GN22: DISCLOSURE—LAUTRO RULES
A—COMMISSION AND REMUNERATION DISCLOSURE
B—PROJECTIONS AND APPROPRIATE CHARGES DISCLOSURE

Classification (see APC)
This Guidance Note is classified in relation to the code of professional conduct as *advisory*.

Scope
United Kingdom.

Application
Appointed Actuary or any actuary called upon to advise a Life Office or Friendly Society (hereinafter referred to as the 'Actuary').

Legislation or Authority
This Guidance Note deals with:

(i) advice given on the disclosure of commission and remuneration in accordance with LAUTRO (Revised Product and Commission Disclosure) Rules 1994.
(ii) advice given on the allocation of expenses to with-profits business and investment-linked contracts where some or all of the charges may not be explicit, in accordance with Part V and Schedules 4 and 4A of the Rules of LAUTRO.

In the case of insurance companies directly regulated by SIB, this Guidance Note is equally applicable.

The PIA has adopted the Rules of LAUTRO and therefore this Guidance Note is applicable to PIA members.

Date of Issue
18 August 1994.
(As this is a 'Fast Track' Guidance Note it must be revised within 18 months.)

A—COMMISSION AND REMUNERATION DISCLOSURE

1. INTRODUCTION

1.1 The Rules of LAUTRO require Members to disclose the commission or remuneration appropriate to a policy. Members are expected to consult their Actuary regarding the costs to be taken into account in determining the remuneration and the way in which these costs will be attributed to individual contracts. The commission and remuneration must be disclosed 'in a manner that is fair, clear and not misleading'.

1.2 LAUTRO have issued Guidance entitled 'Commission and Remuneration Disclosure—Guidance'; this should be carefully studied, noting in particular Section 5.2.

1.3 Where a policy is sold by an independent intermediary, the commission payable by the Member must be disclosed.

1.4 The remuneration to be disclosed where a policy is sold by a company representative is to include both cash payments and the cost of benefits and services provided.

1.5 In the case of a company representative employed by an appointed representative who is not a connected person *vis-a-vis* the Member, the remuneration will be based on the amount of commission paid and services provided to that appointed representative by the Member.

1.6 Where the company representative is employed by an appointed representative who is a connected person *vis-a-vis* the Member or where the company representative is employed by a marketing associate (e.g. a Bank) which is itself a Member of LAUTRO, the remuneration will be the payments, benefits and services provided to the company representative whether provided by the product provider or by the appointed representative or marketing associate. In addition a profit margin will be added to reflect comparability with IFA firms and unconnected appointed representative firms, where the commission payments effectively include a profit element.

1.6.1 The profit margin should either be 15% or such lesser amount as the company, after consultation with its Actuary, considers to represent the profit margin made from carrying out activities the costs of which are disclosable as part of remuneration ('disclosable activities').

1.6.2 In estimating whether a lesser profit margin than 15% would be appropriate, the Actuary may wish to consider one of the following approaches:

(i) A comparison with the remuneration scales of similar unconnected appointed representatives either of the same company or more generally in the market. For example, if the remuneration without the 15% uplift is lower than scales typically payable to unconnected representatives but with the 15% uplift the remuneration is higher, then an intermediate uplift may be appropriate.

(ii) An apportionment of the expected profit on the policy between that generated by disclosable activities and that by other activities (e.g. risk taking, administration, etc). In making such an apportionment, the Actuary should be careful not to overestimate the profit made on the other activities.

1.6.3 In cases where a commission payment is made to a marketing associate or connected appointed representative, the amount disclosed under this Section (1.6) should not be less than the amount which would be disclosable under Section 1.5 were the marketing associate or appointed representative unconnected with the Member.

1.7 The objective of the LAUTRO Rules is that the amounts disclosed by company representatives should be, as far as possible, consistent with the amounts of commission that would be disclosed by an independent intermediary and this underlying principle should be borne in mind.

1.8 In this Guidance Note, benefits and services refer to those benefits and services the costs of which must be disclosed as part of the cost of remuneration according to Part IV of Schedule 6 of the LAUTRO Rules. The Actuary should consult with the Member's Compliance Officer to ensure that all the costs of those categories of benefits and services which fall within remuneration disclosure have been included. Sections 3 and 4 of the LAUTRO Guidance 'Commission and Disclosure—Guidance' should be studied with particular care in this regard.

There may be circumstances where the Member feels that a straight addition of all the disclosable costs may give rise to a misleading result. One such situation might be the start-up of a new company where the very high initial overhead costs of establishing distribution channels are being met out of shareholders' capital rather than expense loadings. For equivalence with established Members, it may be appropriate in this situation for some of the otherwise disclosable costs to be excluded. Such circumstances should be discussed with the Compliance Officer.

1.9 In cases of doubt about whether certain categories of cost should be included or excluded, the Compliance Officer may wish to consult directly with LAUTRO or the Actuary should consult directly, with the agreement of the Compliance Officer.

2. REMUNERATION

2.1 The estimation of the cost of benefits and services should be based on the most recent experience of the Member. Only if the Actuary has strong grounds to believe that business plans for the period concerned will produce material variations from the historic results should budgets/projections be used.

2.2 The costs of benefits and services should be split into new business costs and the costs of servicing existing clients.

The costs attributable to servicing (e.g. handling enquiries on existing policies or processing claims) should be assessed directly in relation to the work carried out by the representatives.

It should be noted that it may not be appropriate to assume that the split bears the same ratio as new business payments bear to renewal payments.

3. CONSTRUCTION OF REMUNERATION SCALES—GENERAL

3.1 The remuneration costs should be spread across the business using a new business remuneration scale and a servicing remuneration scale.

3.2 The following principles should apply to the construction of remuneration scales:

3.2.1 The incidence of the remuneration should be disclosed as well as the amounts.

3.2.2 The new business remuneration scales when applied to the total anticipated value/volumes of business should reproduce the total anticipated remuneration costs (payments, benefits and services plus profit (if appropriate)) and similarly for the servicing scales.

3.2.3 LAUTRO permits the remuneration scale (for a given product) to be an average across the company representative salesforce as a whole. If, however, a Member operates two or more different structures of salesforce remuneration then the remuneration scale should be calculated separately for each.

3.2.4 Where a company representative agrees with an investor to forgo a part of his normal payment in order to improve the terms of the contract, the same uplift factor (see 4.2.3 below) may be applied to the reduced payment or the same monetary cost of benefits and services may be used.

The former route should only be adopted if the policyholder is to receive the benefit of the payment forgone and if this route is adopted, the proportion of payments forgone must be allowed for in calculating the uplift factor.

Where an average scale of remuneration is used, the percentage reduction in payment in respect of the individual salesman should be applied to the average payment in order to calculate the reduced payment.

3.2.5 Payments, benefits and services relating to non-investment business are to be disclosed in the circumstances outlined in Sections 2.9 and 2.10 of the LAUTRO Guidance.

4. CONSTRUCTION OF REMUNERATION SCALES—SUGGESTED METHODS

4.1 After being consulted by the Member, it will be up to each Actuary to recommend to that Member a suitable remuneration scale which conforms to the principles outlined above and those set out in the LAUTRO Guidance. The following methods, however, are suggested in the circumstances outlined.

4.2 Where the company representative is paid by a transaction based payment scale related to volume and/or value of business sold:

4.2.1 The payment scale is adjusted for any anticipated over-ride payments based on anticipated new business. Furthermore any additional (and previously undisclosed) commission (e.g. additional renewal commission) in respect of previous years' business (see Section 2.12 of LAUTRO Guidance) is added. The payment scale applied to the anticipated new business should reproduce the anticipated payments.

4.2.2 The payment scale is divided into a new business payment scale and a renewal payment scale.

4.2.3 The cost of benefits and services is expressed in the form of a new business uplift factor and a servicing uplift factor.

$$\text{New business uplift factor} = \frac{\text{Cost of new benefits and services}}{\text{New business payments}}$$

$$\text{Servicing uplift factor} = \frac{\text{Cost of servicing benefits and services}}{\text{Renewal payments}}$$

4.2.4 The calculation may be done separately for as many or as few different classes of business as will ensure that any resulting differences are justified by actual differences in circumstances and that any significant differences are not masked. The calculation may be done separately for different classes of company representative or averaged across the salesforce (see Section 3.2.3).

4.2.5 The payment scales are grossed up by new business uplift factors or servicing uplift factors as appropriate to reflect the cost of benefits and services. The grossed up scales represent the new business and servicing remuneration scales, and are applied to the individual policy concerned to derive the disclosable remuneration.

Note: Where the level of payment in the first year of a policy equals the level of payment in subsequent years (level payment scale) then, for the purposes of 4.2.3, 'new business payments' refers to the payments in the first policy year and 'renewal payments' refers to the level of payments in subsequent policy years.

4.3 Where company representatives do not receive any payments related directly to value or volume of business (e.g. are paid by a fixed salary), Section 6.2 of

LAUTRO Guidance refers to the 'apportionment of the total costs over individual contracts in a way which reflects the value of the contract to the Member or the Member's group'.

4.3.1 The Actuary, in consultation with the Member, ascertains the relative measure of value placed on the individual contracts by the Member (or the Member's group). In this context it is appropriate to judge 'value' in relation to any (non-remunerated) internal scale of success or validation which the Member applies to judge the relative success of individual salesmen, branches or regions. If no such scale exists it may be appropriate to judge 'value' broadly in relation to the expense contributions or charges generated by the contract or on a scale of value mutually agreed between the Actuary and the Member as being appropriate.

4.3.2 Salary costs are added to the costs of benefits and services and split between new business and servicing costs to determine new business remuneration and servicing remuneration. The apportionment of new business remuneration between individual contracts is according to the relative measure of value and an appropriate relative measure of value should be used to apportion servicing remuneration.

4.4 Where other methods of remuneration are employed e.g. part salary and part related to the volume/value of sale the salary element should be added to the cost of benefits and services and the method in 4.2 may be employed (see LAUTRO Guidance, Section 2.6).

5. REVIEW OF SCALES

The Actuary should advise the Member if at any time he becomes aware that the remuneration figures have become misleading. A review should take place at least annually in consultation with the Compliance Officer.

B—PROJECTIONS AND APPROPRIATE CHARGES DISCLOSURE

6. INTRODUCTION

6.1 The Rules of LAUTRO require Members to take into account 'appropriate charges' and 'cost of risk benefits' when calculating any projections of future benefits under life assurance policies.

6.2 For a with-profits policy, the appropriate charges are defined as those expenses which a LAUTRO Member 'reasonably determines to be appropriate to the contract, having regard to:

(i) the principal terms of the contract;
(ii) any tax relief which will be available to the Member in respect of so much of the Member's gross expenses as can properly be attributed to the contract;

(iii) any transfers to shareholders' funds, or equivalent retentions from established surplus offset by any sustainable rate of transfer of surplus from non-profit business; and

(iv) any guidance published by the Institute of Actuaries or the Faculty of Actuaries (or by both jointly)'.

6.3 The Rules of LAUTRO also require the disclosure of the cumulative sum of the charges and expenses expected to be levied against the contract including mortality and morbidity costs ('effect of deductions' and 'total actual deductions') and a statement of the effect of the appropriate charges (only) on the investment growth (reduction in yield).

6.4 Disclosure has to be made in the following documents:

6.4.1 Documents containing projections of future benefits (Rule 5.5(1)).

6.4.2 Key Features, which LAUTRO Members are required to prepare according to Rule 5.8 and Part I of Schedule 6 of the LAUTRO Rules.

6.4.3 Post-Sale Information, which LAUTRO Members are required to send by post (or 'give' in the case of industrial life business) to investors in accordance with Rules 5.9 and Part II of Schedule 6.

6.4.4 The With-Profits Guide, which LAUTRO Members must provide to anyone requesting a copy (Rules 5.14 to 5.18 and Schedule 8).

6.5 In the first three cases, the disclosure relates to the particular policy under consideration or, in certain circumstances, a contemporary example policy (using expenses and mortality at the level expected to be incurred over the period of use of the figures).

6.6 For With-Profits Guides, disclosure, limited to the reduction in yield, is also required in respect of example policies issued in past years (using actual expenses incurred).

6.7 In accompanying guidance, LAUTRO states that it would expect its UK Members to consult with their Actuary before making the determination referred to in 6.2 above.

7. APPLICABILITY OF GUIDANCE

7.1 This Guidance Note has been prepared to assist the Actuary in providing advice when consulted by the Member in the circumstances set out above. It may also be of relevance to other circumstances in which actuaries are called upon to advise on the apportionment of expenses.

7.2 While the expenses which are taken into account in projections and disclosure are ultimately the responsibility of the Member, the LAUTRO Rules require Members to have regard to any guidance published by the Institute of

Actuaries or the Faculty of Actuaries (as well as expecting consultation with the Actuary—see 6.7 above).

7.3 This Guidance Note applies to both conventional and unitised with-profits business and to investment-linked contracts where some or all of the charges may not be explicit.

8. COMMERCIAL EQUITY AND SENSITIVITY

8.1 The outcome of the apportionment will ultimately be reflected in published figures. The Actuary should ensure that the results of the apportionment give rise to figures which, in the context in which they will be presented, fairly reflect the effect of expenses upon the return under the policy and which are not misleading.

8.2 The Actuary should bear in mind the commercial sensitivity of these figures, particularly projections. He should adopt an approach which is neither too conservative nor unduly optimistic (i.e. 'a best estimate' approach should be used).

9. ADJUSTMENTS TO REPORTED EXPENSES

9.1 Those commission and management expenses that were, or would be, reported in Form 41 of the DTI Returns or, in the case of an authorized Friendly Society, Form 6 of the Annual Valuation Returns, will normally provide a suitable starting point for any expense apportionment.

9.2 Adjustments should be made where necessary to make the base more relevant to the purpose of the apportionment. Such adjustments may be required because of timing differences, for example accounting year *vis-a-vis* base year for expense disclosure, and to ensure that all expenses properly attributable to the long term business fund are included. For example due allowance should be made for:

9.2.1 Notional interest forgone on subsidized loans to staff, appointed representatives or company representatives, including investments in appointed representative firms on non-commercial terms, using an appropriate commercial rate as a guideline;

9.2.2 Full commercial rent on premises occupied by the Member and owned by the Member (whether by the life fund or the shareholders' fund) or any other company within the group;

9.2.3 Either actual or SSAP 24 contributions to staff pension schemes and medical expenses schemes. Whichever approach is adopted, that approach should be followed consistently from year to year;

9.2.4 Amortization of capital expenditure in respect of purchase of equipment or of development costs (see 9.3 below);

9.2.5 Bad debts on commission or any other advances or loans to appointed or company representatives or independent intermediaries;

9.2.6 Costs of investment management, but excluding dealing costs and costs associated with the routine management and servicing of existing property investments;

9.2.7 The actual cost of services provided to the Member's company on non-commercial terms by other companies within the same group.

9.3 Development costs will normally be written off in the year in which they are incurred. Where, however, the development costs are of an exceptional one-off nature, they may be amortized over a limited period, related to the period over which the benefits of the expenditure are expected to be obtained, and not normally exceeding five years. If amortization of development costs is adopted, the amortization, with interest, of prior years' costs should be brought into account.

10. INITIAL APPORTIONMENT

10.1 In making an apportionment, the Actuary would be expected to consider that some expenses will not vary with the volume of business (and may be regarded as fixed costs in the short term) whilst other expenses may increase or decrease as the volume of business rises or falls (and may be regarded as variable costs). The relationship with volume is not necessarily direct or proportionate and changes in variable costs may lead or lag behind changes in volume. The allocation between fixed and variable costs is not an exact science and this is especially so where large development costs are being incurred or if the company is young and small.

10.2 The Actuary may find it helpful first to divide costs into different categories, each of which may be subdivided into fixed and variable elements. Such categories might include:

- —New business or initial costs (including the costs of cancellations from outset and unsuccessful sales efforts);
- —Renewal, maintenance or discontinuance costs;
- —Claim costs;
- —Investment costs;
- —Development costs;
- —Overheads (e.g. general management).

Judgement must be exercised in any subdivision, although a degree of objectivity is possible in most categories.

10.3 The Actuary would also be expected to consider that many expenses can be identified with particular product lines, both with-profits and non-profit. This can be done either explicitly, or by the use of techniques such as time-spent analysis. The actual expense loadings implicit in with-profits policies may not be relevant to this process particularly if they are out of date. The Actuary should ensure that the allocation of expenses to non-profit business is fair and not in excess of those which are sustainable by that class of business.

10.4 The apportionment of overhead costs, which can be a significant proportion of the total expenses, requires considerable judgement and can be carried out in a number of credible and equitable ways depending upon the type of overhead cost. For example, overhead costs could be added as a layer on top of some or all of the non-overhead costs listed in 10.2.

Overhead costs could also be allocated uniformly over all product lines or with a bias towards classes of business which benefit most from them (for example, those classes requiring most management attention).

10.5 It is important to recognize the need to allocate costs. particularly fixed and overhead costs, in a manner that is consistent with the ways in which the costs would be taken into account by managers when business decisions are taken.

Consistency is a crucial element in the way costs are allocated:

—across all product lines;
—in the treatment of regular and single premiums, and increment policies;
—across all companies within the same marketing group;
—over various distribution channels;
—across all territories;
—one year to the next.

A major change in the basis should normally reflect a significant change in the way in which a company or group conducts its business.

10.6 The result so obtained should be adjusted for any expected variation in costs from the period of analysis to the period relevant to the projections and disclosure if the Actuary considers it would make a material difference. This would normally include an adjustment for inflation and for any expected change in commission or other form of sales remuneration. Only if the Actuary has strong grounds to believe that business plans for the period concerned will produce material variations from the historic results should budgets/projections be used.

11. TRANSLATION TO POLICY LEVEL

11.1 Each different category of expenses so obtained must be translated down to the policy level by dividing it by the measure of volume appropriate to that category of expense.

11.2 If using budgets/projections, the Actuary should ensure that any volume assumptions for future periods are justifiable taking into account:

—current volumes;
—the company's plans;
—expected market conditions (including levels of early terminations);
—any other factors which the Actuary considers to be appropriate.

and new business assumptions for future periods should be consistent with the assumptions made regarding acquisition expenditure for those periods, taking into account the company's recent experience of the cost of expansion if necessary.

12. CONSISTENCY WITH BONUS PHILOSOPHY

12.1 For with-profits policies the apportionment of expenses for the purpose of projections and disclosure should be consistent with the current methods of apportionment of expenses for the purpose of determining bonuses.

Reasonable adjustment should be made to the apportionment to ensure this, Section 10.5 notwithstanding. Examples of when an adjustment might be reasonable are:

12.1.1 If the policy fee differs from the apportioned fixed expenses expressed on a per policy basis—in which case the policy fee could reasonably be regarded as the only fixed expense per policy and the excess spread onto the variable expenses. Inflation of renewal expenses should be allowed for in this context (see Section 11).

12.1.2 If no account is taken of known differences in expenses between different policy categories when determining bonuses—in which case the attributed expenses should not be differentiated.

12.1.3 If a policy is offered at more than one price to reflect different acquisition or renewal costs between or within different distribution channels—in which case there would normally be different attributed policy costs for each.

12.1.4 If the attributable expenses for unitised with-profits business exceed the explicit charges—in which case the Actuary may consider it appropriate to express the excess as an additional fund-related charge particularly if, in profit testing the product, an implicit management charge is assumed.

12.2 It would not normally be appropriate to ignore any expenses attributable to with-profits business. If, for example, investment earnings from the estate were considered by management to act to reduce the expenses attributable to one or more categories of policy then this cannot be taken into account.

It is permissible, however, to ignore the investment management costs on the free estate.

13. TRANSFERS TO SHAREHOLDERS' OR OTHER FUNDS

13.1 Where transfers are likely to be made to shareholders' funds out of profits arising from with-profits business then allowance should be made for the expected cost of those transfers.

13.1.1 Transfers should normally be assumed to take place with the same frequency and in the same manner as has been the case in the past, unless any change is intended.

13.1.2 Transfers should be assumed to be the same proportion of distributable surplus as has been the case in the past, unless any change is intended. Future emergence of surplus should be assumed to be at the level which would be supported by the investment return required to be assumed.

13.1.3 The bonus structure assumed should accord with that currently applying, unless there is a specific intention of a different structure applying in future.

13.1.4 In taking account of shareholder transfers, appropriate allowance should be made for the way in which those transfers are calculated. Where, for example, the shareholders' transfer entitlement is one-ninth of the valuation cost of with-profits bonuses, the transfers should be calculated using appropriate assumptions about the rate of bonus supportable and the valuation basis. The current valuation basis would normally be assumed to continue unchanged, subject to adjustment as appropriate to ensure consistency with other future assumptions, notably the future investment return.

13.2 Where the Member, whether proprietary or mutual, has the practice or intention of permanently withholding a proportion of surplus from with-profits policyholders, this retention should be treated in a similar manner to a transfer of surplus to shareholders. An example would be when an office has traditionally withheld surplus to expand its estate with no intention to return it to policyholders, even as terminal bonus, and has no intention to change this practice.

Contributions to a bonus smoothing account which are not systematic and where contributions to and from the account should average out over the longer term are not 'equivalent retentions'.

13.3 Amounts of transfer or retentions determined as above may be offset by 'realistically sustainable profits from non-profit business'. The starting point for assessing this offset should be a best estimate of the current level of surplus from non-profit business attributable to the with-profits fund. This amount could then be expressed as a proportion of the surplus transferred to shareholders and/or withheld. A similar proportion of future transferred or retained surplus, adjusted as appropriate for any changes in the mix or profitability of in-force business reasonably anticipated, could then be offset. The offset cannot, however, be greater than the cost of transfer or retention.

14. MORTALITY AND OTHER COSTS

14.1 Both projections of future benefits and the disclosure of cumulative deductions are required by LAUTRO to include mortality and morbidity on either the current rate or scale (where explicit charges are made) or on a basis appropriate to the class of investor (where no explicit charge is made).

14.2 In the latter case, the mortality (including allowance for AIDS) or morbidity assumed should be a best estimate of the rates expected to apply in the period of use of the figures. No improvements should be anticipated for future periods for insurances, although this may be appropriate for annuities.

15. TAXATION

15.1 The investment return upon which projections are based and upon which the effect of expenses is being determined is set by LAUTRO at the same level for both mutual and proprietary companies. For consistency, the Actuary should therefore ignore any possible difference in the rate of the tax relief that might apply to proprietary companies by using the rate which would apply to mutuals.

15.2 Where legislation specifies that tax relief on expenses shall be automatically deferred (e.g. the spreading of acquisition expense relief) allowance should be made for this deferment. No allowance should, however, be made for the effect of any other tax losses or unrelieved expenses being carried forward. This will ensure consistency with the net investment return regardless of the Member's actual tax position.

16. INFLATION

16.1 Any expenses which are expected to be incurred other than at the inception of a policy should be adjusted for the effect of future inflation.

16.2 The rates of inflation assumed are required by LAUTRO to be as specified in Paragraph 1(1) of Part II of Schedule 4 to the LAUTRO Rules. It should be noted that different assumptions are required for projections at different rates of investment return.

16.3 Expenses expressed at policy level as a percentage of funds will, of course, automatically include an implicit allowance for inflation.

17. GENERAL

17.1 In the case of a brand new product, the Actuary should be guided by the expenses attributable to the existing product that most closely corresponds to it, but with proper regard to what the Actuary regards as material differences in cost.

17.2 Some of the smaller Friendly Societies may not have the data for the Actuary to carry out the detailed analysis set out in this Guidance Note. In this circumstance, or in the more general circumstance of lack of up-to-date data, the Actuary may make appropriate approximations. In doing so, the Actuary should be conscious of the requirement of Section 8.

17.3 Expense disclosure must be maintained up to date. Whenever the Actuary believes that it is appropriate to review the apportionment of expenses such a review should be conducted. This should not be less frequently than annually. If the Actuary believes that the current projection basis and expense disclosure is no longer appropriate then the Member should be advised.