSFI's guideline E-16 effective January 2023. E-16 was updated to provide:

- additional clarification of OSFI's expectations, to aid companies in their interpretation of the ICA and the Regulations and to facilitate greater consistency of practices by companies in satisfying the requirements of the ICA and the Regulations; and
- additional guidance on the disclosure requirements of the Regulations, to promote greater transparency and consistency of policyholder disclosures.

The actuary would refer to E-16 itself for more complete information regarding OSFI's expectations in this regard. The actuary would also refer to the educational note titled *Guidance on Fairness Opinions Required under the Insurance Companies Act* published in October 17, 2023 for other guidance regarding interpretation and application of revised content of E-16.

1.2 Scope

1.2.1 Applicability

The SOP apply to work in Canada (subsection 1160), which itself depends on the ultimate purpose of the work. In this situation, the standards, and therefore the guidance in this educational note, apply to the determination of dividends under participating individual life, annuity and health policies issued for delivery in Canada. Although this educational note is currently being updated to reflect changes in OSFI's E-16, the actuary would note that this guidance material is equally relevant and appropriate to be applied for policyholder dividend determination practices in other Canadian jurisdictions.

When the actuary advises on dividends for policies issued for delivery outside Canada, the actuary would follow the actuarial principles and practices in the particular country. In the absence of such actuarial principles and practices, the guidance in this educational note would be appropriate.

Although in some situations the actuary advising on policy dividend determination is the Appointed Actuary (AA) of a company, this is not necessarily always the case. This guidance applies to any actuary advising on dividend determination.

Individual life insurance, annuity and health policies may be composed of several distinct agreements, each of which has a defined consideration and benefit structure. For example, in addition to the basic benefits, a life insurance policy may include disability and accidental death benefit provisions, or term riders. This guidance may be applied separately to any of these different types of agreements that are participating.

1.2.2 Illustrations

This educational note does not provide guidance on illustrations of dividends, as provided to policyholders or prospective policyholders. The actuary is referred to guidance provided by the Canadian Life and Health Insurance Association (CLHIA) Guideline G6.

1.2.3 Determination of divisible surplus

This educational note does not address the determination of the aggregate amount deemed to be available for distribution to policyholders at a point in time. This determination is a decision to be made by the board of directors of the company in the context of the participating account management policy, taking into account a number of factors, the most significant being the continuing solvency of the company and its ability to fulfil all contractual obligations.

However, the following guidance is provided with respect to determining whether the contribution principle (see Section 3) is being followed.

The contribution principle, which is the basis for the generally accepted method of determining dividends in Canada, relies on the ability to determine the earnings of the participating account(s).

Under the *Insurance Companies Act* (ICA), Section 456 requires the maintenance of separate and distinct accounts for participating and non-participating business. This makes it possible for the contribution principle to be followed for the participating business of a federally licensed stock company; similarly for a stock company that is subject under provincial law, foreign law or company charter to substantially similar provisions. In Canada, because there are very few companies that are not subject to such provisions, the general practice is to maintain separate accounts for participating business, non-participating business and the shareholders' account, and to significantly restrict transfers from the participating account to the shareholders' account (see Section 1.2.4).

If separate accounts are not maintained, but instead some other method is used that:

- is applied consistently from year to year;
- uses sound accounting and actuarial principles;
- is capable of independent review; and
- gives results similar to those that would be produced by separate accounts,

the contribution principle can be followed. If the method does not meet these requirements, the actuary will not be able to say that the contribution principle has been followed in the determination of dividends.

The actuary would also consider the company's philosophy with regard to contributions to surplus from its participating policies, and this philosophy would be expected to be consistent over time. The actuary would apply judgment to take into account external or internal factors that may have changed since the contributions to surplus were initially established and that may warrant a change. Any change to the contributions to surplus would need to ensure that fairness is maintained and be consistent with the company's philosophy.

The company's participating account management policy is required to include "a description of the company's approach in managing and using the surplus, if any, in the participating account".

1.2.4 Limitations on amounts transferred among accounts

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[1] 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.

Given that there is an appropriate method in place for the determination of the aggregate amount deemed to be available for distribution to participating policyholders, the degree of limitation on transfers to the shareholders' account can be addressed. The limitation which generally applies in Canada is that of Section 461 of the ICA. If the maximum permissible amount in any prior year was not transferred, it should not be added to the current year's transfer amount – i.e., meaning that no subsequent adjustment for such amounts is permissible. Under subsection 461 (c), the AA must opine that the 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.

Where separation of accounts is not used, moving an amount from the experience of a participating line would be regarded as equivalent to a transfer from the particular participating line.

2. Environment and regulatory change

The participating life insurance policy – whether provided by a mutual company, a stock company or a fraternal benefit society – has been a long-standing staple of the Canadian life insurance industry throughout its history of more than 150 years.

In that time there has been significant change in the industry itself, the economic environment in which it operates and the regulatory landscape. In addition, the participating insurance products have become more complicated over time.

These factors have combined to contribute to a regulatory environment that has increased its focus on disclosure and the equitable treatment of policyholders.

2.1 Regulatory changes

There have been accounting and reserving changes that have had considerable effect on management of these portfolios.

The underlying framework for participating life insurance is an important focus of the ICA, which governs how Canadian insurance companies manage their affairs. While the ICA is a federal act, it tends to set the stage for provincially regulated companies as well.

The ICA and the Regulations, in combination with guidance provided by E-16 (introduced in September 2011 and updated in January 2023) provide a framework for actuarial and regulatory work in connection with participating insurance.

A company's board of directors must adopt the following:

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[1] In the context of a company that has demutualized, an open fund within the participating account can be any fund that was established post demutualization. Thus an open fund may be currently open or closed to new business.

- a participating account management policy;
- a dividend policy;
- a method of allocating investment income; and
- a method of allocating expenses.

2.2 Appointed Actuary's opinion

Annually, and at the time of any change, the AA must review the policies and opine on their fairness to the participating policyholders. The AA must also opine that dividend actions are fair and in accordance with the dividend policy. This will require the AA to have access to any studies or analyses that allow this opinion to be supported.

2.3 Fairness

The subject of "fairness" is beyond the scope of this educational note, but the principles described here may assist the actuary in assessing the fairness of dividend practices. For more specific guidance, the actuary is referred to the educational note *Guidance on Fairness Opinions Required Under the Insurance Companies Act*).

2.4 Consolidations and demutualization

Over the last thirty years, there was an unprecedented level of consolidations in the life insurance industry in Canada, resulting in a declining number of companies.

As well, several large mutual companies went through demutualization resulting in further consolidation. These transactions generally caused specific restrictions and provisions to be imposed on the participating accounts of the affected companies.

In commenting on the management of these accounts and the determination of the dividends to be paid, actuaries are required to understand and follow the specific requirements of these provisions as they relate to their specific companies.

2.5 Policyholder reasonable expectations

In addition to the general principles on fairness, the actuary would consider Policyholder Reasonable Expectations (PRE). PRE are the reasonable expectations by policyholders of the company's exercise of discretion in matters concerning their policies. PRE may arise from a number of sources, including:

- the company's communications in marketing materials;
- information provided at the point of sale (such as policy dividend and investment performance illustrations);
- the company's past and continuing administration practices; and
- general market conduct.

Past practice includes the non-exercise of discretion by the company. It is important that consideration of PRE be balanced with consideration of fairness, especially in circumstances where the two may be in conflict (i.e., where a strict interpretation of PRE might result in large inequities among experience factor classes[2]).

2.6 Accounting rules and actuarial practice

Throughout the twentieth century, traditional book value accounting methods based largely on amortized cost valuation of assets led to a relatively stable approach to determining portfolio returns for participating accounts. More recently however, mark-to-market practices and the developments in International Financial Reporting Standards have caused companies to alter certain practices with the management of the participating accounts.

Similarly, actuarial reserving practices have evolved over time and the requirements of Canadian Asset Liability Method (CALM) reserving modified the nature of participating account asset balances as there was no longer a cash value floor underlying the reserve. CALM reserves were subject to more volatility than was common with previous valuation methods.

For reporting years beginning on or after January 1, 2023, the CALM reserving regime was replaced with IFRS 17, a new international accounting standard for accounting for insurance contracts. The CIA has issued an educational note to provide guidance related to the measurement and presentation of Canadian participating insurance contracts under IFRS 17, *IFRS 17 Measurement and Presentation of Canadian Participating Insurance Contracts*.

At the same time, practices in asset liability management continue to evolve, with more tools and asset classes being available to manage portfolios, including the use of alternative investments and synthetic investments such as derivatives.

As a consequence, company-specific practices must be developed to deal with a much wider range of issues in participating accounts than prevailed previously. The implementation of IFRS 17 is an example of one such instance, where company-specific practices that use accounting or earnings information as inputs would be reviewed in the context of the new accounting regime. Policies and practices for managing participating insurance accounts need to adapt to changing circumstances and endure through a history of many changes.

2.7 Consumer disclosure

In the realm of consumer disclosure, market conduct issues led to the development of Guideline G6 by the CLHIA, which provides industry guidance on practices related to dividend illustrations – both at point of sale and for in-force policies.

2.8 Adjustable policies

As required by the ICA, a company's board of directors must also establish criteria for certain changes made in respect of adjustable policies, and these criteria are also subject to a fairness opinion from the AA. An adjustable policy is specifically defined as being non-participating.

To the extent a participating policy has an adjustable feature – for instance, a non-guaranteed premium level – it is not considered to be an adjustable policy within the scope of the ICA.

[2] OSFI guideline E-16 and other actuarial literature refers variously to "cohorts, policy classes, dividend classes" or similar expressions. Consistently with the educational note on fairness opinions required under the *Insurance Companies Act*, this educational note uses the expression "experience factor classes."

3. Definition of the contribution principle

The contribution principle is a principle of policy dividend determination whereby the amount determined to be available for distribution to policyholders by the directors of a company is divided among policies in the same proportion as policies are considered to have contributed to that amount.

The objective of the principle is to achieve reasonable equity between participating policyholders.

In its pure form, the principle applies to the amount deemed to be available for distribution each year. However, it can also be related to amounts deemed to be available for distribution over an extended period of time when constraints on such amounts or the dividend distribution system prevent the application of the principle each year.

E-16 contains general principles for deciding on fairness for policy dividends, which include:

- There should be no material, planned or systemic cross-subsidization, such as dividends or contributory amounts (i.e., contribution to surplus), of one cohort by another.
- The method for determining dividends should be objective, unbiased, impartial and conform to rules established at issue.
- All experience factors and other contributory factors (i.e., contribution to surplus) to dividend determination should be taken into consideration when deciding on fairness of policy dividends. Dividend experience factors should be consistent with the associated underlying experience of each participating account and applied consistently to maintain fairness to participating policyholders. Post-issue changes to dividend experience factors (if any) should be justified and not be disadvantageous to participating policyholders.
- Contributory amounts, including the contribution to surplus (if applicable) should be similarly defined for all policies within each dividend class or cohort to promote fairness to participating policyholders.

The actuary would refer to E-16 for other principles for deciding on fairness as set out by OSFI. The actuary would include commentary on the application of the contribution principle in the report as described in Section 7.

4. The process of dividend determination

The application of the contribution principle to the determination of dividends requires two basic elements:

a) policy factors reflecting the assumptions used to be measured against any future experience; and

b) experience factors reflecting the actual experience that emerges over time.

Various methods may be used in the determination of dividends and are described in actuarial literature, including:

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

f) the reversionary bonus method.

Methods a)-e) above, by their nature, meet the contribution principle. The reversionary bonus method could satisfy the contribution principle over an extended period of time.

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.

It may be that a particular method for the determination of periodic dividends that does not itself satisfy the contribution principle will do so when terminal dividends are taken into account.

E-16 contains general principles for deciding on fairness for policy dividends. These additional fairness principles include: “The method for determining dividends should be objective, unbiased, impartial, and conform to rules established at issue.”

Dividend determination is a process subject to practical constraints. Such constraints include the cost associated with the dividend scale change and the practicality of dealing with small groups of policies, and it may be appropriate to make use of approximations or simpler processes and formulae where the circumstances warrant such applications (see the educational note *Guidance on Fairness Opinions Required Under the Insurance Companies Act* for more information on the topic).

Terminal dividends

A company may also have terminal dividends payable upon events such as death, maturity or surrender.

The report described in Section 7 would include a description of the process used to determine terminal dividends, and of the sources of funds (such as the investment gains) that are being used to support the dividend. The actuary’s report would state:

1) whether or not terminal dividends are paid and under what circumstances terminal dividends will be paid;
2) whether terminal dividends equitably reflect the incidence, size and growth of the policy’s share of the amounts previously accumulated on behalf of the policies on which such dividends are payable;
3) whether differences in terminal dividends among different policies reflect differences in corresponding amounts accumulated;
4) any discretionary aspects used when setting the level of terminal dividends;
5) the differences between terminal dividends and normal periodic policy dividends; and
6) whether terminal dividends are expected to be recurring and/or for a temporary period.

Furthermore, E-16 requires details on terminal dividends to also be included in the company’s dividend policy, as follows: “The company should explicitly state whether or not it pays terminal dividends, as well as under what circumstances terminal dividends will be paid. If the company pays terminal dividends, it should describe 1) the discretionary aspects when deciding on the level of the terminal dividends, and 2) any difference between terminal dividends and normal periodic policy dividends.”

5. Policy factors

Policy factors are those elements that reflect the assumptions against which experience would be measured. Generally, they are based on the guarantees or underlying actuarial structure of the policy. Examples of policy factors may include, but are not limited to:

a) cash values
b) reserve factors

c) gross premiums

d) policy loan interest rate

e) pricing assumptions (e.g., interest and mortality)

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. Policy factors may also have to consider terms established at demutualization.

For example, the 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.

6. Experience factors

6.1 General

Experience factors are those elements that reflect actual experience and would be consistent with the underlying experience of the participating account. 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 per cent 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.

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 would be based on differences in actual experience between those two classes.

The general principles for deciding on fairness for policy dividends outlined in E-16 include: “All experience factors and other contributory factors (e.g., contribution to surplus) to dividend determination should be taken into consideration when deciding on fairness of policy dividends. Dividend experience factors should be consistent with the associated underlying experience of each participating account and applied consistently to maintain fairness to participating policyholders.”

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 would be made uniformly for all classes. Such projection would 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.

Contractual guarantees, other legal circumstances or existing company practices may justify paying the same dividends to policies with differing experience expectations. An example of such a situation could be the grouping of underwritten policies of a particular whole life plan with conversions from term policies to that same plan. Although the company anticipates different mortality and lapse experience from these two sets of policies, it may have established an implicit agreement with the converting policyholders to treat them in all respects identically to those who purchased underwritten whole life policies.

Guarantees, such as minimum or fixed dividends, can also be found in acquisition or demutualization agreements. Such guarantees would be factored into the calculation of the dividends.

PRE would also be taken into account in setting dividends. Potential challenges may include:

- changing dividends on a block where the dividend scale has not changed for many years when experience in those years would have warranted changes;
- paying a cash dividend smaller than the one from the prior year if a company has for many years been following the practice of ensuring dividends do not decrease; and
- the consideration of PRE set by the previous company when setting dividends for an acquired block.

6.2 Experience factor classes

Experience factor classes would be established at issue. The placement of a policy within one experience factor class or another would be based on uniformly applied criteria designed to group together policies with similar levels of experience.

The general principles for deciding on fairness for policy dividends outlined in OSFI's guideline E-16 include: "Post-issue changes to dividend experience factors[3] (if any) should be justified and not be disadvantageous to participating policyholders." Justifications would be documented and supported and would demonstrate that the post-issue change is fair to the policyholders, and that the impact on the group of policyholders impacted is not expected to be disadvantageous in total to those participating policyholders.

Classifications of experience factor classes 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 supported and would be free from arbitrary bias against any particular group or class.

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. An example of addressing statistical credibility issues in mortality and morbidity experience is provided in Section 6.3. For acquired blocks of participating policies, approximations are appropriate when the information needed to calculate the experience factors by the classes set at issue is not available.

6.3 Claims factors

The claims factors represent annual rates of mortality or morbidity, depending on the product. Elements that may have a significant impact on claims factors include, but are not limited to, age at issue, sex, risk selection class and time elapsed since policy issue.

[3] Guideline E-16 uses the term "dividend experience factors" to describe what are referred to as "experience factors," "experience factor values" and "experience factor classes" in this educational note.

In the determination of actual claims factors, groups of policies with similar experience may be combined in order to obtain more credible data.

6.4 Investment income factors

The investment income element is usually a major component in the amount of dividends paid to policyholders. The investment income experience factor generally reflects the investment experience of the participating account for which dividends are being determined. This may include not only interest earnings reduced by investment expenses, but also the effects of capital gains and losses.

The investment income for a given group of policies may be directly affected by factors such as:

- the amount and timing of investable cash flow generated by the insurance operations of the group of policies;
- the investment income rates initially and subsequently applicable to that cash flow due to investments actually made;
- the rate of rollover of those investments, which affects investable cash flow in subsequent periods; and
- the effect of permanent or temporary tax differences.

The use of either the portfolio average approach or the investment generation approach to determine investment income is considered generally accepted practice. The portfolio average approach averages the effect of the items above over all groups of policies. The investment generation approach recognizes the effect of the items above 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 lines of business but use a portfolio average approach to allocate investment income within one or more such lines of business.

It is generally accepted practice to reflect the effect of policy loans in the investment income factors. 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 and the policy loan experience levels. Policy loan interest can be reflected in the investment income factors in a number of ways:

- In aggregate with other investment income to recognize the utilization rate of loanable funds.
- Directly to borrowing policyholders on a policy-by-policy basis, or at a class level.

6.5 Policyholder behaviour

The termination factors represent annual rates of termination of coverage for policyholder behaviour reasons other than claim. Elements that may have a significant impact on termination factors include, but are not limited to, time elapsed since policy issue, age at issue, sex, risk selection class, frequency of premium payment, plan, size of the policy and how far in-the-money any guaranteed elements are.

The impact of the difference between actual and expected annual rates of termination due to policyholder behaviour will vary depending on the underlying product design, amongst other factors. Company-specific practices are required on how differences between actual and expected termination rates are considered in the determination of policy dividends.

In addition to the termination factors, the rate of election by policyholders of specific dividend options (such as being paid in cash or being used to purchase dividend additions), or such features as premium offset and the sustainability of such features may be important considerations. The rate of election and impact of such options may vary with general investment and economic conditions.

The Regulations require that the company's dividend policy include "a description of how specific policyholder behaviour is reflected in the dividend or bonus scale." Guideline E-16 outlines the following in respect of this requirement: "The company should clearly describe whether or not specific policyholder behaviour (e.g. policy loans taken at guaranteed rates, bonus payable if policy not lapsed for a certain number of years, etc.) is reflected in policy dividends. If specific policyholder behaviour is reflected in policy dividends, the company should describe how this behaviour impacts policy dividends."

6.6 Expense factors

Direct expenses are those that can be specifically related to a particular policy, such as commissions, underwriting expenses, and policy issue and maintenance expenses. Other expenses are indirect, such as general overhead costs. In the determination of unit expense rates for dividend purposes, direct costs would be charged to the groups of policies generating those costs and indirect costs would be allocated using sound principles of expense allocation. The allocation would result in reasonable and fair expenses charged to each class.

6.7 Taxes

The participating account management policy would describe the allocation of taxes to the participating account, including the effect of any permanent and temporary differences.

Taxes may be included explicitly in the dividends using tax factors, or they may be included as part of other factors. For example, the investment income factors may be increased to recognize the preferential tax treatment of some assets, such as dividend-paying Canadian equities.

6.8 Smoothing

Smoothing is commonly used to avoid undue yearly fluctuations in the dividend scale, by introducing the effect of changes in experience on a gradual basis. The actual experience for each factor may be smoothed separately, generally over a few years. Smoothing would not result in material cross-subsidization of one experience factor class by another. In general, the total impact of smoothing at the class level would align with the impact of smoothing at the aggregate level.

The general principles for deciding on fairness for policy dividends outlined in OSFI's guideline E-16 include: "Smoothing of dividends should be allowed, and may even be desirable, but should not result in cross-subsidization of one cohort by another. Smoothing should only be used to avoid undue yearly fluctuations in the dividend scale and the method used should be reasonably justifiable and documented. An internal guideline on smoothing should be established in advance as part of the dividend and/or management policies required by the Regulations." It is generally expected that the internal guideline on smoothing would form part of the company-specific practices documented by management in implementing the company's dividend policy.

Furthermore, E-16 outlines details on smoothing to be included in the company's dividend policy, as follows:

> The company should disclose whether or not smoothing is used for dividend determination. When smoothing is used, the disclosure on smoothing is expected to include:
>
> - the objective of smoothing;
> - the factors considered when deciding on smoothing;
> - any differences in smoothing by sub-account or by dividend class; and
> - whether or not the company has established an internal guideline to govern the practices of dividend smoothing.

6.9 Other considerations

The actuary would consider the dividend policy and the participating account management policy in determining dividends for each class.

For stock companies, the maximum amount allowed as a transfer from a participating account to the shareholder account is a percentage of distributed dividends. The resulting interaction between the dividend scale and the expected transfer to shareholders would be considered in setting the dividends.

6.9.1 Other potential adjustments to dividends

The general principles for deciding on fairness for policy dividends outlined in E-16 include: "All experience factors and other contributory factors (e.g. contribution to surplus) to dividend determination should be taken into consideration when deciding on fairness of policy dividends."

Adjustments to dividends can be made for a variety of reasons, such as:

- to reflect gains or losses on supplementary benefit riders;
- to reflect losses arising from the presence of settlement option guarantees;
- to smooth the transition from one dividend scale to another;
- to serve as a balancing item so that aggregate dividends equal aggregate divisible surplus;
- to distribute gains from extraneous sources such as non-par benefits or lines of business; and
- to smooth the incidence of dividends within a dividend scale by policy duration.

Considerations regarding policyholder behaviour are outlined in Section 6.5 above.

6.9.2 Capital considerations

Another important consideration for many companies is to manage their dividend scales in such a way as to ensure that they are able to classify their participating business as a block of qualifying participating products for purposes of regulatory capital requirements, which reduces the amount of required capital in recognition of the reduced risk of losses due to the ability to pass adverse experience through to policyholders.

OSFI's guideline on Life Insurance Capital Adequacy Test (LICAT) specifies the criteria that must be met in order to qualify for this treatment. Section 9.1.1 of the 2023 LICAT guideline outlines these criteria, which include requirements on the content and disclosure of the insurer's participating dividend policy; requirements on the process for determining the policyholder dividend scale, including requirements on frequency of review (regular, at least once a year), and the pace at which shortfalls in actual overall experience are passed through in policy dividends; and requirements to be able to demonstrate to OSFI that the insurer follows the dividend policy and practices referred to within the criteria. The criteria are detailed and granular, and it is recommended that the actuary refers directly to the LICAT guideline for further review of the criteria.

In addition, the LICAT guideline notes that "A DSR (Dividend Stabilization Reserve) or similar experience levelling mechanism ceases to be available to absorb experience shortfalls when it has been reduced to zero or has become negative. …Negative DSRs and negative reserves resulting from similar experience levelling mechanisms are deducted from Tier 1 capital (q.v. LICAT Section 2.1.2.10) irrespective of materiality."

6.9.3 International Financial Reporting Standards

In the calculation of the investment income component of the dividend, it is common to multiply the investment income factors by an amount that is representative of the policyholder's share of the participating account. The policyholder's share of the participating account can be approximated by the guaranteed cash value of the policy or by a reserve factor.

Since the introduction of market value reserves and IFRS, the sum of the amounts used in the dividend formula to represent the policyholders' share of the participating account may be quite different from the actual reserve held for the participating account. An adjustment to the experience factors may be necessary.

For many years, participating accounts have experienced relatively stable investment earnings that have resulted in slowly changing dividends scales. Since the introduction of market value accounting, the investment income on participating accounts has become more volatile. To meet PRE of stable dividend scales that have arisen historically, the actual experience in a given year can be reflected in the dividend scale gradually over a period of time.

7. Suggested report content

When preparing a report in accordance with subsection 2720 of the SOP the actuary would take into account the relevant general considerations from Section 1800 of the general SOP.

There is no specific requirement as to the recipient(s) of this report. The report is intended to serve as documentation of the advice provided on dividend determination and is not necessarily provided to the board of directors.

As per subsection 2720 of the SOP, the report should include:

- a description of the process used to determine dividends;
- the manner in which policy and experience characteristics are reflected in that process;
- the methodology used to calculate dividends, including specific factors used to reflect policy and experience characteristics; and
- a statement of whether or not the contribution principle has been followed, and, if it has not been followed, the report should describe any deviations and their rationale.

The actuary would also consider including in the report:

- a description of each of the experience factors used in the calculation of dividends;
- the value of each experience factor by experience factor class, and changes in such values;
- a description of any change in practice with respect to the determination of experience factor classes or placement of policies within them;
- information regarding material approximations and guarantees; and
- a description of adjustments that are made to experience factors or to dividends.

Other specific items that may be appropriate to discuss in the report include:

- the use of experience trend projections to determine experience factor values;
- the allocation of investment income to different classes of policies;
- the method used to reflect the effect of policy loans in the dividend scale;

- the allocation of expenses to different classes of policies;
- the method used to recognize taxes in the dividend scale; and
- the method used to smooth the dividend scale.

7.1 Scenario analysis

The actuary may judge it worthwhile to provide additional information regarding the potential impact on future dividend scales under various alternative scenarios with regards to future experience; for example, by assessing the impact of various assumptions as to:

- interest rates;
- returns on non-fixed income assets;
- mortality and morbidity experience; and
- policyholder behaviour (i.e., lapse experience).

Such analysis could potentially be of value by providing an indication of the type and level of emerging experience that could warrant more specific or careful consideration in managing dividend scales over a period of time, such as potentially unrecoverable losses or potentially unfavourable regulatory capital implications.

8. References

Canadian Institute of Actuaries (CIA). 2023. *Guidance on Fairness Opinions Required Under the Insurance Companies Act .* Ottawa.

Canadian Life and Health Insurance Association Inc. (CLHIA). 2009. "Guideline G6."

Minister of Justice. 2023. *Insurance Companies Act.*

Office of the Superintendent of Financial Institutions (OSFI). 2023. "Guideline E-16 Participating Account Management and Disclosure to Participating Policyholders and Adjustable Policyholders."

Canadian Institute of Actuaries
360 Albert Street, Suite 1740
Ottawa, ON K1R 7X7
613-236-8196
head.office@cia-ica.ca
cia-ica.ca
seeingbeyondrisk.ca

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