SUBMISSION

Parliamentary Joint Committee on Corporations and Financial Services - Inquiry into the life insurance industry

November 2016

Contents

Executive summary

Australia's life insurance industry is prudentially sound, operating with an adequate excess of capital above minimum regulatory requirements. The industry, however, is under continuing pressure from a range of sources, and responding to these pressures has been challenging. Some insurers have managed these challenges better than others. In particular, those insurers with sound governance, a strong risk management framework, an effective risk appetite statement and a robust approach to capital management have proven best able to manage and adapt to operating conditions. More needs to be done.

Life insurers generally issue long- term business in excess of two years duration; the long tail liabilities and long term guarantees involved mean that issues and challenges can take a long time to emerge and be addressed. Sustainability of the business and the market requires a continued focus over a longer term time horizon, which can extend well beyond the shorter term perspective of the share market, and even beyond the tenure of many executives in an insurer.

Insurers must operate on a sustainable basis in order to be financially and operationally viable into the future. A sustainable market serves the interests of consumers, by insurers meeting their financial promises over the long term and by avoiding a recurrence of the significant price discontinuities experienced in recent years. To this end, APRA has strengthened the life insurance prudential framework and heightened its supervisory intensity of life insurers in recent years.

The life insurance industry is characterised by complexity, driven by a complex legacy of long term contracts and outdated systems. The Financial System Inquiry (FSI) recommended the rationalisation of legacy life products. There are a range of legal, consumer and tax issues that inhibit an insurer's ability to update legacy products. Introducing a rationalisation mechanism, as recommended by the FSI, would help address this issue; this, however, requires legislative change.

In APRA's view, there is a great deal more that industry can do in relation to legacy products, without waiting for a legislative solution. In particular, life insurers need robust systems and processes capable of fairly and accurately administering their books of legacy business and have not always invested enough in these systems and processes. APRA will continue to increase the pressure on insurers to invest more in this area, so that their systems and processes are more capable of meeting community and policyholder expectations.

Chapter 1 sets out a brief overview of the life insurance industry.

Chapter 2 discusses Australia's system of financial regulation, including APRA's mandate and the core capabilities in place to deliver it.

Chapter 3 includes further information regarding APRA's core capabilities and discusses the toolkit of responses available to address emerging issues.

Chapter 4 discusses recent prudential activities in the life insurance industry.

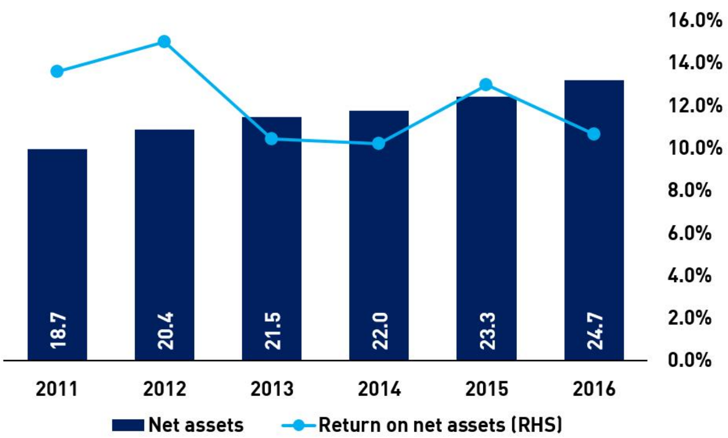
Chapter 5 discusses the issues caused by legacy products in the life insurance industry. It sets out some key steps that can be undertaken by industry to address those issues, together with some recommendations for legislative change to support appropriate rationalisation of legacy products.

Chapter 1 – overview of the life insurance industry

The number of life insurance entities has remained relatively static in recent years, with 29 APRA-authorised life insurers and 12 friendly societies. Only two new life insurance licences have been granted in the past two years.

The market is relatively concentrated, with the top five life insurers accounting for 80 per cent of gross industry assets (at 30 June 2016). Ownership changes have been of some interest, with Japanese life companies acquiring stakes in Australian insurers in the last five years.

Chart 1 - Return on net assets (% and $bn)



Despite facing significant challenges, the industry return on net assets at September 2016 was 10.6 per cent (Chart 1), well below the 10-year industry average of 15 per cent. The rather sharp fall in 2013 can be attributed mostly to poor performance in group lump sum business and this continued into 2014, exacerbated further by losses in individual disability income insurance (DII).

Chart 2 shows the losses in more detail compared to other risk products. Traditional individual lump sum business has maintained its profitability throughout the five year period. Improved net profit after tax in 2015 and 2016 reflects increases in premium rates for group lump sum business to more sustainable levels. DII in both individual and group remain problematic.

Chart 2 - Net profit after tax (insurance risk products) ($bn)

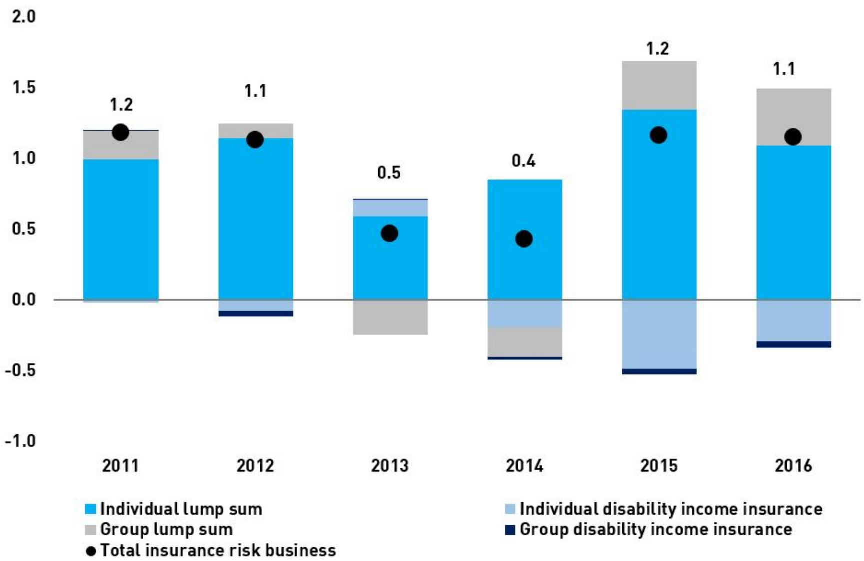
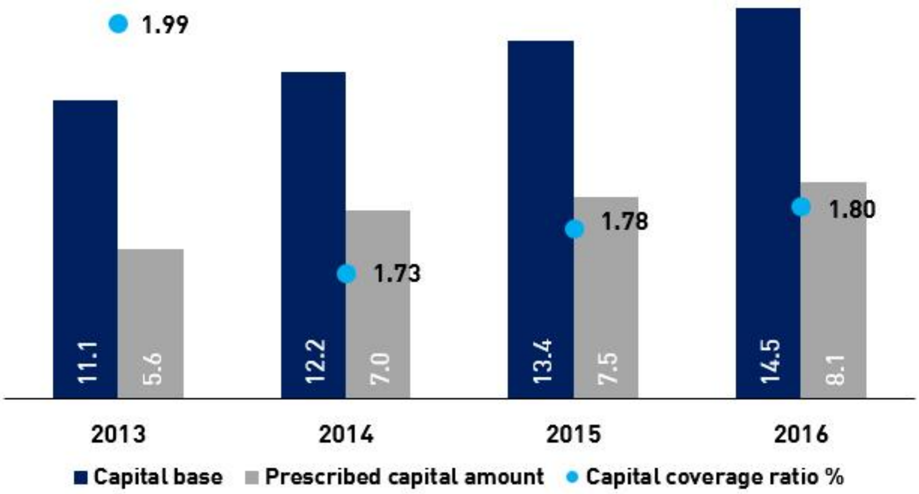


Chart 3 - Capital adequacy (total entity) ($bn)



Relatively strong capital ratios have been maintained in recent years, with an aggregate capital coverage ratio as at 30 September 2016 of 1.8 times the minimum regulatory requirements (Chart 3).

The amount of surplus capital held above regulatory requirements differs between insurers and this reflects the heterogeneous nature of the industry with different risks and business models. Capital management practices have generally improved over time and APRA has seen increased capital buffers in response.

Further detail on the market is available in Annex A.

Chapter 2 - financial regulation and APRA's mandate

APRA is one of five independent agencies that oversee the Australian financial system. The other four are the Australian Securities and Investments Commission (ASIC), the Reserve Bank of Australia (RBA), the Australian Competition and Consumer Commission (ACCC) and the Australian Transaction Report and Analysis Centre (AUSTRAC). Each of these regulators has a clearly defined and distinct mandate.

- APRA is responsible for prudential supervision of individual financial institutions (authorised deposit-taking institutions (banks, building societies and credit unions), life and general insurance and reinsurance companies, private health insurers, friendly societies and superannuation funds (excluding self-managed funds)) and for promoting financial system stability in Australia.
- ASIC is responsible for financial market integrity, business conduct and disclosure, and consumer protection in the financial system.
- The RBA is responsible for monetary policy, stability of the financial system and the safety and efficiency of the payments system.
- The ACCC is responsible for competition policy.
- AUSTRAC is responsible for anti-money laundering and counter-terrorism financing.

In undertaking its mandate, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, and, in balancing these objectives, to promote financial system stability in Australia.[1]

APRA establishes and enforces prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions it supervises are met within a stable, efficient and competitive financial system.

APRA seeks to fulfil its mandate through three key capabilities:

- Policy – which establishes the minimum prudential standards that all insurers must meet;
- Supervision – which involves day-to-day oversight of insurers to ensure they are not at risk of breaching minimum prudential standards; and
- Resolution and enforcement – which provides means for APRA to intervene in the affairs of an insurer should it be at material risk of breaches or failure.

The diagram in Annex B illustrates how these capabilities work together.

[1] Refer to section 8(2) of the *Australian Prudential Regulation Authority Act 1998*.

Chapter 3 - APRA's core capabilities in detail

This Chapter sets out further information on APRA's core capabilities of policy, supervision and resolution and enforcement. It discusses the graduated toolkit of responses available to address emerging issues and provides an illustrative case study of supervisory action on a life insurer.

Policy

As noted above, APRA has a policy toolkit at to address emerging issues in pursuit of its mandate. APRA administers a prudential framework consisting of three tiers:

- primary legislation in the form of Acts of Parliament and regulations under those Acts – the legislation establishes the objectives and legal powers of APRA, requires institutions to be authorised by APRA in order to undertake business in Australia, and empowers APRA to make and enforce prudential standards.
- subordinate legislation in the form of prudential standards – the prudential standards are legally enforceable, and establish APRA's minimum requirements regarding financial soundness, appropriate governance and prudent risk management in regulated institutions. The prudential standards are principles-based, and implemented in a manner appropriate to the size, business mix and complexity of individual institutions.
- prudential guidance - APRA issues guidance in the form of prudential practice guides and other similar documents. This guidance sets out non-enforceable expectations of prudent practice and explains ways that institutions can comply with the principles-based prudential standards.

APRA also issues reporting standards under the *Financial Sector (Collection of Data) Act 2001*. These reporting standards are legally enforceable and require institutions to report data to APRA in prescribed forms and according to detailed instructions. The reported data may be collected and used for a number of purposes, including prudential supervision by APRA, publication and to assist in the formation of policy.

In addition to these formal aspects of the prudential framework, APRA seeks to influence the behaviour of insurers through a range of communication channels such as letters, speeches, submissions, information papers and other publications.

Supervision

APRA's supervision is based on the principle that the primary responsibility for the sound and prudent operation of an institution rests with the board and the senior management of that institution.

APRA undertakes supervision of regulated institutions with the aim of identifying potential weaknesses as early as possible and ensuring institutions take steps to address them. Each institution has an APRA supervision team responsible for the risk based supervision of that entity. Supervision activities are varied and include regular analysis of data and information and proactive entity interactions. These include meetings with various representatives (often involving the board and/or senior management), providing technical advice, engaging in discussions on business or strategy changes, dealing with regulatory issues such as breaches and complaints, routine correspondence and analysis of market information.

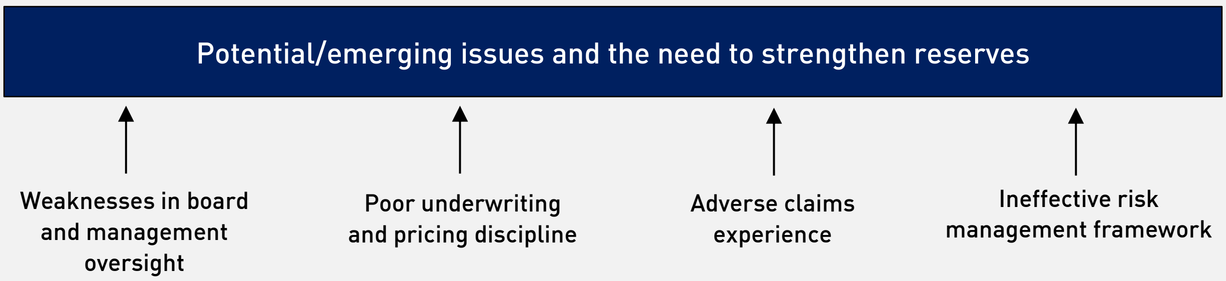
Risk-based supervision means that the intensity of supervision varies between institutions and over time based on APRA's assessment of the risk profile of that institution. The intensity of supervision varies in line with the institution's risk profile and aims to address any emerging risks before they pose a threat to the institution and its beneficiaries. APRA's supervisory actions are driven by its Supervisory Oversight and Response System (SOARS) and can range from a normal (more routine, less intensive) level of supervision to a heightened supervisory stance that requires extra supervisory oversight, mandating improvements or restructuring an institution.

Determining an institution's risk profile requires a detailed assessment which is undertaken by APRA supervisors using a structured process referred to as the Probability and Impact Rating System. This involves consideration of the risks to which an institution may be exposed, the controls in place to manage those risks and the capital support available to the institution.

APRA's supervisors use a range of approaches in their assessment of institutions, including prudential reviews, prudential consultations, Board interactions, financial analysis and thematic reviews.[2] A detailed outline of APRA's supervision approach is set out in 'The APRA Supervision Blueprint' available on the APRA website.[3]

Case Study of supervisory action on a life insurer

There can be a number of reasons why an insurer's sustainability may be at risk. In this case the diagram below shows a number of poor practices that have resulted in the potential for significant losses for the insurer.



The insurer's supervisory team identifies the factors exposing the insurer to potential significant current and future losses through its regular supervision. As a result of these

[2] Prudential reviews assess in detail a particular risks area within an institution, and the adequacy of the associated management and controls. Prudential consultations allow for discussion between supervisors and the board and/or senior management of the institution on key strategic and risk issues. Financial analysis is undertaken based on the institution's financial and statistical returns provided to APRA. Thematic reviews occur across a group of institutions on a specific issue.

[3] The Australian Prudential Regulation Authority, http://www.apra.gov.au/AboutAPRA/Publications/Pages/default.aspx

weaknesses, supervisors will then increase the intensity of supervision and implement remediation requirements with the intention to mitigate the risks and enable the insurer to return to a sustainable position. This process is demonstrated in the diagram below.

The next diagram outlines the type of supervisory actions undertaken to return the insurer back to a sustainable position.

Identification of prudential concerns	Remediation – prudential requirements	Recovery
• Targeted on-site and off-site prudential review activity • Document review and specialist analysis	• Reserve strengthening and capital injections • Improvements to capital and risk management frameworks • Additional reporting requirements	• Strengthened underwriting and pricing practices • Temporary controls on capital reductions (dividends) • Enhanced internal and regulatory reporting

Resolution and enforcement

If an institution is unwilling or unable to respond to APRA's concerns, APRA has a robust enforcement and resolution powers to ensure that issues are addressed and beneficiaries are protected.

APRA's supervisory approach is aimed at identifying and evaluating potential risks in institutions, and ensuring that these are appropriately mitigated before they could pose any threat to the viability of the institution, its prudent operation or financial system stability in Australia. As a prudential regulator, APRA has to date used its formal enforcement powers less than traditional law enforcement agencies, preferring instead to focus on supervision so that institutions implement effective risk management and prevention measures.

APRA has a graduated toolkit of responses available to use depending on the seriousness of the issues that need to be addressed. If it appears likely that poor risk management or other issues may give rise to serious prudential concerns, such as unacceptable losses or non-financial impacts, for an institution, APRA will intervene to protect the interests of policyholders. APRA will also liaise and consult with other regulators where there are heightened prudential concerns. APRA has information sharing arrangements in place with many domestic and foreign regulators, including ASIC, the RBA, the ACCC and AUSTRAC.

APRA's powers are designed to reinforce APRA's primary role as a prudential supervisor. The use of formal legal powers is considered if ordinary supervision is unable to achieve the appropriate outcome. The kinds of powers currently available to APRA in respect of the life insurance industry are information seeking, investigation, directions, enforceable undertakings, injunctions, and actions against individuals and companies.

One of APRA's strategic objectives is building recovery and resolution capability in readiness for possible financial failure and crisis.[4] This includes strengthening powers that would assist APRA achieve an orderly exit from the industry if there was an entity failure. The Final Report of the Financial System Inquiry (FSI) noted there are some gaps and deficiencies in the Australian statutory framework for crisis management and resolution when compared with international standards.[5] These were identified in a consultation paper published by the Treasury on 'Strengthening APRA's Crisis Management Powers' in 2012, and include the need for such things as broader investigation powers, strengthened directions powers, improved group resolution powers and enhancements to statutory and judicial management regimes, including the ability to appoint a statutory manager over a life company[6]. The Treasurer has recently reiterated the Government's intention to proceed with these improvements to APRA's crisis powers.

4 APRA, *Corporate Plan 2016-2020*, http://www.apra.gov.au/AboutAPRA/Publications/Pages/Corporate-plan-2016-20.html

5 The Financial System Inquiry, *Final Report,* http://fsi.gov.au/publications/final-report/, 2014

6 The Australian Government Treasury), *Strengthening APRA's Crisis Management Powers Consultation Paper,* http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/APRA, 2012

Chapter 4 - APRA's recent life insurance prudential activities

The above section outlined the toolkit of responses available to APRA to respond to emerging risks and issues. This section discusses a range of activities APRA has undertaken to address prudential risks in the life insurance industry. These activities can be categorised into two main streams of work:

- addressing the impacts of mispricing/poor risk management on the sustainability of insurers, particularly in relation to insured benefits offered through superannuation (also known as group risk business); and
- reviewing organisational risk culture.

Sustainability of group insurance

In recent years, APRA has been concerned about the poor risk management within the group insurance sector and the potential impact on insured benefits offered to superannuation fund members, with APRA regularly raising these concerns with both the superannuation and life insurance industries (see timeline of recent communications in Annex C). Poor risk management has led to poor profitability with significant losses threatening the long-term sustainability of life insurers (see Annex A for more information on profitability).

APRA's supervisory and policy actions to address the risks in group insurance include:

- identifying to both industries the key sources of risk to be addressed to reduce risks to long-term sustainability of the life insurance offering within superannuation;
- increased supervision of group insurance providers and superannuation trustees to ensure appropriate actions continue to be taken to improve long-term sustainability;
- setting clear expectations in both the superannuation and life insurance contexts through enhanced prudential standards and guidance; and
- reviewing claims processes and governance to ensure insurers align claims management with their long term claims philosophy, and do not reject claims to address short term profitability issues.

Identifying key sources of risk to sustainability

APRA has written to, and met with, CEOs of insurers and trustees on numerous occasions to discuss poor profitability and its causes. This communication has allowed APRA to emphasise that part of the group insurance market had fallen short of appropriate practice in respect of risk management and governance, causing APRA to respond with heightened intensity of supervision.[7]

[7] APRA, *Letter to life insurers: Group insurers*, http://www.apra.gov.au/lifs/Pages/Letter-to-LI-entities-on-Group-Insurance-18-May-2015.aspx ,18 May 2015.

As noted in APRA's letter to the industry in May 2015, there were various reasons for losses including:

- underwriting and pricing practices in both the life insurance and reinsurance industry left both the direct and reinsurance market exposed to adverse movement in market conditions. In particular, thin margins were exposed by pricing that did not properly align with the policy benefits. A notable example was a trend whereby default coverage increased in group life schemes, but the underlying premium rates did not increase, and in many case fell, despite the increased exposure;
- decreases in global interest rates reduced investment returns;
- competitive tension in group life market tendering saw the process often weighted toward acquisition and retention of business rather than sustainability leading to short-termism among decision makers;
- increased plaintiff solicitor involvement has led to an increase in lump sum total permanent disability claims; and
- an increase in the number of TPD claims related to mental illness and other complicated injuries, and changing community standards as to what conditions give rise to claims, has also resulted in more claims payments and required greater claims management and resourcing.

Some of the poor industry practices identified relevant to life insurance consumer claims experience included[8]:

- basic disablement and trauma definitions that are open to interpretation (even if they have worked effectively in the past) because of the broad way they are worded;
- disablement and trauma definitions that cover ailments that are inherently difficult to assess with confidence, or that are prone to obsolescence;
- complex products that are difficult to understand and to administer; and
- inadequate resourcing or skills for sound claims management (including to cater for changing social attitudes/behaviour and market conditions).

Increased supervision

Increased supervision sought to encourage improved risk and business management practices. APRA found that insurers had taken a range of actions to restore profitability to their group insurance business, including[9]:

- no longer making 'opt-in' offers that allow members to take or increase cover with little or no evidence of health status;

[8] APRA, *Speech by Ian Laughlin A challenge to the life industry: managing for long term portfolio health*, http://www.apra.gov.au/Speeches/Pages/Life-Risk-Insurance-A-challenge-to-the-lifeindustry-managing-for-long-term-portfolio-health.aspx, 3 March 2015

[9] APRA, *Letter to life insurers: Group insurers*, http://www.apra.gov.au/lifs/Pages/Letter-to-LI-entities-on-Group-Insurance-18-May-2015.aspx, 18 May 2015.

- increasing the length of the 'at work' period for members to become eligible for cover (e.g. from one day to one month);
- tightening the definition of TPD (for example, from 'unlikely to work' to 'unable to work');
- introducing severity-based TPD benefits;
- introducing TPD benefits payable via instalments rather than as a lump sum;
- reducing default TPD benefits and increasing default Group Salary Continuance (GSC) benefits;
- reducing automatic acceptance limits;
- making greater use of health questions for optional cover;
- making greater use of exclusions for pre-existing conditions, hazardous occupations, suicides and pandemics; and
- reinsurers mitigating the impact of the poor profitability on their business by significantly reducing or even ceasing to write or tender for new business.

APRA observed that many insurers chose to increase premiums to improve profitability. While some premium increase was needed to return pricing to a sustainable level following a period in which premiums were insufficient to reflect risk, in APRA's view, these increases did not by themselves address the underlying problems and have produced an unexpected increase in the cost of insurance for superannuation fund members.

Set clear expectations through enhanced prudential standards and guidance

APRA introduced *Prudential Standard SPS 250 Insurance in Superannuation* (SPS 250) to provide greater clarification and improved rules for superannuation trustees with respect to making insured benefits available to beneficiaries in superannuation funds.

Box 1: *Prudential Standard SPS 250 Insurance in Superannuation* (SPS 250)

SPS 250 establishes requirements for trustees for making insured benefits available to beneficiaries. The standard establishes that the board of a trustee is ultimately responsible for having an insurance management framework that reflects the risks associated with making available insured benefits and that is appropriate to the size, business mix and complexity of the trustee's business operations. The insurance management framework must include the insurance strategies for each fund that are required by the SIS Act.

A trustee must also ensure that insurance arrangements adequately address minimum requirements set out in the standard; and formulate and giving effect to appropriate selection processes for, and due diligence of, insurers and monitor relationships with insurers on an ongoing basis.

This prudential standard supplements amendments to the *Superannuation Industry (Supervision) Act 1993* (SIS Act) also introduced in 2013, to require trustees to have an insurance strategy and to only offer insurance if the cost of insurance does not inappropriately erode the retirement outcome of beneficiaries.[10]

APRA provided further clarity for insurers by issuing *Prudential Practice Guide LPG 270 Group Insurance Arrangements* (LPG 270), released in October 2014 (see Box 2 below for summary).[11]

Box 2 Prudential Practice Guide LPG 270 Group Insurance Arrangements (LPG 270)

LPG 270 provides guidance to life insurers regarding key aspects of group insurance business. It sets out better practices and assists insurers in understanding the impact of SPS 250 on group insurance. A key aspect of LPG 270 relates to the claims philosophy of an insurer. Claims philosophy encompasses those claims management processes and controls of the insurer that support the insurer paying all valid claims in a timely manner. APRA expects an insurer's claims philosophy to be clearly articulated.

SPS 250 requires superannuation trustees to consider an insurer's claims philosophy. APRA expects that a trustee's policies and procedures for claims assessment would include the consideration of whether an insurer's claims management practices remain consistent with the stated claims philosophy.

In particular, it is important that a trustee is able to understand the insurer's practical application of the definition of disablement.

LPG 270 sets out a range of illustrative examples of how the claims philosophy may be supported by an insurer.

Reviewed claims processes and governance

APRA expects that an insurer's claims philosophy would not change in the short term with a view to improving profitability by denying or reducing otherwise legitimate claims. In APRA's view, the claims management processes of an insurer should align with the claims philosophy, which is a long-term commitment. The insurer's claims philosophy should be designed to support the long-term sustainability of the business.

[10] Refer to s. 52(7) of the *Superannuation Industry (Supervision) Act 1993*.

[11] APRA, *Prudential Practice Guide LPG 270 Group Insurance Arrangements* http://www.apra.gov.au/lifs/PrudentialFramework/Documents/Prudential-Practice-Guide-LPG-270-Group-Insurance-Arrangements-October-2014.pdf, October 2014.

APRA's May 2015 letter noted its concerns of how poor profitability could impact claims management - insurers are obliged to treat claims fairly under the *Life Insurance Act 1995.*[12] The letter highlighted insurers' legal responsibilities and clearly articulated APRA's position on a long term claims philosophy. The letter also encouraged strong dialogue between insurers and trustees in the case of group insurance:

> *"APRA would be concerned if insurers chose simply to take a 'harder line' in considering claims in an effort to reduce claims costs. Insurers need to be satisfied that claims are assessed fairly and in accordance with the policy terms. This is an important requirement in order for the board to be confident that it is meeting its obligations under section 48 of the Life Insurance Act 1995.*
>
> *APRA considers that active dialogue between insurers and trustees on this issue builds trust between the parties and we encourage insurers and trustees to discuss in detail proposed changes to the claims philosophy or approach before they are implemented".*

In April 2016, APRA met with the CEOs of insurers, and undertook a review of claims processes.
APRA identified a number of areas where both life insurers and trustees can improve their practices to better meet expectations in relation to insurance claims.[13] These are:

- reviewing insurance benefit design and definitions with a stronger focus on delivering insurance benefits appropriate for members at an appropriate level of cost;
- better sharing of information between insurers and trustees). For example, information that could be shared more readily includes claims data and trends, and regular reporting on key performance indicators;
- closer co-operation and alignment between trustees, insurers and reinsurers to optimise outcomes for beneficiaries; and
- clarifying the approach to claims in the claims philosophy of both insurers and trustees to improve claimants' understanding of how claims will be managed.

Throughout this work on group insurance and claims, APRA has worked closely with ASIC. In particular, APRA continues to work with ASIC to establish a consistent public reporting regime for claims data and claims outcomes, including claims handling timeframes and dispute levels across all policy types. APRA's supervisors are also following up on any findings in ASIC's report that raise prudential concerns in relation to individual institutions.

APRA also made a submission to the Financial Services Council (FSC) draft Code of Practice for Life Insurers consultation (draft Code). The submission suggested a number of areas where the draft Code could be improved, in particular in relation to coverage of insured benefits provided to members of superannuation funds. Subsequently, the FSC committed to

[12] APRA, *Letter to life insurers: Group insurers,* http://www.apra.gov.au/lifs/Pages/Letter-to-LI-entities-on-Group-Insurance-18-May-2015.aspx, 18 May 2015

[13] Insurers' submitted information in response to APRA's 4 May 2016 information request on claims oversight and governance. APRA, *Information request related to claims oversight and governance,* http://www.apra.gov.au/lifs/Documents/1605-Letter-industry-LI-Claims-Oversight-Governance.pdf, 4 May 2016

working with industry associations representing the superannuation industry to extend coverage of the consumer protections of the draft Code to superannuation fund members.

Comminsure

APRA also increased supervisory intensity of individual life insurers noted in the media reports, including Comminsure. APRA's consideration of these matters is continuing, however, part of this process has included:

- APRA engaging with the board and senior management of CommInsure to gain assurance over the robustness and completeness of the independent reviews commissioned to investigate the allegations and to ensure a focus on stakeholder and community expectations through this process; and
- APRA also met with the whistleblower and is considering whether the whistleblowing provisions in the *Life Insurance Act 1995*, which are designed to prevent the identification and victimisation of whistleblowers, have been adhered to in this matter.

Current outcomes and future plans

The group life insurance industry has made good progress in addressing the underlying structural issues that caused market stress a few years ago. Data shows that the group life insurance industry has returned to profitability in 2015/16, improving the long term sustainability of the sector.

However, more needs to be done. The current phase of APRA's work in the group insurance market focuses on the long-term sustainability of superannuation insured benefit structures: these need to be viable for insurers and also meet the needs of fund members. In particular, a key objective is to reduce the likelihood of another significant period of price discontinuity, as seen in recent years.

APRA continues to discuss how the market can be strengthened with insurers and reinsurers active in group risk insurance, as well as with trustees. Areas with scope for further strengthening include the review of complex and old definitions, and enhanced dialogue between trustees and insurers to improve benefit design in light of the trustee's obligations to not inappropriate erode retirement balances of superannuation members. The outcomes APRA is seeking to achieve through this work include:

- emphasising the need for insurers and trustees to address sustainability - this requires both sides of the group risk market to work together for positive outcomes for members;
- developing guidance on what constitutes better practice in sustainable benefit design; and
- enhancing APRA's ability to monitor the on-going sustainability of the market.

Insurers and trustees continue to consider how to balance product and benefit design to provide adequate and sustainable insurance cover for members while ensuring insurance costs do not inappropriately erode retirement benefits.

Organisational risk culture and social licence

Risk culture is the influence of organisational culture on how risks are managed in an organisation. It is how staff identify, understand, discuss and act on the risks an organisation confronts and takes, including how life insurance claims are managed.

Prudential standards relating to risk culture

In January 2015, APRA introduced explicit requirements in relation to risk culture as part of the strengthened risk management prudential requirements of the new cross-industry *Prudential Standard CPS 220 Risk Management* [14] and *Prudential Practice Guide CPG 220 Risk Management*[15] (see Box 3 below). The new standard takes account of international developments, lessons from the GFC and APRA's experiences in supervising institutions.

Box 3: *Prudential Standard CPS 220 Risk Management* (CPS 220) and *CPG 220 Risk Management* (CPG 220)

On 1 January 2015, a new risk management standard CPS 220 was implemented. This standard harmonises risk management requirements across the banking and insurance industries, bringing together a range of risk management requirements into a single standard.

A key part of CPS 220 is APRA's expectation of the board's role in relation to risk culture. APRA expects that the board form a view of the risk culture in the institution and the extent to which that culture supports the ability of the institution to operate consistently within its risk appetite, identify any desirable changes to the risk culture and ensure the institution takes steps to address those changes.

Risk culture information paper

Risk culture continues to be an important part of APRA's cross-industry agenda, consistent with the broad theme of improving the financial system's resilience. In 2016, APRA continued to promote the development of sound risk cultures within financial institutions, consistent with the long-held philosophy that the responsibility for the sound management of financial institutions rests first and foremost with the boards and managements of those institutions.

APRA released an information paper on risk culture to help institutions understand current risk culture practice and the management of risk culture.[16] This paper notes that while there has clearly been a stronger focus on risk culture in recent years amongst APRA-regulated

14 APRA, *Prudential Standard CPS 220 Risk Management,* http://www.apra.gov.au/CrossIndustry/Documents/Prudential-Standard-CPS-220-Risk-Management-January-2015.pdf, January 2015

15 APRA, *Prudential Practice Guide CPG 220 Risk Management,* http://www.apra.gov.au/CrossIndustry/Documents/Prudential-Practice-Guide-CPG-220-Risk-Management-January-2015.pdf, January 2015

16 APRA, *Information paper: Risk Culture* http://www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf, October 2016

institutions, continued effort and ongoing attention is required by institutions to better understand and manage their risk cultures.

APRA found that:

- approaches to understand and manage risk culture are at a relatively early stage of development; and
- many institutions are grappling with how best to:
    - clearly articulate what type of risk culture they aspire to;
    - identify any specific weaknesses in their current risk culture; and
    - effectively address those weaknesses.

The information paper recognises that APRA cannot regulate sound risk culture into existence. It is ultimately the responsibility of each institution's CEO and senior executives to establish a sound risk culture, supported and overseen by their board.

However, APRA will apply greater supervisory intensity to institutions that are either unwilling or unable to address behaviours that are inconsistent with prudent risk management practices. APRA will also continue to work to identify practices that are associated with sound, and less sound, risk cultures, and share these observations with institutions and other stakeholders.

Prudential regulation and social license

Poor consumer experiences can be a significant indicator of poor risk culture and can have significant prudential impacts. A recent speech by APRA Board member Geoff Summerhayes referred to the notion of trust and social licence and the importance for these to be upheld. [17] The financial sector has increased its focus on this area, but life insurance has much to do to rebuild trust following the negative media attention on claims management, and in light of the ASIC report released on 12 October 2016. The viability of an institution's business model may come under question once consumer trust is broken.

Remuneration and risk culture

Remuneration frameworks, and the outcomes they produce, are important barometers and influencers of risk culture. Remuneration has been an area of focus for international regulators since the GFC. Inappropriately designed remuneration structures can drive poor behaviour. Accordingly, remuneration needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements.

In April 2010, APRA introduced various prudential requirements in relation to remuneration,[18] to address the impact remuneration arrangements can have on risk-taking in the management of the business of an institution. The requirements are not intended to

[17] APRA, *The view from the other side of the table: Regulation, trust and social licence,* Speech by Geoff Summerhayes, http://www.apra.gov.au/Speeches/Pages/The-view-from-the-other-side-of-the-table-Regulation-trust-and-social-licence.aspx, 5 October 2016

[18] APRA , *APRA finalises position on remuneration,* http://www.apra.gov.au/MediaReleases/Pages/09_38.aspx, 30 November 2009

prescribe business decisions regarding pay levels or limit innovative methods of rewarding staff, provided such measures do not compromise the requirements of the prudential standards.

APRA will be increasing its focus on this area by conducting a review of current industry remuneration policies and practices to gauge how well existing requirements in *Prudential Standard CPS 510 Governance* are being implemented, and how they are interacting with the risk cultures of institutions. This will include reviewing the remuneration arrangements and outcomes for some senior executives, risk and control staff, and material risk takers at a sample of institutions.

Chapter 5 - Legacy product issues in life insurance

Life insurers regularly introduce new products to better reflect consumer demand and changed market conditions. While the previous products (legacy products) are typically no longer made available for new business, they must continue to be administered in accordance with the original contract terms, potentially for an extended period of time.[19] As life insurance products involve a contract between the life insurer and the policyholder, terms cannot be unilaterally modified by either party to the contract.

Legacy products arise particularly in life insurance and superannuation, where the financial products often last a lifetime, but the financial, legal and social environment continually changes. In addition, the life insurance sector has undergone a significant consolidation over the past 20 years, leading to many duplicated and outdated products. The industry is still grappling with the challenge of addressing those issues.

Over time, legacy products become more complex and expensive to administer and may no longer meet the requirements of policyholders. Industry estimates suggest that approximately 25 per cent of all funds under management are in legacy products.[20] The cost of these legacy products is ultimately borne by the policyholders in the form of poor service and increased prices, while insurers experience increased operational risk and poor efficiency.

Consumers cannot switch from a legacy life insurance policy easily to access current new policy offers and updated definitions. In the case of risk business, a policyholder may not be able switch to a newer product or provider readily, as their health status may have changed in the interim meaning that they either cannot obtain replacement insurance or can only do so at significantly increased cost.

Opportunities for industry initiatives

APRA strongly believes that there are opportunities for industry to address the complexity issues created by legacy products by investing in better systems and data management. Historically, life insurers have underinvested in their systems and are unable to efficiently manage the ever increasing number of legacy products. Data on legacy claims and policies is not readily available in a reliable way to inform decision makers.

APRA has been concerned about underinvestment in systems and data capabilities and the associated increased operational risk for some time. As noted earlier, APRA identified that collecting comprehensive and accurate data to manage and measure its portfolio is one of the basic needs of an insurer. While we understand the some insurers have recently begun

[19] This contrasts with general insurance, where cover is for a set, relatively short period and the contract is renewed on new terms and conditions each year.

[20] The Financial System Inquiry, *The Financial System Inquiry: Final Report, Recommendation 43*, http://fsi.gov.au/publications/final-report/, November 2014

long-term projects to upgrade systems, many insurers will still find this a challenge.[21] Better data processes and systems benefit both the consumer and the insurer by: delivering better customer service in the event of a claim; and by improving the efficiency and decision making of the insurer. A lack of robust, reliable data, together with old systems and software, imposes significant constraints on the ability of an insurer to manage its business efficiently and evolve to meet future challenges.

Opportunities for regulatory reform

One area of potential change identified by APRA relevant to this Inquiry is the introduction of a mechanism to allow the rationalisation of legacy products to occur more easily. There are a number of very complex legal, consumer and tax issues that arise if a life insurer seeks to move policyholders from a legacy product to a new product, restricting the ability of insurers to close legacy products.

The benefits of a simpler, though still robust, mechanism to rationalise legacy financial products has been recognised for some time. The issue was, for example, a recommendation of the *Report of the Taskforce on Reducing Regulatory Burdens on Business* in 2006.[22] As noted in the FSI Final Report, between 2007 and 2010, Government worked with industry to develop a mechanism to facilitate product rationalisation. However, such a mechanism was not finalised or implemented.

The mechanism would have facilitated rationalisation of genuine legacy products — that is, not simply those that are performing poorly — subject to a 'no disadvantage test' for relevant consumers. It would also have provided tax relief to ensure consumers were not disadvantaged as a result of triggering an early capital gains tax event.

Accordingly, the FSI Final Report recommended the development of an appropriate mechanism for rationalising legacy products.[23] This recommendation was accepted by the Government.[24]

APRA continues to strongly support the need to comprehensively address this issue.[25] From the perspective of the product provider, it would help mitigate the increasing operational risk that such products create, as well as improve the industry's operational efficiency. From the

[21] APRA, *Life Risk Insurance – A challenge to the life industry: managing for long term portfolio health,* Speech by Ian Laughlin, http://www.apra.gov.au/Speeches/Pages/Life-Risk-Insurance-A-challenge-to-the-life-industry-managing-for-long-term-portfolio-health.aspx, 3 March 2015

[22] Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, http://archive.treasury.gov.au/documents/1141/PDF/Reducing_Regulatory_Burdens_on_Business_Final_Government_Response.pdf, page 103, 31 January 2006

[23] The Financial System Inquiry, *The Financial System Inquiry: Final Report, Recommendation 43*, http://fsi.gov.au/publications/final-report/ , November 2014

[24] The Australian Government, *Government response to the financial system inquiry: Improving Australia's Financial System,* http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt-response-to-the-FSI/html, 20 October 2015

[25] APRA , *Financial System Inquiry: Response to the Interim Report,* http://fsi.gov.au/files/2014/08/APRA_2.pdf, 26 August 2014

consumer perspective, it has the potential to improving consumer outcomes by updating definitions, improving efficiency and administration, and lowering costs.

Annex A: Overview of the Life Insurance Industry

APRA supervises life companies (including friendly societies) registered under the *Life Insurance Act 1995* (Life Act). Life insurance helps protect Australians against the economic impacts of premature death, as well as long term or short term illness, injury or disability that impacts their ability to earn an income.

The most common risk products provided by life insurers are death cover, total permanent disability (TPD), trauma, and income protection. Annuities and other investment products are also provided by some insurers.

- Life Insurance Death Cover pays a lump sum to the policy owner. If the policy owner and the life insured are one and the same then often beneficiaries would be a partner or child upon the death of the life insured. In some cases, a terminal illness benefit may be available and is an advancement of the death cover paid if the insured is medically certified as being terminally ill within a defined period (usually 12 or 24 months).
- Total Permanent Disability – known as TPD – pays a lump sum if the insured becomes totally and permanently disabled.
- Trauma provides payment if the insured person is diagnosed with a specified illness or injury. These policies include the major illnesses or injuries that will make a significant impact on a person's life, such as cancer or a stroke.
- Income Protection replaces the income lost due to a person's temporary inability to work due to injury or sickness. Sometimes also referred to as disability income insurance or salary continuance insurance.
- Annuity: An investment product providing a guaranteed income for either a fixed term or the lifetime of the policy holder.

Life insurance business can be divided into three groups according to the type of policyholder.

- Individual risk insurance: This insurance is sold to the final consumer directly or via a financial advisor. Individual consumers can choose whether to hold one or a range of life products listed above. The Life Insurance Act contains specific restrictions that significantly limit the ability of the life company to re-price the policy or change its terms and conditions. The policy holder is entitled to a guaranteed renewal of their policy.
- Group risk insurance: This insurance is sold to superannuation funds to provide cover to their members. Group insurers provide a default level of automatic cover, usually including TPD and death cover and sometimes income protection cover, to the trustee. Typically, fund members can also acquire additional cover through the same insurer. The policyholder is the trustee of the fund who contracts the insurance on behalf of the membership. The terms, conditions and pricing of the policy are typically periodically re-negotiated periodically between the insurer and the trustee.
- Reinsurance: is insurance that is purchased by an insurance company (the cedant) from one or more other insurance companies (the "reinsurer") as a means of risk management. The cedant and the reinsurer enter into a reinsurance agreement which

details the conditions upon which the reinsurer would pay a share of the claims incurred by the ceding company in exchange for a premium.

As at September 2016, there were 29 authorised life insurance companies (see table below). Insurers are comprised of a number of distinct groups: eight large diversified insurers, four insurance risk or annuity specialists, ten relatively smaller niche market players and seven reinsurers.

Some reinsurers both reinsure and sell life insurance directly. Many large insurers that provide individual life policies also provide group insurance to superannuation fund trustees but there are a number of insurers that largely specialise in servicing the group insurance market. Most insurers offer both life lump sum (TPD and Death) and income protection policies. Some insurers write both direct and reinsurance business.[26]

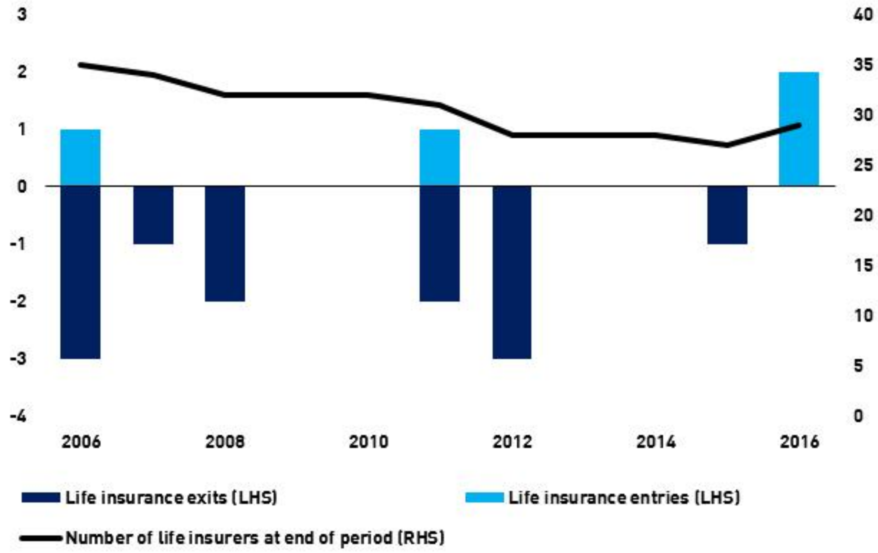
Life insurer	Sector
AIA Australia Limited	Direct
Allianz Australia Life Insurance Limited	Direct
AMP Life Limited	Direct
Challenger Life Company Limited	Direct
ClearView Life Assurance Limited	Direct
Combined Life Insurance Company of Australia Ltd	Direct
HCF Life Insurance Company Pty Ltd	Direct
Hallmark Life Insurance Company Ltd	Direct
Macquarie Life Limited	Direct
MetLife Insurance Limited	Direct
MLC Limited	Direct
OnePath Life Limited	Direct
QBE Life (Australia) Limited	Direct
QInsure Limited	Direct
St Andrew's Life Insurance Pty Ltd	Direct
St. George Life Limited	Direct
Suncorp Life & Superannuation Limited	Direct
TAL Life Limited	Direct
The Colonial Mutual Life Assurance Society Limited	Direct
The National Mutual Life Association of Australasia Limited	Direct
Westpac Life Insurance Services Limited	Direct

[26] Under the Life Insurance Act, there is no distinction in the authorisation required to conduct direct or reinsurance business.

Life insurer	Sector
Zurich Australia Limited	Direct
General Reinsurance Life Australia Ltd	Reinsurer
Hannover Life Re of Australasia Ltd	Reinsurer
Munich Reinsurance Company of Australasia Limited	Reinsurer
Pacific Life Re (Australia) Pty Limited	Reinsurer
RGA Reinsurance Company of Australia Limited	Reinsurer
SCOR Global Life Australia Pty Limited	Reinsurer
Swiss Re Life & Health Australia Limited	Reinsurer

The number of licensed life insurers has been relatively static in recent years, with two new life insurance license granted in 2016 (chart 4). Aside from the recent two entries, the number of life insurers has steadily declined since 1990, when the number of licences peaked at 61. Since that time, mutually-owned insurers - which were once the largest life insurers in the market - have largely disappeared, while the banking industry has developed a prominent role in the ownership of life insurance and wealth management businesses more generally.

Chart 4 - Number of life insurance entries and exits



An interesting development in the Australian market is the increased interest by Japanese life insurers in acquiring stakes in Australian life companies:

- 2011: Dai-Ichi Life's 100% takeover of Tower Life (following an initial acquisition of 29.7% in 2008);
- 2016: Nippon Life's 80% acquisition of MLC; and
- 2016: Sony Life announced that it will acquire 14.9% of ClearView Life.

Japanese corporates have increasingly been looking to overseas markets for future growth, particularly in the US, UK and Australia. The factors driving this include the ageing and declining population in Japan, together with negative interest rates. Fuelling this is the fact that Japanese banks are eager to lend to corporates seeking funding for overseas acquisitions.

Although insurers have been profitable between 2009 and 2016, this has been primarily driven by Individual Life Lump Sum business (includes Death Cover, Trauma, and TPD). However, it masks the low returns and deep losses experienced by individual disability income insurance, and group lump sum business lines (see Chart 5 and 6 below).

Chart 5 - Individual disability income insurance profitability ($bn)

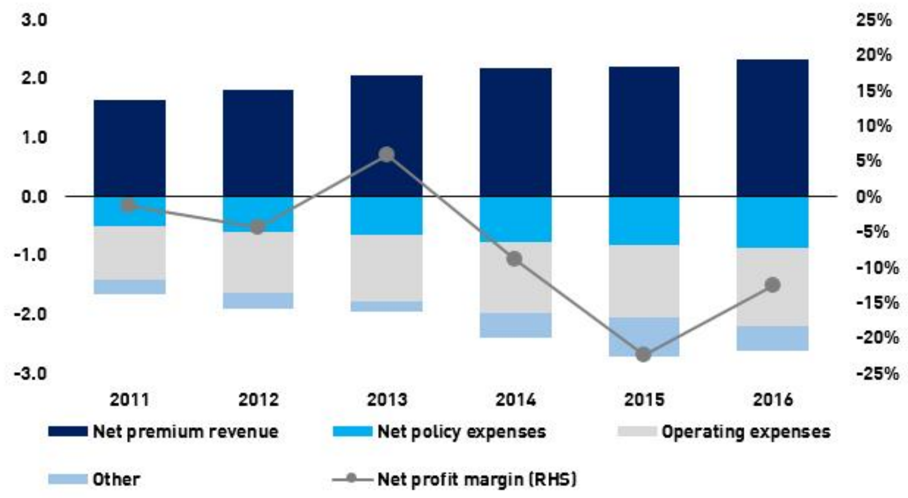
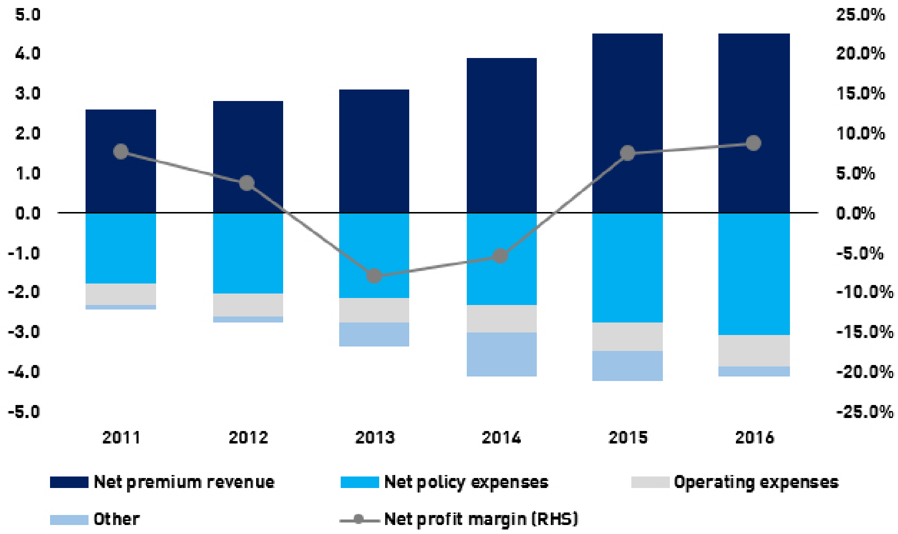


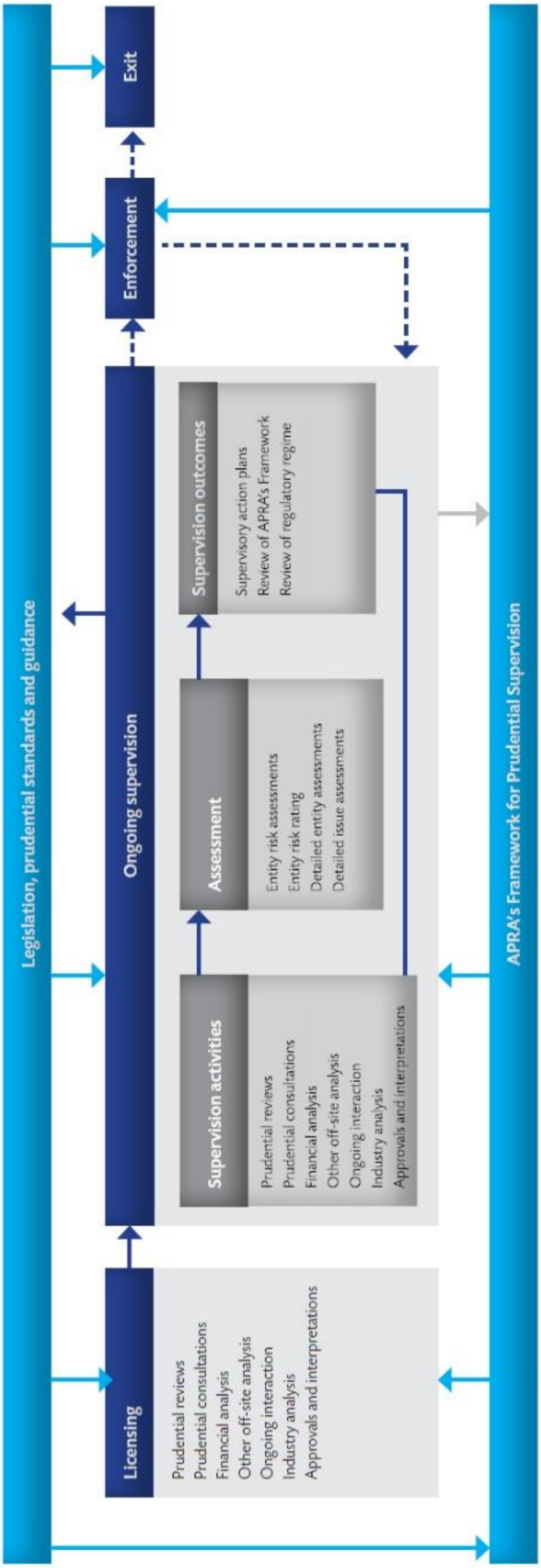
Chart 6 - Group lump sum profitability ($bn)



During 2015 and 2016 group insurance has returned to profitability has been driven mainly by increases in premium rates to more sustainable levels as a response to these higher claim costs

The life insurance industry continues to address the issues experienced in group business and, more recently, in individual disability income business. The industry's response to ongoing market volatility and a persistent low interest rate environment, together with pressures on overall industry operating efficiency, will continue to be areas of focus for APRA.

Annex B – illustration of APRA's approach



Annex C – timeline of APRA's group insurance activities

Date	Document
15 November 2012	Prudential Standard SPS 250 Insurance in Superannuation introduced http://www.apra.gov.au/MediaReleases/Pages/12_30.aspx
July 2013	Letter to insurers regarding group insurance profitability concerns
December 2013	Letter to group insurer regarding possible supervisory actions to address profitability concerns
2014	Thematic review of insurance in superannuation. This review examined the adequacy of governance practise for the provision of insurance benefits to members.
February 2014	APRA Board Member (Ian Laughlin) meeting with CEO's of group life insurers outlining how the sector had fallen short of appropriate risk management and governance practice.
March 2014	Thematic review letter requesting information regarding actions taken to address poor profitability.
29 April 2014	Speech by APRA Board Member (Helen Rowell), ASFA Unpacks: the future of insurance in superannuation. http://www.apra.gov.au/Speeches/Pages/APRA%E2%80%99s-expectations-of-superannuation-fund-trustees.aspx
October 2014	Prudential Practice Guide LPG 270 Group Insurance Arrangements released. http://www.apra.gov.au/lifs/PrudentialFramework/Documents/Prudential-Practice-Guide-LPG-270-Group-Insurance-Arrangements-October-2014.pdf
2015	Insight article published on insurance in superannuation thematic review. http://www.apra.gov.au/Insight/Documents/15-Insight-Issue-1.pdf
3 March 2015	Speech by APRA Board Member (Ian Laughlin), A challenge to the life industry: managing for long term portfolio health. http://www.apra.gov.au/Speeches/Pages/Life-Risk-Insurance-A-

	challenge-to-the-lifeindustry-managing-for-long-term-portfolio-health.aspx
29 April 2015	Speech by APRA Board Member (Helen Rowell), The super system – what is on APRA's watchlist? Notes Insurance in Superannuation is on APRA's regulatory agenda. *http://www.apra.gov.au/Speeches/Pages/The-super-system---what-is-on-APRA's-watch-list.aspx*
18 May 2015	Letter to life insurers: Group insurers outlining thematic review findings and highlighting claims philosophy requirements http://www.apra.gov.au/lifs/Pages/Letter-to-LI-entities-on-Group-Insurance-18-May-2015.aspx
27 April 2016	Letter and Submission to Senate standing committee on economics Inquiry into the scrutiny of financial advice – Life Insurance http://www.apra.gov.au/Submissions/Documents/Letter-SenateStandingCommitteeonEconomics27APR16.pdf http://www.apra.gov.au/Submissions/Documents/APRA-submission-to-Financial-Advice-Life-Insurance-Inquiry.pdf
April 2016	Meeting with CEO's of life insurers regarding poor claims outcomes
4 May 2016	Letter requesting information on claims processes and governance for supervisory review. http://www.apra.gov.au/lifs/Documents/1605-Letter-industry-LI-Claims-Oversight-Governance.pdf
19 August 2016	Speech by APRA Board Member (Geoff Summerhayes), Insights from APRA's 2015 life insurance stress test
September 2016	Submission to the Financial Services Council Draft Code of Conduct for Life Insurers.
October 2016	Letter to insurers and trustees setting out findings from claims processes and governance review http://www.apra.gov.au/lifs/Documents/APRA_LI_Assessment_Feedback_letter_with_signature_002.pdf

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