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Enhancing Life Insurance •Regulatory Regimes in **ASIA**

Australia's supervision of life insurance

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Australia's Supervision of Life Insurance

INTRODUCTION

This paper provides background to the prudential supervision of life insurance business in Australia.

The paper describes what we hope to achieve, why we do what we do and what we do in practical terms.

The material is focussed on the current practices.

GOALS

The aims of life insurance supervision are twofold:

- To protect policyholder interests; and
- To foster a competitive and innovative marketplace.

APRA carries out its role with an emphasis on these requirements very much in this order.

- **Protection of the Interests of Policyholders**

Policyholder protection involves several aspects. We seek to ensure that the industry operates in a manner so as to

- Provide for the current and expected prospective capitalisation of life insurance companies at adequate levels;
- Ensure policyholder's liabilities can be met as and when they fall due (often a considerable period of time into the future);
- Ensure new entrants to the market are able to conduct life insurance business properly and are aware of their obligations;
- Maintain confidence in the industry; and
- Ensure that the equitable treatment of the participation of policyholders in the profits of the fund is secured on an ongoing basis.

Whilst less desirable, the regulatory structure also provides for the orderly and equitable transfer of business between and within companies, permitting exit from the market and the regulatory approval of changes in ownership of companies and control of assets. Regulatory management of companies is also available where the interests of policyholders is at risk.

Our interest extends beyond current policyholders to include prospective policyholders.

PHILOSOPHY OF APPROACH

Our approach to the prudential supervision of life insurance can be characterised as seeking that

(i) the ultimate responsibility for the company rests with the directors;

(ii) actuaries and auditors are critical advisers to the board, have responsibilities in the management of the company's business through the *Life Insurance Act 1995* (the Life Act), and a whistle blowing role to the regulator;

(iii) intervention reinforces the responsibility of the board, actuaries and auditors, and maintain the ‘ring fence’ (see below);

(iv) it is important to maintain an active, visible presence in the industry; and

(v) firm public enforcement is a last resort. Preference is given to anticipate any likely issues and to see them resolved by the company before they escalate.

We adopt a stance based on an expectation that companies will comply with regulatory requirements at all times both in spirit as well as the letter of the law.

This approach has met with the general but not uniform agreement of all companies on all issues at all times but remains our preferred stance.

- **The Ring Fence Approach**

Insurance regulation both in Australia has historically been structured on a 'ring fence' basis. That is, the regulatory structure and approach is based on the underlying proposition that the company can be contained within itself if it comes under duress.

This approach has been included in the design of Australian legislation and is reflected in our attitudes to the interaction of the company with external parties (whether part of the same group or otherwise).

Over time, there has been debate as to the merits of the ring fence approach although the practitioners believe that the 'fence' is sufficiently robust. This approach has implications for the potential structure and approach for APRA. Extending the ring fence, for example, would result in some matters, including the ultimate responsibilities of directors and the sanctions on companies, raising concerns with most companies.

An insight into the actual methods used to implement the goals and objectives is included below.

LEGISLATIVE ENVIRONMENT

- **The Life Insurance Act**

The principle supervisory instrument is the *Life Insurance Act 1995*, which substantially modernised the original legislation which was enacted in 1945. This act sets out a regulatory framework covering, amongst other matters,

- Requirements for registration and deregistration of life insurance companies;
- Operation of statutory funds in support of policyholders interests;
- Provisions requiring ongoing capital adequacy and solvency of statutory funds and capital requirements for the shareholders funds of a company;
- Obligations on Directors of companies to give priority to the interests of policyholders;
- Requirements for standards of corporate governance;
- Requirements covering Actuaries and Auditors;
- Restrictions and requirements of a financial nature regarding the allocation of expenses to statutory funds, treatment of assets, distribution of profits and capital from statutory funds and the payment of dividends;
- Provision of a mechanism for the (Federal Court) approval of the transfer of groups of policies from one company to another.
- Provisions relating to statistical and financial reporting to APRA.
- Powers for APRA to monitor and inspect companies and documents, demand information, make (some) standards and rules, formal investigations.

- Appointment of Judicial Managers and provisions to wind up companies which are all included in the Life Act (rather than utilising other mechanisms – for example Corporations Law).

The Act also provides for the establishment of a Life Insurance Actuarial Standards Board which publishes standards of actuarial practice required under the Act. These currently include minimum surrender values, valuation of liabilities, calculation of solvency and calculation of capital adequacy.

Aside from the Actuarial Standards, the Act is supported by a structure of Regulations, Prudential Rules, and Circulars. All except Circulars have the force of law although the penalties for breaches are limited. These are public documents and are widely circulated.

Circulars are further supplemented by a series of "Letters to CEOs / Appointed Actuaries / Approved Auditors". These tend not to have a broad public circulation although are accessible within each life insurance company and are treated as obligatory.

- **IATA / FSSA**

The Insurance Acquisitions and Takeovers Act (IATA) and the Financial Sector Shareholdings Act (FSSA) both provide an important additional legislative control.

The objective for the FSSA, from a prudential perspective, is to provide for the approval of changes of ownership (including internal restructure) of companies. Particular consideration is given to

- the capacity of any proposal to enable the continued operation of prudential regulation;

- the protection of the rights of policyholders, particularly any minority groups of policyholders or those with particular policy conditions; and

- ensuring that inappropriate people and organisations do not gain control of licensed companies.

IATA provides a similar structure to control the transfer of assets without the exchange of the shares of the company.

- **Registration Policy**

Registration of life insurers is carried out after a detailed assessment of the company's proposals and application material. As a matter of course, registration is restricted to those that conform to our ongoing policy positions.

Life insurers must have a minimum paid up share capital of $10 million, although up to $5 million can be utilised for short to medium term support of the insurer's statutory funds.

Aside from compliance with the Act and other regulatory requirements, the company and its officers are assessed regarding their capacity on a 'fit and proper' basis. This considers financial standing, ethics and expertise. Experience and expertise tend to be the most difficult issue for applicants.

The understanding of long term commitments a company is planning to take on is tested. In particular, as capital can be an ongoing issue for a new company, advice is required to check that the company is capitalised sufficiently for it's most optimistic business growth expectations over a ten-year time horizon.

We do not register branches of overseas companies (on the basis that a subsidiary offers greater security - is better ring fenced). There are some branches still in existence for historic reasons. There is no pressure to register branches from potential applicants on either taxation or capital grounds. Rather, the trend is for branches to domesticate to subsidiary status.

- **Statutory Funds**

Life insurance business must be conducted through statutory funds within a life insurer in order to provide a separate accounting of the policyholder business and assets from shareholder business and assets. Premiums must flow to statutory funds with claims and operating expenses paid from statutory funds. Any excess leads to an accumulation of assets with the investment income on those assets also flowing back to the relevant statutory fund. For new companies or new statutory funds capital injections from shareholders will often be required to cover set up costs and to finance new business growth. There is a tracking of shareholder capital as well as an annual determination of statutory fund profit, which is allocated between participating policyholders and shareholders, with a consequent tracking of each group's retained profits. Distribution of policyholder profits is subject to solvency requirements being met while distribution of shareholder profits is subject to capital adequacy requirements being met.

In the investment, administration and management of the assets of a statutory fund the life company must give priority to the interests of policyholders and the directors have a duty of care to policyholders and must place policyholder interests before shareholder interests.

There are rules about the types of business that can be conducted in the same statutory fund and there are investment restrictions on statutory fund assets, such as no borrowing and very limited investments in related companies. There are also rules about the establishment, division, transfer and amalgamation of statutory funds.

- **Solvency and Capital Adequacy**

The solvency standard for a statutory fund is aimed at ensuring the fund can meet its existing liabilities as and when they fall due with a high degree of probability. Therefore it is a conservative assessment of the assets needed to run off existing liabilities. The detail is set in an actuarial standard and does provide for conservative future assumptions, the ability to withstand shocks to economic markets and the inadmissibility of assets likely to evaporate in a stressed situation.

The capital adequacy standard for a statutory fund is aimed at ensuring the fund can remain financially viable, continue to write new business and is likely to meet the solvency requirement is 3 years time with a high degree of probability. Some of its elements are less conservative than the solvency standard because it is based on a continuing rather than a close down scenario, but the new business growth plans can make it more onerous than the solvency standard. Also, the capital adequacy requirements can not be less than the solvency requirements, so in practice they are quite similar for mature stable funds, but capital adequacy is more onerous for quickly growing funds.

Failure to meet the solvency standard is regarded as extremely serious and unless it was clearly only temporary, or only in part of an insurer, we would usually move to place the insurer under judicial management with a view to having it sell its business on and move out of the industry.

Failure to meet the capital adequacy standard would raise concerns with us and we would be ensuring the insurer fully understands how it got into such a situation, the serious of it and had realistic plans to become capital adequate within a reasonable time frame. There is the added incentive that shareholder's capital or retained profits can not be transferred out of capitally inadequate statutory funds without the regulator's approval.

- **Financial Management**

  Life companies are required to keep financial records to a particular level of detail and to produce and lodge annual audited financial statements with APRA. Through one set of integrated financial statements life companies must show their profitability on a realistic market value basis as well as their solvency position relative to the legislative minimum, which involves a conservative assessment of liabilities with a market value of assets. Life company auditors are approved by APRA and are responsible for certifying that the apportionment of income and outgoings in the financial statements are equitable. They also have a role to whistleblow to APRA regarding breaches or activities that prejudice the interests of policyholders.

Each life company must have an audit committee made up of directors, with a majority of non-executives and the audit committee not being the chairman of directors.

Each life company must have an appointed actuary who is responsible for advising the directors on premium rates, policy terms and conditions, unit pricing, surrender values and reinsurance; performing the annual valuation of policy liabilities; checking the company's compliance with the solvency and capital adequacy standards; producing a report on the financial condition of the company and advising on the financial consequences of distributions from statutory funds. The appointed actuary also has a whistleblowing role regarding breaches or activities that prejudice the interests of policyholders.

- **Monitoring and Investigation**

APRA has extensive powers inspect records and request information of a life insurer and to take action where it appears the insurer is or is likely to become unable to meet its liabilities. These extend to freezing assets, formally investigating an insurer, directing a company to take specific action (eg stop writing new business), applying to the Court to place the company under judicial management or have the company wound up.

IMPLEMENTATION

This section sets out the practical application of the philosophy and legislative frameworks within the life insurance group.

For the life insurance group this involves the following :-

- We start from a standpoint of needing to understand the industry. As a result, we maintain a watch of industry press, commentary, research papers, conference activity, and carry out our own specific research on practices and issues. A network of practitioners and others is maintained.

- We consider the issues facing the industry as a whole and various segments, through our own research and continued dialogue with all companies,

- We also maintain contact with all companies to ensure continual understanding of the strategic issues faced by each company, the capacity of management to deal with these issues, and the progress toward solutions. Monitoring of progress toward corporate goals is regularly discussed with company CEOs, and senior management.

- **Data Collection and Analysis**

- Companies provide quarterly, half-yearly and annual returns. The annual returns are the most significant and include a copy of the board report on the financial condition of the company prepared by the Appointed Actuary as well as the financial statements and statistical returns.

Financial Condition Reports consider both the current *and prospective* financial condition of the company and the distribution of profits to policyholders and share holders. They also consider the company's capacity to comply with the regulatory regime and continue operating.

Half yearly returns provide statistical and financial information but not as comprehensively as the annual returns and quarterly returns focus on certain exception issues (derivative usage, large asset exposures etc).

- **Off-Site Emphasis**

- Annual returns are reviewed formally against assessed risks which are categorised as relating to

  Liabilities, (considering the nature of the business in force and new business profile, profitability of terms and conditions, expense structures and outlook, reinsurance etc);

  Assets (including significant exposures, handling of derivative products, credit risk etc.);

  The **interaction of Assets and Liabilities**, (the appropriateness of the investments and investment policy to the types of policies written, the extent of mismatching and the adequacy of capital held to provide for mismatch risks, liquidity);

  Operational Risk (management capacity, corporate governance, systems, effective functioning of the board, audit and actuarial roles); and

  Capitalisation and Solvency including profitability. (Is the company solvent and capitally adequate and can it expect to remain so?)

- Annual reviews are prepared by an analyst assigned to the company. Each analyst will have a number of companies to consider. Aside from checking compliance the analyst forms a preliminary view on the various risks and seeks any clarification of a factual nature from the company.

  The work of the analyst is reviewed and mentored by a more senior member of the group.

  The result of this process is a rating for the company and a report which recommends the appropriate action.

- Reviews are then assessed through senior management which confirms (or amends) the recommended rating and considers the recommended actions which should then be taken. This step reinforces the focus on a risk assessment approach.

- **Inspection and Enforcement Philosophy and Approach**

- Our risk based assessment leads us to leave some companies pretty much alone. We maintain informal contact regarding strategic direction through informal visits on a convenient basis (at least every 18 months). These tend to be short meetings.

- Other actions that arise from a review vary with the assessed risk and generally include :-

  Telephone queries of issues raised to validate our assessment and enquire of the actions being taken by the company;

  Letters to the company;

  Informal visits for discussions;

  Formal on site reviews by a small team;

  Inspection of documents or a request for further reports and submissions on issues;

  Close monitoring of a particular issue through half yearly and quarterly returns;

  Requests for the company actuary to attend meetings at our Office; [More serious matters require requests to the CEO, Auditor or possibly the Chairman] and

  Statutory inspection visits;

  Although rare, we would move to formal monitoring and inspection on the basis of a 'show cause' letter. This would reflect a grave situation indeed and the matter having been actioned by other processes but not achieving the desired results.

  The degree of activity is treated as a clear signal of our relative satisfaction.

- For industry wide issues, we request information from companies on a survey basis. Sometimes this is done selectively on the basis of market information (profitability of premium rates) or for all companies (Y2K).

  Where a company is part of a selective survey they are immediately aware of our interest and concern on a specific issue. It is usual to provide responses to individual companies where we have further concerns and to provide generic feedback through letters to CEOs such that acceptable standards are more widely understood.

  On site reviews of a sample of companies can also follow from these surveys, both to ensure that we have a complete understanding of the state of the industry and to place

pressure on the poorer performers.

- Quarterly and Half Yearly returns are not analysed in any detail unless they have been identified as critical as part of the annual review. This reflects current resourcing constraints.
- Analysts also take the lead on any other action that occurs during the course of the year for the company. This tends to be extensive and ranges from routine approvals of a minor nature to the monitoring of service contracts and agreements, press material, consideration of IATA and FSSA applications, various approvals relating to reinsurance etc. and the consideration of applications for court ordered transfers of business between companies.

Company On Site Review Processes

Perhaps in contrast to other areas, we have tended not to have a formal program that determines **timing** of inspections for all companies **in advance**. Rather, we aim for each company to be reviewed on site[1] in some detail at least every three years. This requirement is monitored at annual reviews.

Companies presenting greater risk are subject to on site review more frequently with a focus on the specific issues of concern.

Once a decision is taken to visit a company, then contact is made to arrange a tentative time and a draft agenda is prepared and sent to the company. Questions are prepared for each session and the relevant team assembled. We generally aim to provide a company with around two weeks notice except where we wish to emphasise our concern with very short lead times.

The agenda for on site reviews varies depending on the availability of the appropriate company officers. Reviews tend to include an inspection of documents, an update on the strategic direction and business performance from the CEO and senior management, then move on to specific issues.

The tone adopted for on site reviews tends to be firm and inquisitional in nature to contrast them to ‘normal’ visits.

Following the visit a written report is prepared for the file and to feed in to the next off site annual review.

Overseas regulators do visit Australia but this is rare and tends to occur when attending an industry conference rather than to visit a local company. They do not come to inspect

[1] There is provision for Statutory Inspections so we differentiate between these in this paper by referring to “on site reviews”.

the local operations of a company and we have not been invited to participate in any visits of the overseas operations to an Australian company.

- **Influence of Industry and Structure**

The Australian life insurance industry consists of a diverse range of players operating in a highly competitive retail, wholesale and reinsurance market. Whilst the various players can be grouped in like categories, history, structures, product ranges, distribution, size and other issues make each category small. A summary of the industry segments along with the key issues facing each at the moment follows :-

Total Assets in Statutory Funds are shown for each segment along with the percentage of the total industry. Attachment A includes a company by company.

- **Long standing players ($94.8 bn, 62.5%)**

  Characterised by large diverse financial services providers operating through several distribution channels but dependent on one main network. Providing a full product range with significant product guarantees and holding inforce portfolios which include closed portfolios of participating business.

  Players : AMP, Colonial, National Mutual, MLC

  Key Issues for this group : Having (with the exception of MLC) recently undergone demutualisation and listing, these companies are now seeking a greater focus on efficiency and shareholder return. In particular, this involves developing an effective capital management culture within the organisation, operational efficiency - particularly through distribution, and cost reduction.

- **Mid Sized Traditional Players ($18.1 bn, 11.9%)**

  Characterised as providing a broad range of (insurance) products, these companies are less diversified than the larger industry players but usually operate Life Insurance, Superannuation and General Insurance operations. These companies are subsidiaries of overseas companies where the parent is in the same business internationally.

  Players : Mercantile Mutual, Norwich Union, Zurich, Tower Life (and a smaller case) Sun Royal.

  Key Issues for this group : Maintaining relevance in a changing market, cost competitiveness.

- **Bank Owned Retailers ($21.6 bn, 14.2%)**

  Characterised by operating as part of a banking group and distributing products through specialised sales staff (financial advisers) integrated with the parent distribution network. Single premium investment business tends to dominate the product range and sales are exclusively to the client base of the parent.

  Players : NAFM, Westpac Life, Commonwealth Life, ANZ Life, Suncorp, St George Life.

  Key Issues for this group : Lead generation to deliver effective distribution costs, Integration into bank culture and structure for more effective support. Generic growth of wholesale acquisition to increase scale (retail acquisition offers no synergies). Systems infrastructure is weak in this group.

- **Bank Owned Product Manufacturers ($7.7 bn, 5.1%)**

  Distributing a specialised product range through the independent financial planning networks. Usually operationally and culturally distinct from the bank parent but with some use of corporate services and treasury, economic and accounting functions.

  Players : Macquarie Life (cash investment), Citicorp, Deutsche (fixed rate annuities), BT Life (funds management)

  Key Issues for this group : Controlled growth whilst maintaining the current strong levels of profitability is the priority for these companies. In addition, both Citicorp and Deutsche are needing to manage the impact of a low interest rate environment on business flows of fixed term annuity business against increased competition from the other players with stronger distribution and broader product range.

- **Subsidiaries of Australian General Insurers. ($5.5 bn, 3.6%)**

  The General Insurance parent dominates these companies. Whilst trading at a profit, they tend to have a broad product range of mixed quality and unfocussed in presentation. The companies are not of sufficient size to stand alone in the market but operate with only limited coordination of effort with the parent. Rather they find the main leverage is the brand recognition and reputation of the direct writing general insurer.

  Players : GIO, NRMA, RACV, FAI Life

  Key Issues for this group : Continuing to seek a relevant market position and

growth in business. The strategic position is weak. Product ranges are in need of attention to update them and make them more competitive. Distribution is problematic for those companies. Lack of size leads to consideration of outsourcing as companies seek to cover overheads - particularly IT costs.

Note that FAI has been acquired by Tower but would still be perceived in the market as operating on the previous stand alone basis at this stage.

- **Boutique operators, niche operators, and others ($2.9 bn, 1.9%)**

  The remaining group of retail operators are small players, generally unique to themselves, and functioning on the basis of some specialisation. Whilst profitable, the return for effort seems unjustified.

  Players : AM (Superannuation Administrator), Challenger (Corporate Finance), Lumley, HCF, Combined, American International, Fortis (various risk business specialisations) and CUNA (Credit Union distribution)

  Key Issues for this group : Lack of size and expertise. Generally limited strategic direction. For some, the option of getting out of life insurance may be drive by external impacts, whilst others haven't considered the option at all. Systems development costs and capital management issues are the subject of most discussions with APRA.

- **Reinsurers ($1.2 bn, 0.8%)**

  Subsidiaries of large European or North American specialist reinsurers providing services to the Australian market through local licensed subsidiaries. Strongly oriented toward risk insurance but with some interest (verbally in excess of actual business) in financial reinsurance (capital). Some small amounts of direct business provided to industry superannuation schemes.

  Players : Swiss Re, Hannover, Munich, Cologne, Gerling, RGA

  Key Issues for this group : Disability insurance profitability and competitiveness in the face of rationalisation of clients.

As a result of this diversity - supervision is as much about understanding each company as it is taking an industry wide perspective. The contrasts from company to company are usually more illustrative than the similarities. Consequently, we compare and contrast views between companies to form a view on practices and the environment impacting on organisations.