26.2 Distribution of Profits

LPS 600 effectively requires a participating benefit to have a substantial exposure to investment risk. For example, group risk business with profit- sharing features via premium refunds is not regarded as participating business. Nor is investment account business if the account balances will always be between 95% and 103% of the value of the assets.

The issues the actuary must consider as part of this advice include:

* policy owners’ reasonable expectations
* equity between policy owners and shareholders
* equity between different groups of policy owners
* the timing of profit emergence
* the impact on the company’s capital requirements
* the capabilities of the policy administration system
* potential impacts on future surrender experience
* potential impacts on future sales of new business

26.3 Reasonable Expectations

Reasonable expectations are based on a combination of policy documentation, promotional material, annual statements and the past practice of the company.

How to manage: regularly remind policy owners how bonus rates might vary in future and apply this bonus philosophy in a consistent manner when declaring bonus rates.

26.4 Reversionary Bonuses

The reversionary bonus becomes a contractual liability of the life company which **cannot be revoked**.

There are three main types of reversionary bonus:

* simple reversionary bonuses are calculated as a bonus rate multiplied by the sum insured
* compound reversionary bonuses are calculated as a bonus rate multiplied by the sum insured plus existing reversionary bonuses
* super-compounding reversionary bonuses are calculated as a bonus rate multiplied by the sum insured plus a higher bonus rate multiplied by existing reversionary bonuses

*At times when interest rates are unusually high, the super- compounding method provides a more equitable outcome as it allows higher investment returns to be passed to policies with longer durations and substantial asset shares, whilst limiting the amount of bonuses added to newer policies with small asset shares.*

**Asset share** calculations for individual policies can be useful as a guide for determining bonus rates. (Chapter 22) The liability calculated using an asset share approach can be compared with the best estimate liability and value of future bonuses calculated using a projection approach. Supportable future bonus rates can then be found by equating the projected liabilities to the asset shares.

26.5 Terminal Bonuses

Terminal bonuses were a useful mechanism for adjusting policy values in response to fluctuating investment returns.

Unlike reversionary bonuses, existing **terminal bonuses could be reduced or removed** from a policy in response to poor investment returns.

The methods for distributing terminal bonuses include:

* terminal bonus equal to a percentage of existing reversionary bonuses
* terminal bonus equal to a percentage of sum insured and existing reversionary bonuses multiplied by the number of years the policy has been in force
* terminal bonus equal to a percentage of existing reversionary bonuses, the rate varying by year of policy commencement
* terminal bonus equal to a percentage of surrender value multiplied by the number of years in force.

*Administration systems may also be a constraint on the method adopted.*

**Risk**: anti-selective surrenders occurring after a major drop in asset values, but before a company has been able to implement a reduction in its terminal bonus rates.

The main advantages of using terminal bonuses are:

improved equity between policy owners

a reduction in shareholder capital requirements

A significant disadvantage for shareholders is the deferral of profit emergence

**Example**: Simple cash dividend calculation for Interest / Mortality / Expense (P164)