



APRA

# insight

ISSUE THREE | 2013

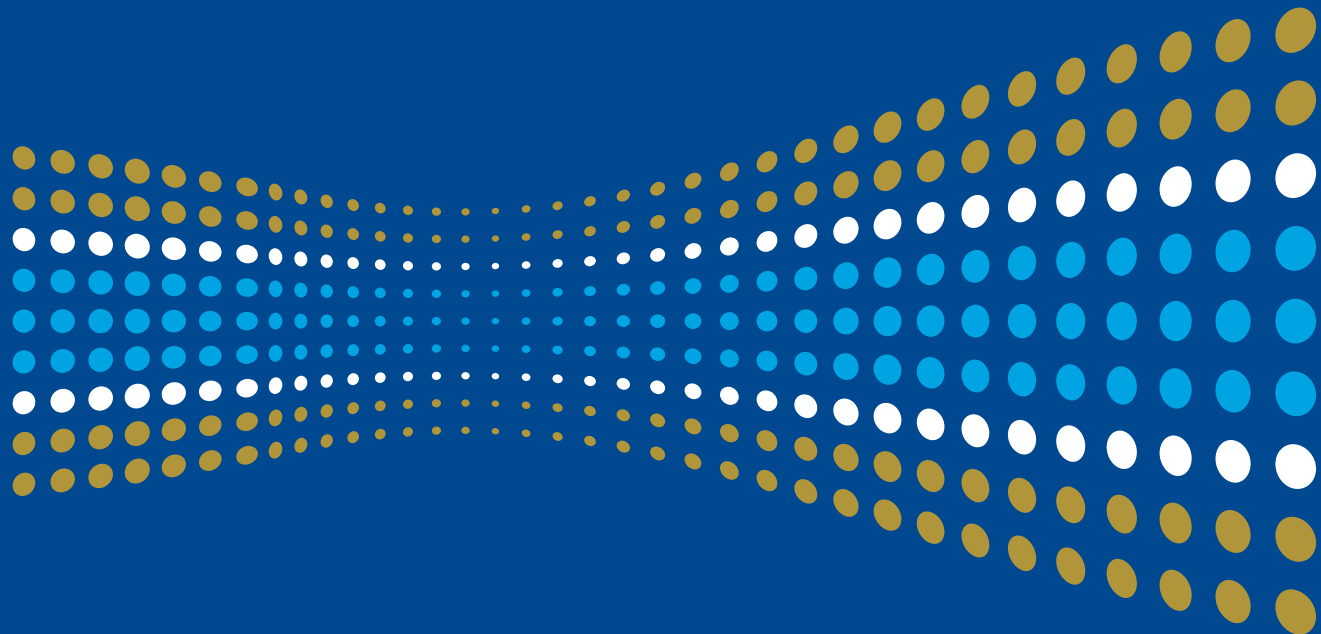
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General Insurance industry overview

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Life Insurance industry overview

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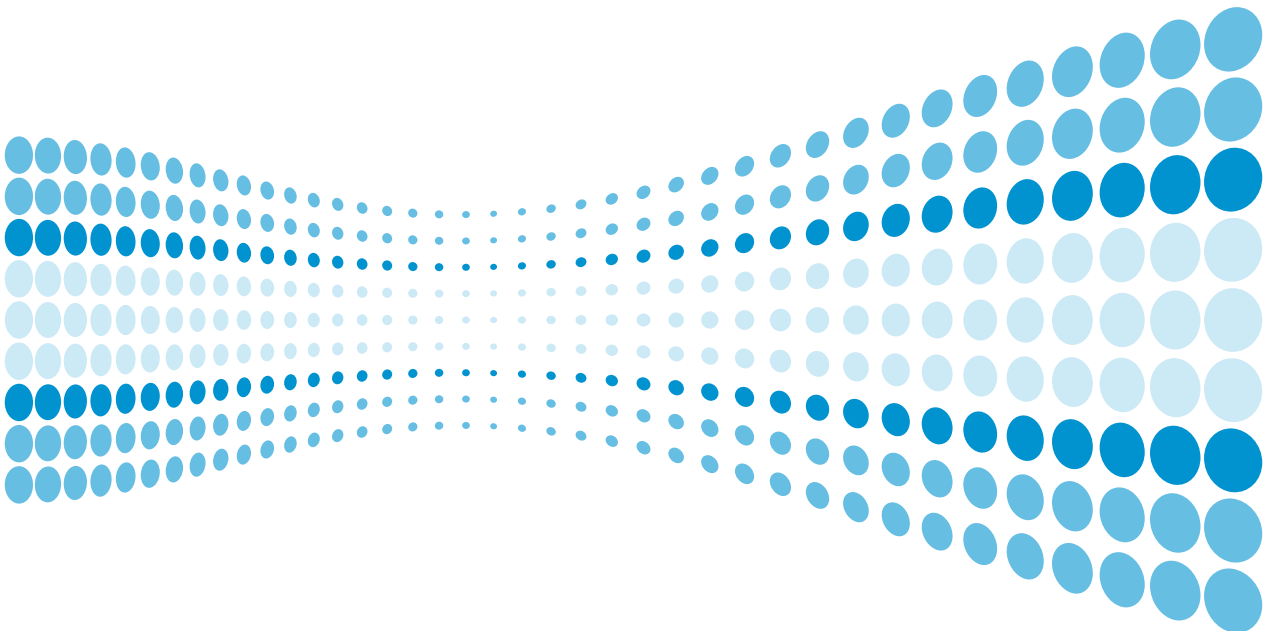




APRA

# insight

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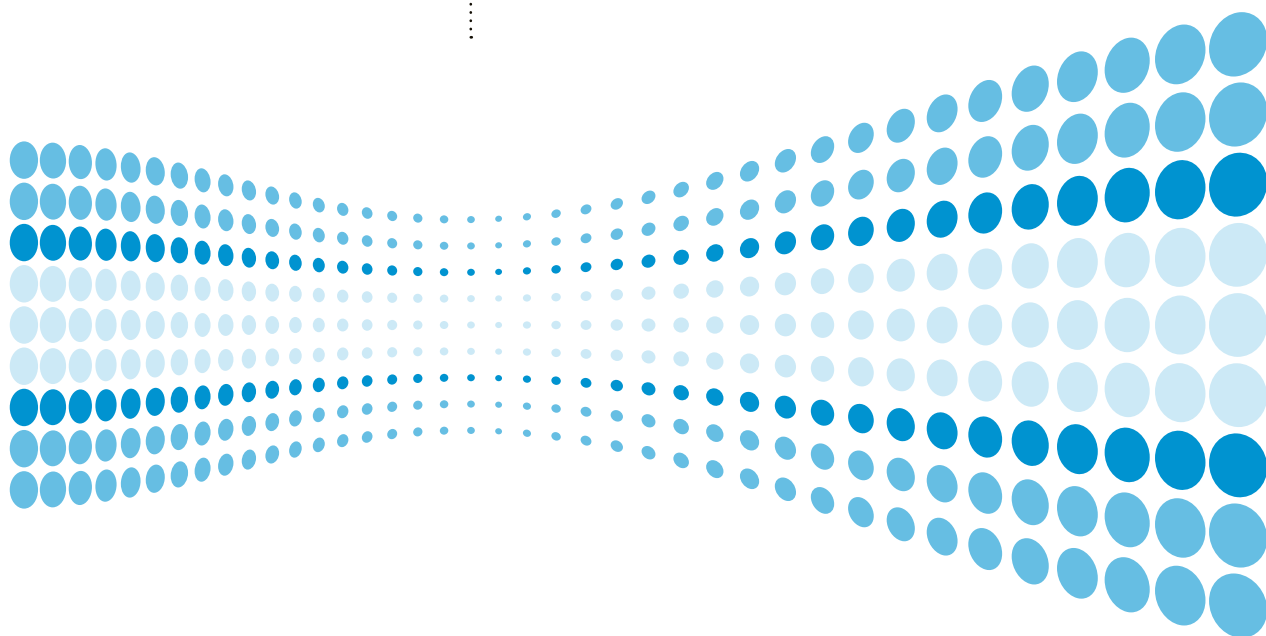
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**4****GENERAL INSURANCE INDUSTRY OVERVIEW**

This article provides an overview of recent developments and key prudential risks in the general insurance industry.

**22****LIFE INSURANCE INDUSTRY OVERVIEW**

This article provides an overview of the life insurance industry (including friendly societies) together with an update of the key prudential risks that face the industry.



# GENERAL INSURANCE INDUSTRY OVERVIEW

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## Introduction

The general insurance industry continued to manage significant changes during 2012/13, including responding to the impact of recent natural catastrophe events, adapting to a low interest rate environment and implementing new prudential requirements. Developments in these areas directed much of APRA's supervisory focus during the year.

Despite these challenges, the industry maintained a sound financial position throughout 2012/13. This was driven by strong profitability, particularly in the property classes of business.

Recent natural catastrophe events have highlighted the critical role catastrophe modelling plays in insurers' decisions on their reinsurance arrangements. APRA continues to engage with the industry on the need for strong governance and risk management by Boards and senior management in overseeing their catastrophe risk management.

APRA has been pleased with increasing Board engagement in this area, although there is scope for more comprehensive consideration. Among some insurers, however, there is still undue reliance on catastrophe model results, and a lack of appreciation of the limitations of the models used and the degree of uncertainty in model output. There are also issues in the quality and management of data used in insurers' catastrophe modelling and the documentation of assumptions and processes.

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### GENERAL INSURANCE INDUSTRY OVERVIEW

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Competitive pressures in the public and product liability and professional indemnity classes of business continue to restrict insurers' ability to reprice their new business in response to recent falls in interest rates. Vigilant underwriting discipline remains important in this environment in maintaining the profitability of new business. A prolonged period of low interest rates also raises the prospect of insurers increasing their investment risk profiles.

The industry has coped well with the changes to APRA's capital requirements, including the introduction of the revised risk-sensitive capital framework and the Internal Capital Adequacy Assessment Process (ICAAP), which came into effect on 1 January 2013. APRA will continue to engage with insurers as they fully embed these changes in their risk management frameworks.

### Operating environment

Natural catastrophe events had a moderate impact on the general insurance industry in 2012/13, with gross claims costs from these events estimated at \$1.2 billion.<sup>1</sup> The flood and storm damage from ex-tropical cyclone Oswald had the most significant effect on insurers' claims while bushfires in parts of Australia had a small claims impact on the industry.

Changes in the personal lines market continued to take place during the year in response to the impacts of recent natural catastrophe events. Most notably, there was a further increase in the number of personal lines insurers offering riverine flood cover in their home and contents policies. This has been occurring in response to the brand and reputational damage suffered by some insurers following the significant Australian flood events in 2011. Because of the new cover, underwriting and pricing risk has increased for insurers offering riverine flood cover for the first time.

<sup>1</sup> Gross claims costs estimated by Insurance Council of Australia (ICA) members for the period 1 July 2012 to 30 June 2013. Source: ICA historical disaster statistics as at 15 October 2013.

Affordability of property insurance for natural perils such as cyclone and riverine flood remains an issue for properties in high-risk areas. Some insurers have reduced their exposure to certain geographical areas in response to the ongoing loss potential in those areas.

Following the floods of 2011 the Government established the National Disaster Insurance Review (NDIR), an independent review into insurance for flood and other natural perils in Australia. The Government's response in early 2013 to some of the NDIR's findings included initiatives to increase funding for flood mitigation works and to improve the quality, consistency and accessibility of flood risk information.

The large increases in the cost of property reinsurance experienced by some insurers since the natural catastrophe events of 2010/11 moderated during the year in line with a continuation of lower local and global natural catastrophe claims costs, and further increases in the availability of non-traditional reinsurance worldwide. However, personal lines insurers offering riverine flood cover for the first time naturally experienced an increase in the cost of property reinsurance.

In 2012/13, APRA saw further developments with insurers accessing property reinsurance capacity through capital markets and looking at alternatives to traditional reinsurance products. Although the use of such alternatives at present remains immaterial for the local industry, APRA remains alert to growth in this area. Any such arrangements should adequately address APRA's reinsurance and collateral prudential requirements, which are aimed at promoting sound risk management in these areas.

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Strong levels of competition are evident in most classes of business. In the personal lines market, the presence of various foreign insurers as well as large retail groups are having an impact as they seek to build market share, particularly in the domestic motor class of business. Price comparison platforms (or 'aggregators') are also focussed on this class but continue to have only a small presence in the market. By highlighting to consumers the lowest premium being offered for their individual risk characteristics, aggregators can lead to increased customer switching behaviour and have an adverse impact on insurer profitability by uncovering any deficiencies in insurers' pricing models. It is important that aggregators make clear the differences in terms and conditions between policies and consumers do not make a decision based solely on price. APRA continues to monitor developments in this area.

### Industry structure

As at 30 June 2013, there were 121 general insurers authorised to conduct business in Australia. Of these, 98 were authorised to conduct new or renewal business while 23 were authorised only to conduct run-off business.

There has been a steady consolidation in the number of licensed insurers and reinsurers in the market over the past four years (see Table 1). The small decrease in the number of licensed general insurers in 2012/13 was due to some insurance groups rationalising licences acquired through their previous acquisition activities.

**Table 1: Industry structure**

	30 June 2010	30 June 2011	30 June 2012	30 June 2013
Number of licensed insurers	118	115	112	109
Number of licensed reinsurers	12	12	12	12
<b>Total licensed insurers/ reinsurers</b>	<b>130</b>	<b>127</b>	<b>124</b>	<b>121</b>

Source: *Quarterly General Insurance Performance Statistics* report

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### GENERAL INSURANCE INDUSTRY OVERVIEW

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#### Financial performance

In 2012/13 the industry reported a strong financial performance, with a net profit after tax of \$5.2 billion and a return on net assets of 17 per cent. Table 2 shows the industry's operating performance over the past four years.<sup>2</sup>

The eight per cent increase in industry gross earned premium to \$39.9 billion during the year was largely the result of higher premiums earned in the householders class of business. These reflected premium rate increases achieved in 2012 and 2013 as insurers sought to recoup the higher cost of property reinsurance since the significant natural catastrophe events of 2010/11.

Since those events, the gross incurred claims costs to property insurers from similar events have reduced considerably. Along with the rise in premium mentioned above, this change has underpinned the very strong underwriting results reported by property insurers.

Insurers' long-tail incurred claims costs in 2012/13 were also lower because the large falls in the interest rates used by insurers to value their long-tail insurance liabilities seen in 2011/12 were not repeated.

The majority of insurers employ duration-matching strategies to limit the impact of movements in interest rates on their existing long-tail insurance liabilities through offsetting movements in the value of their matched fixed income investments. The lower investment income at \$4 billion this year reflects the fall in realised and unrealised gains recognised by insurers on their fixed income investments.

Insurers typically hold a range of interest rate securities, not only Commonwealth Government Securities. The narrowing in credit spreads over risk-free yields seen during the year led to mark-to-market investment gains on the fixed income corporate bonds held by insurers.

<sup>2</sup> Table 2 includes data for both insurers and reinsurers and, as such, there is a degree of double-counting shown in items such as gross claims.

**Table 2: Industry financial performance (\$ million)**

	12 months			
	30 June 2010	30 June 2011 *	30 June 2012	30 June 2013
Gross written premium	33,216	34,289	37,413	39,889
Gross earned premium		34,288	36,947	39,937
Gross incurred claims (current and prior years)	23,627	35,938	27,868	24,564
Reinsurance recoveries revenue (current and prior years)	4,992	15,787	5,815	4,638
<b>Net insurance claims (current and prior years) of which:</b>	<b>16,329</b>	<b>17,708</b>	<b>19,659</b>	<b>17,835</b>
Current period net claims expense		18,993	19,514	19,308
Non-recurring items that are part of net claims		-1,285	145	-1,473
<b>Total underwriting expenses</b>	<b>6,584</b>	<b>6,961</b>	<b>7,563</b>	<b>7,879</b>
<b>Underwriting result</b>	<b>2,570</b>	<b>1,196</b>	<b>568</b>	<b>4,156</b>
Investment income	4,854	4,656	5,413	4,092
Other operating expenses	2,054	1,793	1,748	1,883
Other items	-672	-137	-519	-1,107
<b>Net profit/loss after tax</b>	<b>4,698</b>	<b>3,922</b>	<b>3,714</b>	<b>5,258</b>
Average net assets (\$m)	29,922	28,931	30,649	30,623
<b>Results on net assets**</b>	<b>16%</b>	<b>14%</b>	<b>12%</b>	<b>17%</b>

\* Figures from September 2010 are reported on an AASB 1023 Basis. Prior figures are based on a prospective reporting framework.

\*\* Quarterly figures expressed as annual percentage rates

Source: Quarterly General Insurance Performance Statistics report

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Releases of claims reserves from prior accident years continued to feature prominently in the underwriting results of some long-tail insurers. These releases from reserves can occur when insurers determine that their actual claims experience is more favourable than that assumed when initially estimating the reserves. In recent years, a key driver of reserve releases has been insurers' favourable claims experience following tort law reform, which impacted on the compulsory third party (CTP) and public and product liability classes.

*The ICAAP needs to be a forward-looking process in which risk appetite, capital management, strategy and business plans are integrated and adequately documented.*

## Capital

### Revised capital requirements and ICAAP

APRA introduced revised and more risk-sensitive capital requirements for general and life insurers (including friendly societies) with effect from 1 January 2013. Insurers have coped well with implementation of these changes. A small number of insurers applied to APRA for transition arrangements.

APRA has continued to engage with general insurers as they prepare for the introduction of the insurance concentration risk charge for a series of significant natural peril events, which takes effect from 1 January 2014.

Under the new capital framework, APRA may increase an insurer's capital requirement if it forms the view that the existing requirement does not adequately account for all of the insurer's risks. Such an adjustment, known as 'Pillar 2', may increase the total required capital amount and/or strengthen the composition of the insurer's capital base (i.e. the insurer may have to hold an increased proportion of higher quality capital). Pillar 2 adjustments have been applied for a small number of general insurers.

APRA also introduced the requirement for insurers to deploy an ICAAP from 1 January 2013. APRA views a rigorous ICAAP, in which the Board is fully engaged, to be of fundamental importance to the sound management of an insurer.

Part of ICAAP implementation has involved APRA reviewing insurers' ICAAP summary statements, a high-level document outlining their capital assessment and management processes. This was the first attempt by insurers to produce ICAAP summary statements and, not surprisingly, the quality varied significantly. APRA's general approach to the evolution of ICAAPs could be characterised as one of seeking 'continuous improvement' both at an industry and individual-entity level, identifying what were considered poor practices while promoting good practices.

The ICAAP needs to be a forward-looking process in which risk appetite, capital management, strategy and business plans are integrated and adequately documented. The ICAAP summary statement should reflect this forward-looking perspective. It should also clearly delineate the Board responsibility for oversight and approval of this process and management responsibility for documenting and implementing the process.

Another key governance aspect is the need for independent review, with the independent reviewer having appropriate skills and being operationally independent of the conduct of capital management. Many ICAAP summary statements examined lacked sufficient detail on this aspect.

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A quality ICAAP summary statement provides an understanding of how an insurer's risk management policies and procedures fit together in practice and outlines its capital and risk management monitoring and reporting processes. The ICAAP must be consistent with the insurer's risk appetite, which in turn should be tested against a range of scenarios ultimately approved by the Board. The scenarios used need to be sufficiently adverse. This would allow the Board to then assess its comfort with probabilities of failure and the anticipated timeframes for returning to target capital levels. The ICAAP summary statement should provide sufficient detail about identified trigger events and the insurer's planned remedial actions.

Insurers have indicated plans to enhance the use of stress testing in their ICAAP. Typical improvements identified include a more effective use of scenario analysis tailored to the insurer's risk profile and the use of reverse stress testing. For general insurers, clear linkages to their catastrophe risk appetite and Reinsurance Management Strategy should also be present in the ICAAP.

Over 2013/14, APRA will review insurers' annual ICAAP reports and the use of the ICAAP in the management of insurers' businesses.

### Recent capital trends

Following the introduction of the revised capital requirements, the general insurance industry reported a healthy capital adequacy ratio of 182 per cent (see Table 3). The amount of capital the industry is required to hold (the 'prescribed capital amount') at \$15.6 billion was largely unchanged when compared to the equivalent measure in place prior to the changes. However, insurers adjusted practices in a number of cases to reduce risk, thus lowering capital requirements. As expected, the impact of the more risk-sensitive capital framework varied between insurers with some insurers having a higher capital requirement and others a lower one.

In 2012/2013, some property insurers and reinsurers experienced an increase in the capital factors applied to a portion of their reinsurance recoverables due from non-APRA authorised reinsurers because of the length of time these amounts had been outstanding. Higher capital factors apply to such reinsurance recoverables unless collateral, a guarantee or letter of credit that meet APRA's requirements is put in place to support them.

**Table 3: Industry capital adequacy**

	30 June 2010	30 June 2011	30 June 2012	30 June 2013
Minimum capital requirement (\$m)	13,882	15,281	15,844	
Prescribed capital amount (\$m)				15,617
Eligible Capital base (\$m)	27,083	26,684	28,166	28,449
Solvency coverage ratio (%)	195%	175%	178%	
<b>Prescribed capital amount coverage ratio (%)</b>				<b>182%</b>

Source: Quarterly General Insurance Performance Statistics report

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The Eligible Capital base of the industry experienced a modest fall following the natural catastrophe events in 2010/11. Since that time, strong underwriting results have bolstered insurers' retained profits thereby strengthening industry capital levels.

The quality of industry capital is high. At end-June 2013, 95 per cent of the Eligible Capital base (excluding branches) was Common Equity Tier 1 capital, less than one per cent was Additional Tier 1 capital and four per cent was Tier 2 capital.

### Industry risks and prudential responses

APRA has continued to pay particular attention to the standard of governance and risk management practices being applied by insurers in their catastrophe risk management. A thematic review of this area was conducted during 2012/13. APRA has also reviewed the impacts of the low interest rate environment on a sample of long-tail insurers and how effectively the risks associated with this environment are being managed.

### Catastrophe risk management processes

The significant natural catastrophe events in Australia and New Zealand during 2010/11 highlighted the importance of strong governance and risk management by insurers when deciding their catastrophe risk appetite and catastrophe reinsurance arrangements. An important part of this is managing the uncertainty inherent in the catastrophe modelling insurers use in their reinsurance purchasing decisions.

Fundamental to these governance processes is an appreciation by Boards and senior management that while catastrophe models are a useful tool, they have inherent limitations. Boards and senior management must have the ability to understand and challenge catastrophe model inputs, assumptions, process and outputs.

APRA's thematic review looked at the strengths and weaknesses of the catastrophe modelling governance and risk management processes applied by a sample of property insurers. Board engagement in this area was found to be mixed: for some insurers it was sound, while other insurers have recognised the need for improvement. One governance practice that appears to work well is the use of committees of senior management and experienced internal modelling specialists as a forum for challenge when making key decisions in the modelling process.

***Governance frameworks should include the Board's consideration of model uncertainty, key responsibilities and whether the modelling return period and output reflects their risk appetite.***

Nevertheless, APRA also found that insurers could benefit from formalising their governance frameworks for assessing their catastrophe reinsurance needs. These frameworks should include the Board's consideration of model uncertainty, key responsibilities and whether the modelling return period and output reflects their risk appetite.

Stress testing and scenario analysis could be used more effectively as tools to challenge the catastrophe model output used in key decisions. In the thematic review the standard of scenario testing varied considerably across the sample of insurers. APRA had concerns in some cases because catastrophe model output was not stress tested at all.

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The use of catastrophe model output should extend further than determining prudential capital needs. Modelling of multiple events, different levels of key assumptions and the size of events considered could be put into scenarios in the ICAAP so that Boards might assess their risk appetite independently of the prudential capital framework.

The ability of insurers to directly engage in the modelling process and challenge model outputs is heavily influenced by the level of internal modelling expertise they employ. Among most of the insurers in the thematic review, internal resourcing was found to be adequate or was being strengthened. The global insurance groups with Australian subsidiaries or branches manage their reinsurance purchasing decisions through their group parent and, typically, most of their modelling expertise is based offshore. Some of these insurers with foreign parents have a dedicated team in Australia and staff employed by their group parent with Australian working experience.

APRA does not necessarily expect all the resources used by insurers to be internal. However, the ultimate responsibility for the modelling process and outputs remains with the insurer if it engages experts such as brokers to assist in the understanding, testing and use of models.

The nature of due diligence on the models used is dependent on the availability of internal resources. Some of the insurers in the thematic review have relied exclusively on their broker to perform the due diligence on the catastrophe model used. There are concerns that some local insurers had insufficient control of the choice of model used, as well as a lack of appreciation of the reasons for selecting a particular model over another and the comparative strengths and weaknesses of each model.

Better practice involves insurers taking control of the assumptions and settings used in the catastrophe modelling process, with appropriate challenge of these coming from their business units and governance committees. Some of the subsidiary and branch insurers of global parents have been using modelling assumptions developed by their global parent that may not be appropriate for Australian perils. They have recognised this as a weakness and are developing the use of local inputs for their modelling process.

APRA found the quality of data used in the modelling process and the management of this data needed improvement by many insurers. Some insurers have initiated projects or system changes to address these issues. The documentation of assumptions, data collection and data quality processes was considered inadequate for the majority of insurers reviewed.

### **Low interest rate environment**

In 2013, APRA conducted a review of a sample of long-tail insurers to evaluate the impact of the low interest rate environment on their pricing, investment strategies and the reserves they hold to meet their insurance liabilities. The review also looked at the governance practices applied by the insurers in managing and monitoring the impacts of this environment on their businesses.

The Boards and senior management of these insurers were generally found to have a sound awareness of the risks associated with the low interest rate environment and appropriate governance structures in place to ensure these risks are being well managed.

The ability of insurers to reprice their new business and thereby compensate for the loss of investment yield continues to be constrained by the competitive environment. This is of particular importance to the long-tail classes of business because investment income makes a substantial contribution to the funding of future long-tail claim payments, which can take many years to settle. Subdued pricing increases are particularly evident in the public and product liability and professional indemnity classes of business where strong competition is present. In other long-tail classes, state regulatory limitations can impact on insurers' capacity to quickly reprice their new business. In this environment underwriting discipline remains key, especially insurers' consideration of their technical pricing and the pricing levels at which unprofitable business is likely to result from their pricing decisions.

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### **GENERAL INSURANCE INDUSTRY OVERVIEW**

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Many insurers have maintained conservative investment strategies for investments backing insurance liabilities. However, in some cases insurers changed their shareholders' fund investment allocations in favour of higher levels of investment risk, with some shifts to investments such as equities and other growth assets. APRA will monitor closely any continuation in this trend should an environment of low interest rates persist.

The challenges that low investment returns pose to the profitability of long-tail classes of business may, in some cases, lead insurers to consider bolstering short-term underwriting profits through inappropriate releases from claims reserves. This can expose insurers to the possibility of significant losses if their claims experience were to deteriorate. There is clear potential in the current environment for the risk of inadequate claims reserves to become more pronounced and monitoring this risk will be an important part of APRA's supervision activity.



# LIFE INDUSTRY OVERVIEW

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This article provides an overview of the life insurance industry  
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(including friendly societies) together with an update of the key  
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prudential risks that face the industry.  
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## Introduction

Over 2012/13, life insurers (including friendly societies) continued to manage their assets and capital against a backdrop of a more positive global environment and generally improved sentiment in global financial markets. The prospect of a period of low interest rates in Australia poses challenges for the investment decisions faced by some life insurers.

Improvement in equity markets was the prime driver of asset growth and profit for the industry in 2012/13. Risk premium growth remained strong but worsening claims and voluntary discontinuance ('lapse') experience resulted in depressed risk insurance profits. This has led, more recently, to substantial increases in premium rates for some product lines. Despite the decline in profitability, the capital position of the industry remained sound.

Amongst a number of significant regulatory changes that the industry has been working through in recent times was the introduction of the new risk-sensitive capital framework, including the introduction of the Internal Capital Adequacy Assessment Process (ICAAP), which came into effect on 1 January 2013. This was generally handled well by boards and management, although it may take time for institutions to fully embed the concepts and techniques in their risk management framework.

*With the introduction of ICAAP came the requirement for institutions to undertake stress testing on a regular basis. APRA has already indicated to the industry that it intends to expand attention in this area over the next two years... The primary aim will be to assist APRA in assessing system-wide vulnerabilities.*

With the introduction of ICAAP came the requirement for institutions to undertake stress testing on a regular basis. APRA has already indicated to the industry that it intends to expand attention in this area over the next two years, with an additional requirement that life insurers undertake a stress test using a common scenario and assumptions defined by APRA. The primary aim will be to assist APRA in assessing system-wide vulnerabilities.

## Industry structure

After the sustained period of industry consolidation that began over 20 years ago, 2012/13 was noticeably quiet in terms of merger and acquisitions activity.

As at 30 June 2013, there were 28 life insurance companies in Australia. The mix has not changed with seven large to very large life insurers selling a diversified range of products (four of these are members of the major banking groups), a smaller number of mid-sized risk or investment specialists, a handful of small life insurers servicing specialist or captive markets, and seven reinsurers.<sup>1</sup> The number of friendly societies was also unchanged at 13.

<sup>1</sup> One life insurer and one reinsurer are inactive.

Measured by assets (and excluding reinsurers), 95 per cent of the life insurance industry is Australian-owned. Measured by regular direct premium income (i.e. excluding investment contributions and reinsurance-only business), however, the shares are significantly different, with only 66 per cent attributable to Australian companies, 22 per cent to Asian-owned companies and the remainder to primarily European and to a lesser extent US-owned companies. This pattern reflects the focus of foreign-owned entities, which is on risk business rather than investment business.

In terms of gross assets, life insurance is relatively highly concentrated with the top three life insurers holding 76 per cent of industry assets as at 30 June 2013; the top 10 manage 96 per cent of assets. However, based on direct regular premium revenue, life insurance is far less concentrated, with the top six insurers (out of 22 direct writers) writing 75 per cent of the industry premium over 2012/13.<sup>2</sup> The five largest friendly societies (out of 13) account for around three-quarters of total friendly society assets as at 30 June 2013.

Life insurers continued to lose market share in superannuation assets, as alternative vehicles such as self-managed superannuation funds (SMSFs) are increasingly preferred by superannuation fund members.

2 AMP and NMLA, as part of the same group, have been combined for the purpose of these calculations.

## Asset growth

Life insurers (excluding friendly societies) and reinsurers held approximately \$252 billion of assets at 30 June 2013 (\$233 billion at 30 June 2012). Growth in assets over the past three years has essentially derived from investment income (see Table 1). Net cash flows after operating expenses but before investment income have been negative.

Friendly societies held around \$6 billion of assets at 30 June 2013, less than three per cent of combined life and friendly society industry assets. Friendly society policy payments exceeded premium income again in 2012/13. There have been net policy outflows over the past three years although assets have shown positive growth over the same period due to investment income.

*Growth in assets over the past three years has essentially derived from investment income... Net cash flows after operating expenses but before investment income have been negative.*

Table 1: Life Insurer statutory fund cash flows (12 months ending June)\*

	2011 \$b	2012 \$b	2013 \$b	2013 Non-Investment Linked \$b	2013 Investment Linked \$b
Premium income <sup>^</sup>	40.2	36.9	38.8	17.5	21.7
Policy payments <sup>^</sup>	-37.8	-36.3	-39.3	-14.3	-26.3
<b>Net policy cash flow</b>	<b>2.4</b>	<b>0.7</b>	<b>-0.4</b>	<b>3.2</b>	<b>-4.6</b>
Operating expenses	-6.6	-6.9	-7.3	-5.4	-1.9
<b>Net non-investment cash flow</b>	<b>-4.2</b>	<b>-6.3</b>	<b>-7.7</b>	<b>-2.2</b>	<b>-6.5</b>
Investment income <sup>^^</sup>	18.3	6.5	29.6	4.7	25.0
<b>Asset growth from policies</b>	<b>14.1</b>	<b>0.3</b>	<b>21.9</b>	<b>2.4</b>	<b>18.5</b>
Other movements <sup>#</sup>	-6.7	2.2	-2.9	-0.3	-1.5
<b>Net asset growth</b>	<b>7.4</b>	<b>2.5</b>	<b>19.0</b>	<b>2.2</b>	<b>16.9</b>
<b>Total assets (eoy)</b>	<b>230.6</b>	<b>233.1</b>	<b>252.1</b>	<b>81.3</b>	<b>171.0</b>

Source: *Life Insurance Quarterly Performance* publication

\* Rounding may cause differences in totals. Investment linked and non-investment linked business may not add up to the total statutory funds figures due to eliminations between statutory funds.

<sup>^</sup> Includes adjustments for net reinsurance premiums and recoveries, and excludes policy conversions.

<sup>^^</sup> Includes realised/unrealised capital gains and losses.

<sup>#</sup> Net capital transfers, dividends and tax payments.

LIFE INSURANCE INDUSTRY OVERVIEW

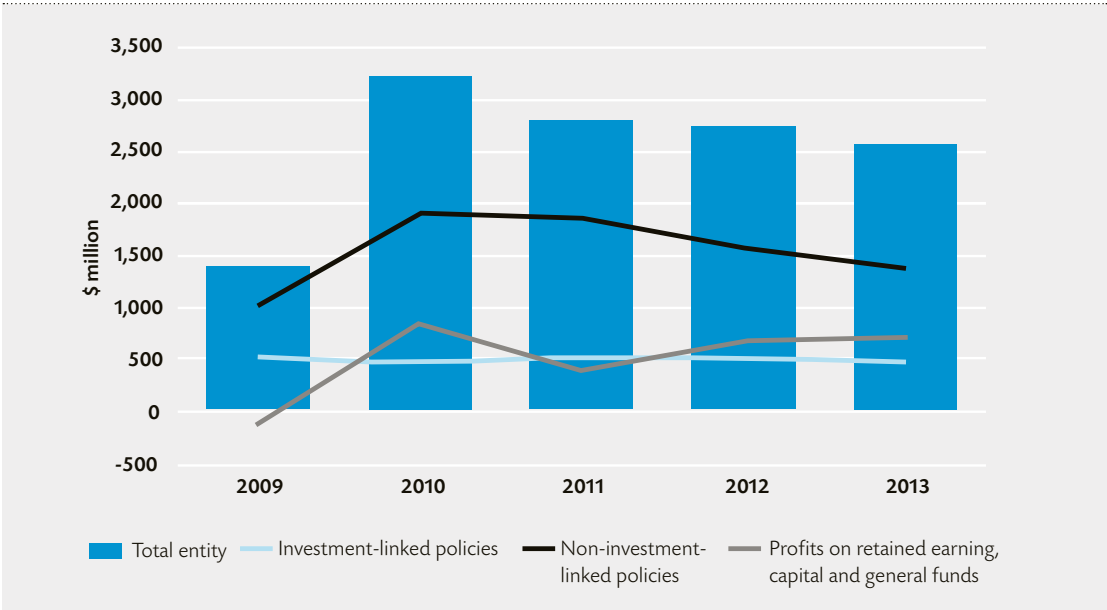
Financial performance – life insurance

Figure 1 shows life insurance industry shareholder profitability for the five years to 30 June 2013.

Industry profits from investment-linked business, while only a small contributor, bring a level of stability to aggregate profits. The return on capital for this business is well above that for

non-investment-linked business, which requires significantly higher levels of risk-based capital as the insurer takes the initial investment risk, not the policyholder. Comparing results from Table 3 (see page 35) and Figure 1 shows that while non-investment-linked business generates nearly three times the profit as investment-linked business, it requires six to seven times the level of prudential capital support.

Figure 1: Life insurers - Net profit by business group (12 months ending June)



Source: Life Insurance Quarterly Performance publication

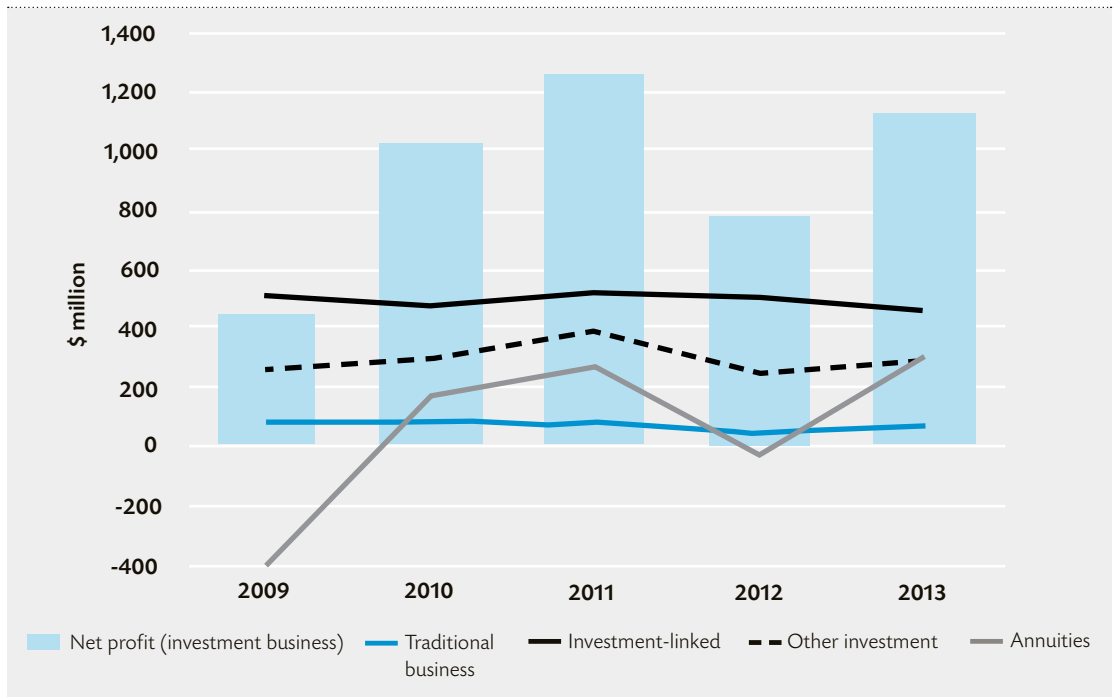
## Investment business

Life insurer net profits by major product groups, in aggregate and for individual product groups, are shown in Figure 2. For most investment business lines, profits are fairly steady from year to year. On the other hand, as noted above, profits for business

where the insurer bears the investment risk (e.g. annuity business) have been highly volatile.

Table 2 (see page 30) shows a break-up of life insurer premium revenue (excluding friendly societies) for the three-year period to end-June 2013, according to major product groupings.

**Figure 2: Life insurers – Net profit by major investment product groups (12 months ending 30 June)**



Source: *Life Insurance Quarterly Performance* publication

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## LIFE INSURANCE INDUSTRY OVERVIEW

Table 2: Life insurance net premium revenue by product group (12 months ending June)\*

	2011 \$b	2012 \$b	2013 \$b
Investment-linked^	25.4	19.5	21.7
Other non-investment-linked investment^	5.0	7.7	5.7
Traditional whole life/endowment	0.3	0.3	0.3
<b>Total investment business^</b>	<b>30.8</b>	<b>27.4</b>	<b>27.7</b>
Death/TPD# lump sum	4.8	5.1	5.7
Disability Income	1.6	1.7	2.0
<b>Individual risk</b>	<b>6.4</b>	<b>6.9</b>	<b>7.7</b>
Death/TPD lump sum	2.5	2.9	3.0
Disability income	0.6	0.7	0.8
<b>Group risk</b>	<b>3.0</b>	<b>3.6</b>	<b>3.8</b>
<b>Total insurance risk business</b>	<b>9.4</b>	<b>10.5</b>	<b>11.5</b>
<b>Total net premium revenue</b>	<b>40.2</b>	<b>37.9</b>	<b>39.2</b>

Source: APRA Statistics

\* Rounding may cause differences in totals.

^ Excludes policy conversions.

# Total and permanent disablement.

Investment-linked premium revenue has shown only patchy growth over recent years, reflecting the diminishing role of life insurers in wealth management. Life insurers' share of aggregate superannuation assets continued its steady downward trend, falling to 14.3 per cent at end-June 2013 from 14.8 per cent 12 months earlier.<sup>3</sup>

## Insurance risk business

As shown in Figure 3 (see page 32), despite high and steady growth in insurance risk premium revenues, net profit from insurance risk business fell significantly over 2012/13. In the past, insurance risk business profits have largely been derived from individual retail death and total and permanent disablement (TPD) business, where both volumes and margins are significantly higher than for other business lines. In the most recent period, this has not been the case as policy liabilities have had to be substantially strengthened as a consequence of poor claims experience for TPD business and increased lapse rates.

As shown in Table 2, group life business accounts for one-third of total insurance premiums (group plus individual) but its profit contribution has been modest at best for a number of years and it was loss-making in 2012/13 due to a material deterioration in claims experience. Further discussion on claims and lapse experience is provided later in this article.

Total net risk premium revenue (after reinsurance) increased by 9.7 per cent in 2012/13, although that increase is less than in previous years. The larger contributor to that increase came from individual risk business. This pattern reverses that observed in 2011/12 where the growth in group insurance was greater.<sup>4</sup>

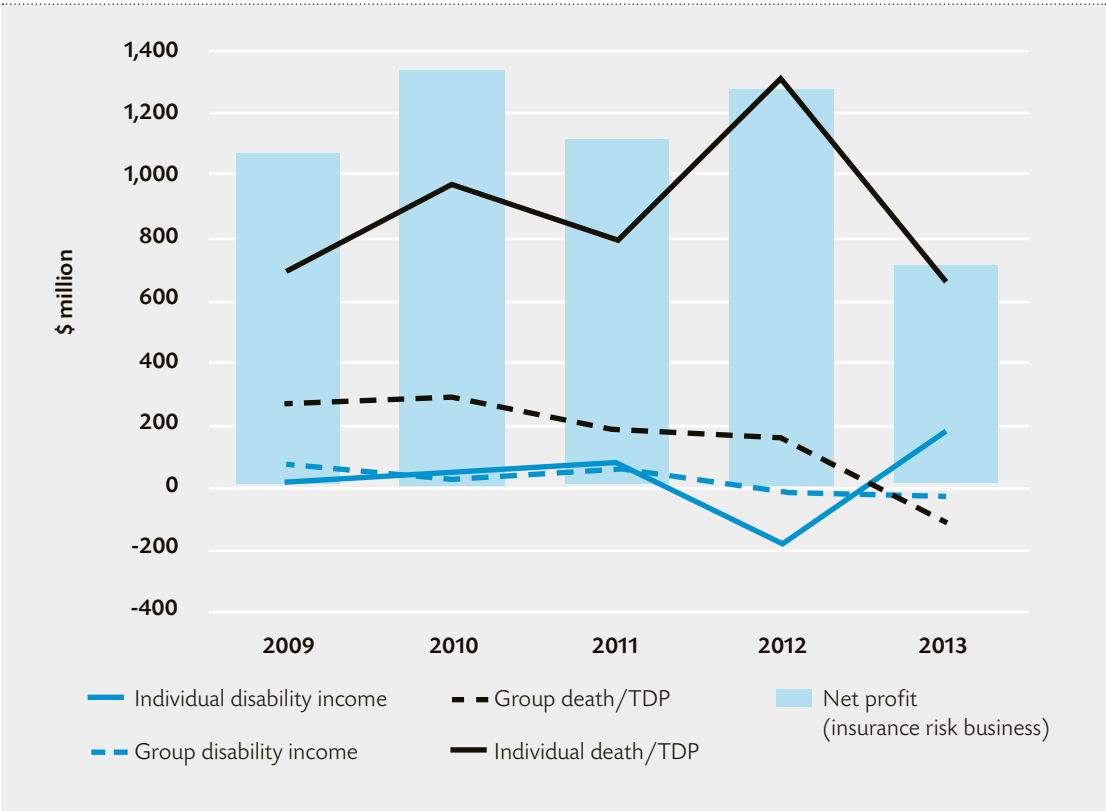
In the past, life insurance risk business growth rates, while often at double-digit levels, were largely due to automatic contractual increases in premium rates rather than new business from new policyholders. Over the last 12 months or more, premium revenue growth has been underpinned by substantial premium rate increases, particularly in group insurance, driven by the industry's worsening claims experience across most benefit types. The apparently high growth rates observed are primarily an outworking of those increases, both automatic and discretionary, as they work their way through the market.

3 A little over 20 years ago, at its peak, the life insurance industry managed 44 per cent of superannuation assets.

4 Refer to *APRA Insight*, Issue 3, 2012, for further commentary on trends over the preceding period.

LIFE INSURANCE INDUSTRY OVERVIEW

Figure 3: Life insurers – Net profit by major insurance risk product groups (12 months ending 30 June)



Source: Life Insurance Quarterly Performance publication

## **Financial performance – friendly societies**

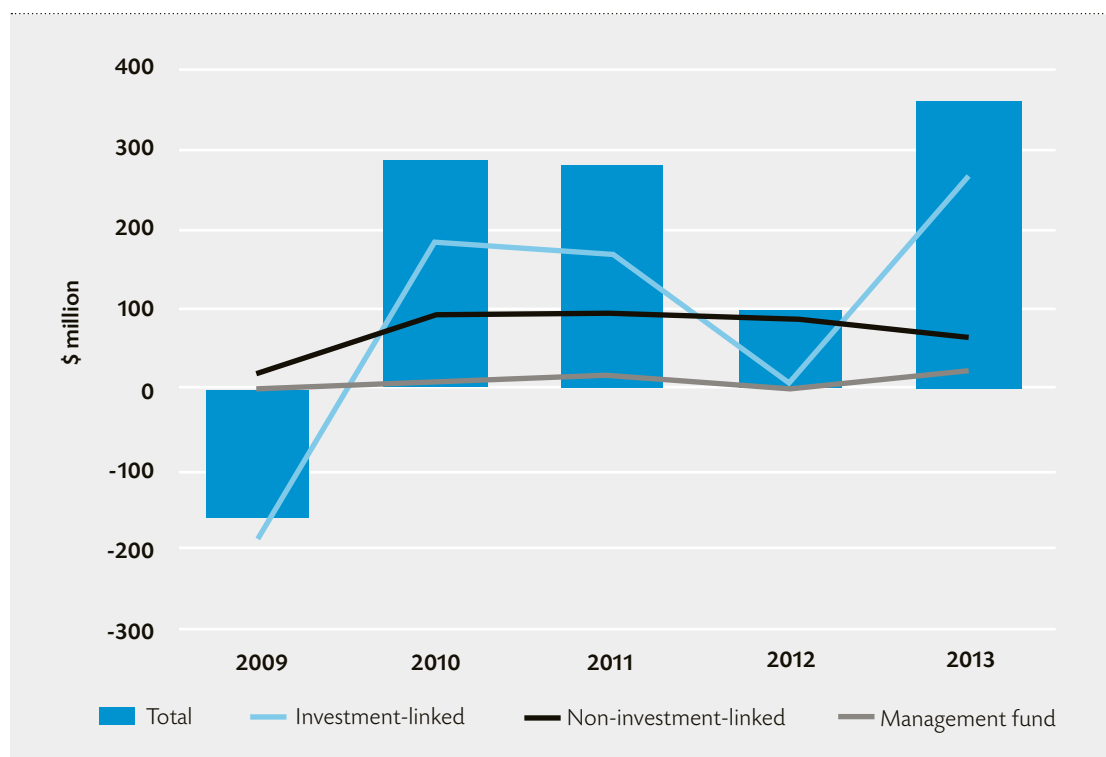
The net profit of friendly societies improved in 2012/13, after some volatility in the earlier years of the global financial crisis (Figure 4, see page 34). For friendly societies, 'profit' is not shareholder profit; rather, it is the total profits of the benefit funds and management fund before allocation to policyholders. The volatility in profit is associated with investment-linked business, which is the key driver of overall friendly society profits and losses. Non-investment-linked business tends to be supported by more conservatively invested assets and returns for this business tend to be more stable.

Specialisation is a prominent characteristic of friendly societies: one society writes mainly education products and accounts for the bulk of education products in the market while another writes funeral bond products almost exclusively, although there are multiple players that compete for funeral fund business.

The friendly society industry continues to seek products that will provide an effective pathway to growth. Growth in the industry has been uneven and has been mainly concentrated in funeral bonds, investment-linked savings or life-event products (such as education bonds).

## LIFE INSURANCE INDUSTRY OVERVIEW

Figure 4: Friendly societies - Net profit by business group (12 months ending June)



Source: Annual Friendly Society Bulletin, June 2013

## Capital

APRA's new risk-sensitive capital regime for the life insurance industry came into effect on 1 January 2013. Caution is needed in drawing direct inferences from aggregate data about the impact of the new capital framework on overall capital strength. The basis of the coverage ratio calculation has been completely redefined; management responses to the new framework have affected the results; and, for the time being, coverage ratios will be impacted by the transition arrangements in place for some insurers.

That said, APRA is satisfied that insurers have been able to manage the transition to the new framework, though it has placed strains on resources in some cases.

For life insurers, the average capital coverage ratios – the ratio of the Capital Base to Prescribed Capital Amount (PCA) – for both investment-linked and non-investment-linked statutory funds, the general funds and entities as a whole at the end of June 2013 are shown in Table 3.

**Table 3: Capital strength of life insurers (at 30 June 2013)**

	Capital Base \$m	PCA \$m	Surplus over PCA \$m	Capital Coverage Ratio
Investment-linked	1,247	646	601	1.93
Non-investment-linked	7,776	4,238	3,538	1.83
Total statutory funds	9,023	4,884	4,139	1.85
General fund	1,794	469	1,325	3.82
<b>Total entities</b>	<b>10,818</b>	<b>5,354</b>	<b>5,464</b>	<b>2.02</b>

Source: *Life Insurance Quarterly Performance* publication

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### LIFE INSURANCE INDUSTRY OVERVIEW

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For non-investment-linked business, 75 per cent of the PCA is the aggregate asset and insurance risk charges. The operational risk charge accounts for a further 13 per cent. In contrast, for investment-linked business, the PCA is largely made up of the operational risk charge (65 per cent) with most of the residual being the asset risk charge on surplus assets.<sup>5</sup>

For friendly societies, the capital coverage ratio for non-investment-linked benefit funds is nearly six times. The ratio is just over two times for management funds and almost 2.5 for entities as a whole at 30 June 2013.<sup>6</sup>

### Risk management

The industry's experience over the past year and more has highlighted the need for strong risk management. Life insurers have had to manage through a convergence of deteriorating claims and lapse experience. Profits have declined (or turned negative) in the face of substantially higher claims than expected and the consequent strengthening of reserves. Substantial increases in premium rates, particularly in group insurance, have been the common response. In a small number of cases, additional capital resources have been required.

APRA has been urging all life insurers to monitor their positions closely and to seek to understand the underlying reasons for their evolving experience and, from this, to form a robust view on likely long-term experience and appropriate business responses. Historically, life insurers have paid more regard to business acquisition than business retention and APRA would expect some rebalancing of focus in this regard.

<sup>5</sup> Full details are provided in APRA's statistical publication *Quarterly Life Insurance Performance*.

<sup>6</sup> For friendly society investment-linked funds, the insurance risk charge is held in the management fund and no other capital charges currently apply to this business.

## Claims experience

The industry has attributed the deterioration in claims experience to a variety of causes, including increased stress in the general populace from corporate downsizing and increased mental health problems in the community. APRA has also observed that the deterioration has happened following an earlier period where benefits and claims definitions were regularly improved and underwriting rules, such as automatic acceptance limits and eligibility terms, were relaxed. Consumers too have an increasing awareness of the availability of substantial insurance benefits offered by superannuation funds without evidence of health. Changes in that earlier period all too often went through without appropriate adjustments to prices; in fact, prices were seen to regularly reduce.

Analysis by some life insurers has concluded that some of the problem can be attributed to old cohorts of policies, while more recently written policies have proven to be profitable. However, APRA is concerned that insurers have not appropriately prepared for the 'anti-selection' effect in each cohort: less healthy lives will be more inclined to retain their policies over time and more healthy lives less so (particularly in the face of rising premiums). APRA is not convinced that more recent cohorts will not eventually suffer from this effect.

*APRA is concerned that insurers  
have not appropriately prepared  
for the 'anti-selection' effect...*

APRA's analysis suggests that it is possible that some life insurers may be relying upon their reinsurance account to maintain the profitability of their business. This is not a sustainable position. While short-term profits can be made from a reinsurance program, reinsurance should be viewed as a risk mitigation and transfer tool.

As a final observation in this area, the number of skilled underwriting and claims management resources within the industry has been very limited for a long period and may be worsening in the face of increased business volumes and claims numbers. To what extent this may be a contributing factor to the recent deterioration in claims experience remains unclear.

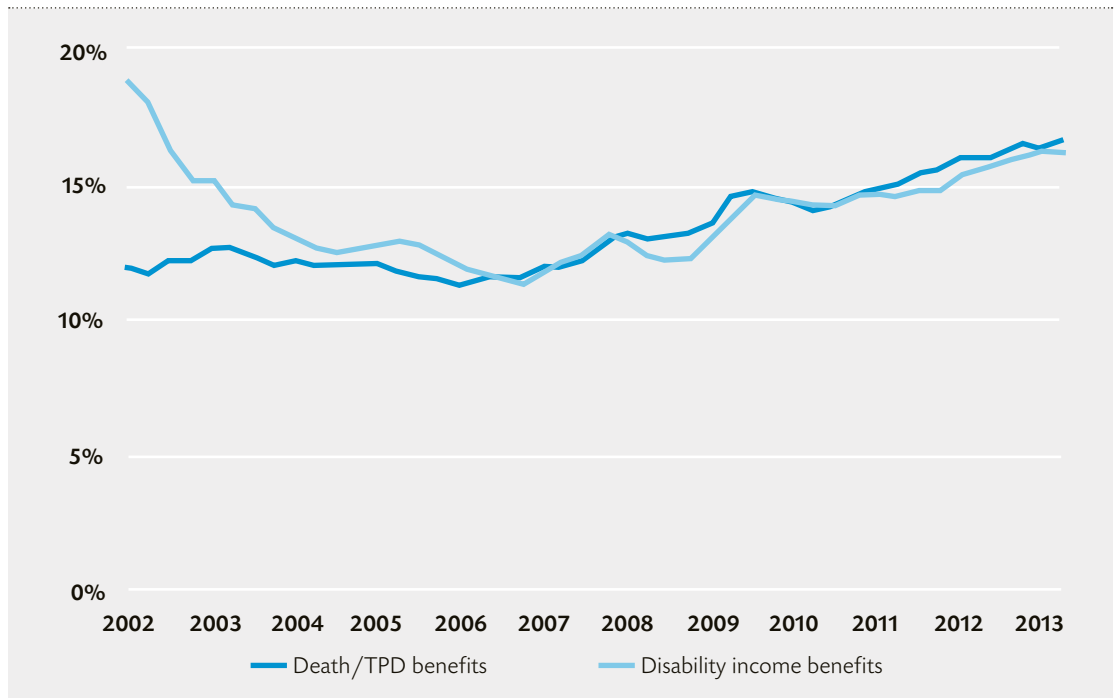
## **Lapses and surrenders**

Life insurers bear many up-front costs when establishing insurance contracts, from marketing (printing of brochures and disclosure materials, telemarketing) and distribution (commissions, call centres) to underwriting (medical tests and examinations, assessment, correspondence) and administration. As a consequence, the profitability of business is highly susceptible to the prospect of early voluntary discontinuance ('lapses') of the contracts, which thwarts the ability to recover those initial costs out of future premium revenue.

The industry has acknowledged that this has become an increasingly significant problem over the past five years. Overall, annual lapse rates for both lump sum (death/TPD) and disability income benefits have increased from 11 to 12 per cent per annum when they were at their lowest level in 2006 to 16 to 17 per cent per annum in 2013 (Figure 5).<sup>7</sup>

<sup>7</sup> Lapse rates have been derived as 12-month rolling averages based on annual inforce premium and voluntary premium discontinuances.

Figure 5: Life Insurers – Lapse rates for individual term insurance



Source: Plan For Life, *Life Insurance Statistics*, June 2013

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### LIFE INSURANCE INDUSTRY OVERVIEW

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The flow-through impact on profits is now evident, as Figure 3 showed. Further, to the extent that adviser remuneration is tilted more to rewarding new business rather than maintaining policies, advisers can be tempted to encourage policyholders to move from one insurer to another. When such activity becomes excessive, it is referred to as 'churning' and, while difficult to identify, its prevalence has become an increasing concern for government and industry bodies. Increasing lapses may reflect an increase in the anti-selection effect, in which case the impact on profitability is even worse.

Other reasons advanced for the worsening trend in lapse rates for risk business include:

- increased disengagement of advisers as they revert to their traditional focus area of investment business; and
- increased unaffordability of life insurance, particularly at higher ages, as premiums increase with age and inflation.

Another factor is the increasing and now significant prominence given by many life insurers to directly marketed business, where a third-party intermediary (adviser or financial planner) is not involved. This form of business intrinsically suffers from very high lapse rates, especially in the first year after sale.<sup>8</sup> While these high rates are allowed for in pricing and valuation bases, there is usually much more uncertainty about the long-term reliability of lapse assumptions than in the case of business sold through more traditional channels.

8 One study found that, on average, nearly 40 per cent of policies purchased direct lapsed within the first year. In contrast, adviser-based business averaged lapses of 8.4 per cent in the first year after sale. By the second year, though, the two forms of business come back into alignment with lapse rates for both running at about 13 per cent. Source: *Analysis of Direct Insurance Market*, Plan for Life, Media Release, 12 July 2013.

APRA has also observed a steady increase in the annual rate of withdrawals and surrenders of investment-linked business, from around two to three per cent of funds under management just prior to the global financial crisis to around three to four per cent today.<sup>9</sup> The key contributing factors to this particular development are likely to be the transition into retirement of baby boomers who are starting their superannuation drawdown phase and the increasing number of individuals transferring their accumulated superannuation from life insurers to SMSFs. These are largely systemic developments with which life insurers will have to cope, unlike the forces behind risk insurance lapse experience which to a significant degree life insurers are able to influence.

## Reinsurance

Reinsurance is an essential tool for life insurers in managing insurance risk and capital. APRA's capital standards, in most respects, treat reinsurers registered in Australia in the same way as direct writers. However, special provisions exist to recognise that reinsurers play a different role in the insurance industry and have access to capital resources via their overseas parents that are usually unavailable to direct writers. Hence, APRA needs to take a close interest in the financial soundness of the overseas parents of reinsurers and will continue to monitor their creditworthiness.

For many years, reinsurance capacity has been sufficient for the industry. However, due to a recent and significant deterioration in claims experience, some capacity in the group insurance market has been withdrawn or is being more cautiously rationed and there has been a substantial hardening of prices. APRA will closely monitor the impacts of these developments.

<sup>9</sup> The ranges indicated reflect systemic seasonal swings throughout the year.

Some life insurers have significant concentration risks with particular reinsurers. APRA supervisors will look to ensure that these risks are being appropriately reflected in concentration risk management frameworks and capital planning.

The rest of this article discusses those thematic areas that are currently receiving more intense supervisory attention from APRA.

*APRA has been concerned for some time about certain trends in tendering for large group life insurance schemes, most particularly the sustainability of prices...and is increasing the intensity of its supervision in this area.*

## Group risk insurance

### Pricing

APRA has been concerned for some time about certain trends in tendering for large group life insurance schemes, most particularly the sustainability of prices. In APRA's view, margins were too finely tuned or optimistic to withstand even reasonably expected deviations in claims experience.

The life insurance industry seemed to be equivocal about the underlying causes for the deterioration in claims experience that was emerging, sometimes suggesting it was seasonal or an outworking of the global financial crisis. Over the past year or so, however, APRA has observed a turnaround in industry sentiment and priorities, with prices for very large schemes hardening substantially. Nonetheless, APRA remains concerned about industry practices, and is increasing the intensity of its supervision in this area.

APRA notes that much growth in group insurance business in the past had been generated from changing benefit designs and structures to better meet superannuation members' needs. This strategy may be nearing exhaustion as it now seems that trustees are redirecting their attention to the impact that the cost of insurance premiums are having on members' retirement benefits, particularly as prices increase.

### **Data quality**

APRA has been impressing upon life insurers and superannuation trustees the need to improve the quality of member and claims data, including that data made available during a group insurance tender. APRA has introduced specific requirements and guidance for superannuation trustees in this regard and believes that the life insurance industry has embraced this effort. APRA also has issued draft guidance to life insurers on what it considers good practice for tendering for group insurance business, improving the quality of the claims data being kept in relation to insurance through superannuation and the provision of that data in the tendering process.

### **Role of appointed actuaries**

A tender for group insurance involves input from a number of professional parties, including product managers, underwriters and reinsurers, to formulate a competitive tender. APRA's view is that appointed actuaries are central gatekeepers in the process under the *Life Insurance Act 1995*, balancing competing interests while all the time watchful of the ongoing health of the insurers they are advising.

It is therefore paramount that, at all times, the appointed actuary maintains both their professional and statutory responsibilities. To this end, APRA continues to hold discussions with appointed actuaries and the profession as to how their responsibilities can be more effectively delivered.

## Capital monitoring and stress testing

Life insurers and friendly societies continue to manage their assets and capital against a backdrop of improved global market sentiment, though global markets are still prone to bouts of volatility. In this environment, APRA will remain vigilant to forces driving investment markets while paying particular attention to those insurers that, while compliant with capital standards, might be more vulnerable than most to investment market shocks. With this in mind, APRA has increased its focus on the role that stress tests can play in equipping the industry to withstand stress.

With the introduction of the internal capital adequacy assessment process (ICAAP) process in 2013, life insurers are now required to make specific reference to how stress tests are utilised within their institution. To assist institutions in developing their ICAAPs, APRA released a prudential practice guide on this topic earlier this year.<sup>10</sup>

Stress testing is a quantitative ‘what if’ exercise aimed at assessing vulnerabilities and resilience in the face of ‘severe but plausible’ shocks. If implemented effectively and with expert judgement, stress testing can be a useful analytical tool to complement other risk management approaches and capital assessment models.

Stress testing is commonly applied in the context of a prescribed regional or global financial market or insurance event (such as a collapse in equity markets or a pandemic). More sophisticated models will make allowance for changes in inter-dependencies or correlations between such events.<sup>11</sup> But stress testing also opens up the possibility of assessing the adequacy of capital for those institution-specific risks that typically have highly uncertain or unquantifiable probabilities and/or impacts such as a major operational or counterparty failure. Stress testing can therefore assist insurers with capital planning and management, the setting of ICAAP risk tolerances, and policies for management intervention and decision-making. In reviewing ICAAP summary statements, both the industry and APRA identified the quality of stress testing in ICAAPs as an area for improvement.

<sup>10</sup> Prudential Practice Guide CPG 110, *Internal Capital Adequacy Assessment Process and Supervisory Review*, APRA, March 2013.

<sup>11</sup> For example, a pandemic might not only lead to a severe increase in mortality but also stresses for business confidence and, hence, financial markets.

Over the next 12 to 24 months, APRA will be placing more emphasis on stress testing undertaken by life insurers. Apart from reviewing insurers' own stress testing modelling and scenarios, APRA will be developing a prescribed common scenario that will play a key role in informing APRA about industry-wide vulnerabilities. A common scenario will provide a consistent basis for industry aggregation in the event of an industry or even system-wide financial shock. It is also one way to ensure that appropriately demanding severity tests are considered by life insurers in their capital planning. APRA-led common scenarios are now standard practice in the ADI industry.<sup>12</sup>

## Regulatory change

The industry has faced significant regulatory changes over the last one to two years, in addition to a challenging economic and business environment. Some major milestones have been passed and, while significant work remains for many insurers, the pressure is gradually easing. Stronger equity markets have also assisted. Nonetheless, insurers remain concerned about remaining regulatory change and the resulting significant imposts on management and personnel.

The Future of Financial Advice reforms (FOFA) continue to consume considerable industry time and resources. 2013 was also the peak period for implementation of the range of Stronger Super reforms that impacted on many life insurers, particularly as MySuper authorisation reached finality, all prudential standards started to take effect and new reporting obligations were implemented.

<sup>12</sup> For a review of APRA's thoughts on and general approach to stress testing, refer to the speech by the APRA Chairman, John Laker, *The Australian Banking System Under Stress – Again?*, APRA, November 2012.

**LIFE INSURANCE INDUSTRY OVERVIEW**

Both FOFA and Stronger Super could lead to the need to rebuild distribution capacity on a different remuneration basis, redesign products and pricing bases, and revise operational systems.

Other developments that continue to garner attention are the continuing evolution of International Financial Reporting Standards (for insurance contracts) and the introduction of the US anti-tax avoidance measures for non-US entities under the US Foreign Account Tax Compliance Act (FATCA). These could present significant challenges in terms of system and process readiness over the next few years.

*While life insurers and friendly societies can usually cope well with stable interest rates, changes from one interest rate regime to another can be a challenge.*

**Low interest rate environment**

The transition to a prolonged low interest rate environment may have significant implications for the industry. For life insurers, the key benchmark is not the cash rate but rather long-term interest rates (five or 10-year bond rates); these have also fallen to record lows of around 3.0 to 3.5 per cent.

While life insurers and friendly societies can usually cope well with stable interest rates, changes from one interest rate regime to another can be a challenge. For example, the prospect of winding back monetary easing in the United States has been fuelling global interest rates increases and could have global share market implications, at least in the short term. As the life insurance and friendly society industry is highly heterogeneous, the nature of each institution's response to such changes will depend on their product offering, investment strategy and competitive flexibility.

The types of business most affected by a low interest rate environment, namely long-term guaranteed business (lifetime annuities and legacy traditional business) and disability income benefits, account for about 13 per cent of supporting industry assets, although the concentrations vary markedly from insurer to insurer. For those life insurers most likely to be impacted, there are a number of distinct prudential risks:

- liability valuations: valuation interest assumptions will be affected and asset-liability mismatches may be exposed;
- reinvestment risk: when investments mature and are rolled over, a negative spread may arise between returns promised to or expected by policyholders and the yield earned on investments;
- risk appetite: some life insurers might seek higher yield by tilting their asset allocations towards lower grade or alternate securities; and
- repricing risk: while pricing and other product terms for rate-sensitive products such as term certain and lifetime annuities can be adjusted to the prevailing investment environment, sales of such products in a low interest rate environment may fall due to historically unappealing returns being locked in for long periods.

APRA is aware that these issues have become more 'top of mind' and is expecting them to be mentioned in insurers' risk registers, Financial Condition Reports and ICAAP reports.

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**NOTES**

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