TAL

27 July 2012

Mr Neil Grummitt
General Manager, Policy Development
Australian Prudential Regulation Authority
400 George Street
Sydney NSW 2000

Dear Neil

RE: Review of Draft Prudential Standards for General Insurers and Life Insurers

Thank you for the opportunity to submit comments on the APRA draft prudential standards released for consultation in May 2012. This letter contains our submission based on our review of the draft Prudential Standards for Life Insurers.

We note that most of the key requirements are now final and hence our comments are more technical in nature related to changes to the supporting requirements.

LPS 001 - Definition of Risk Business

In LPS 001, the definition of Risk business excludes "policies that have terms that continue for the entire lifetimes of the lives insured". By definition, all policies that pay a death benefit have terms that continue for the lifetime of the life insured. Note most yearly renewable term policies (YRT) have terms that are defined to a high age, such as age 100, which could be considered effectively whole of life. Hence, this definition is confusing and could be interpreted to require certain YRT policies to have a surrender value.

We understand that the definition has been selected for the purpose of the operational risk charge. One solution may be simply to define risk business as business that does not have a surrender value.

Recommendation

We suggest that the definition of risk business could end after the first sentence. The use of the concept of long term risk business ensures that surrender values are paid, where appropriate, for long term risk business.

LPS 001 - Definition of Variable Annuities

In LPS 001, the definition of variable annuities could be interpreted to include policies that provide for a minimum maturity benefit of the return of premium with inflation. TAL has such policies that were issued by FAI Life Insurance in the 1980 and 1990s. We understand that it is not the intent to define such policies as variable annuities.

Recommendation

We recommend that APRA adjust the definition to exclude products written prior to 1 January 2004 (or a similar date prior to the first modern variable annuity policies being written).

Alternatively, paragraph 26 of LPS 110 could be modified to state "APRA may instruct a life company to calculate the prescribed capital amount for a statutory fund with liabilities for variable annuity business in accordance with Attachment A." This would leave APRA the alternative of allowing the standard requirements to apply.

LPS 001, LPS 340 - Definition of "risk free"

LPS 340 (paragraph 58) states that future cash flows much be a discount rate that the life company considers to be risk free. We note that the definition in LPS 001 may be considered to apply being one based on government bond rates. This definition differs from that contained in Section 8.7 of AASB1038 being "risk-free discount rates based on current observable, objective rates that relate to the nature, structure and term of the future obligations". In particular, swap rates are considered to meet the definition in AASB1038 while such rates do not meet the definition in LPS001.

Recommendation

We recommend that APRA include an additional statement in LPS 340, that the risk free rate is defined based on the AASB1038 definition not the LPS001 definition.

LPS 112 – Deferred Tax Assets

We are concerned that the elimination of deferred tax assets in Attachment B of LPS 112 inadvertently includes deferred tax assets in respect of policyholders benefits particularly deferred tax assets that relate to the Virtual Pooled Superannuation Trust (VPST). As these deferred tax assets are included within the unit price and hence the adjusted policy liabilities, it is not appropriate to eliminate them. We also consider footnote six is significant and should be covered directly in the definition.

In our discussions with APRA, the following wording was noted in LPS 112 "If policy benefits can be reduced in response to a fall in the value of an asset listed in this Attachment, the asset does not have to be deducted. However, the asset will be subject to a 100 per cent capital charge when applying the default risk stress under Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge." We question whether this wording was intended to apply to deferred tax assets as the concept of default does not directly apply to deferred tax assets.

Recommendation

We recommend that the last line of paragraph 10 of Attachment B be adjusted to say:

"For the purposes of paragraph 9, the deferred tax assets and liabilities are (a) after making an allowance for any tax effects that would result from adjustments to policy liabilities; (b) after making an allowance for any tax effects from any other adjustments applied in accordance with this Prudential Standard; and (c) after excluding items that have been recognised in the unit price for investment linked contracts or otherwise recognised as a component of policyholders benefits."

LPS 112 – Deferred Revenue Liability

When preparing general purpose financial statements, TAL has the practice of showing the deferred revenue liability (DRL) that arises under the management services element of investment contracts separate from the policy liability. The draft standards could be read that this item is not part of the policy liabilities due to the presentational approach taken (we note that LPS 340 does include the DRL as part of the policy liability). The related deferred acquisition asset is eliminated under paragraph 14 of Attachment B.

We acknowledge in our discussions with APRA that this is not an issue if the DRL is included as a component of the policy liability when submitting APRA returns.

Recommendation

For clarity, we recommend that the following wording is added to Paragraph 23 of Attachment B after the term Policy Liability: "(including any liability required under the management services element of an investment contract show separately on the balance sheet)".

LPS 320 Actuarial Advice

Although we recognise that Sections 24-27 of LPS 320 do not relate directly to capital, we consider that these could be modified to make them more effective.

The materiality considerations related to pricing advice are difficult to apply. A literal reading of Paragraph 24 is that a policy modification to change a policyholder's name on marriage would require referral to the appointed actuary and approval from the appointed actuary that the change is not material. We also note that no materiality considerations apply to reinsurance advice even though these changes can be often minor.

Recommendation

We recommend that Section (b) of Paragraph 24 be replaced with the following:

"(b) the proposed modification is assessed by the life company as not being material under the written materiality policy approved by the Board for the purposes of paragraph 27; and

(c) the Appointed Actuary must provide an assessment in the annual Financial Condition Report as to the suitability and effectiveness of this materiality policy."

We recommend that the same text be added to Paragraph 26 and that Paragraph 27(b) be updated to refer to the new Paragraph 26(b).

LPS 001, LPS 360 – Funeral Bonds

The current cost of funerals often exceeds $15,000 and this limit has remained unchanged for a number of years. We suggest the limit be increased and appropriately indexed to provide a more appropriate benefit to consumers.

The definition of funeral bonds also encompasses contracts with regular premiums. Hence, the term Funeral Plans may be more appropriate than Funeral Bonds.

(If this definition is only intended to apply to single premium policies than the definition could contain words to the effect "a policy in respect of which there is no contractual obligation on the owner to make any payments of premiums after the first year for which the policy is in force".)

We are unsure of the relevance of the wording "on terms and conditions agreed at the commencement of the policy" as such a concept applies to all life insurance contracts.

It is unclear why paragraph 13 of LPS 360 has a heading of "Unbundled investment business". Funeral Bond policies do not generally separately disclose the costs of investment services which is a requirement of the definition of unbundled investment business.

Recommendation

We recommend that the standards replace the term "Funeral Bonds" with "Funeral Plans" and that the definition be: "Funeral plan business means policies providing continuous insurance against the contingency of death where (a) the primary purpose of the benefit is to meet the expenses of and incidental to the funeral of the policy owner, their spouse or children; and (b) the amount of the benefit (excluding any entitlement to bonus) is no greater

than $20,000 as at 31 December 2012 and then indexed at the rate of increase in consumer prices."

For clarity, we recommend that Funeral Plans be excluded from the definition of "Long Term Risk Business" rather than this definition including a reference to the $15,000 sum insured limit.

(Note if Funeral Bonds are defined as single premium only then we would recommend that the definition of Long Term Risk Business should exclude sums insured greater than $20,000 subject to indexation.)

For clarity, we recommend that the heading "Unbundled Investment Business" comes after paragraph 13 of LPS 360 and that the sixth word of the first sentence of paragraph 14 be deleted (being "other").

LPS 360 – Termination Values

Paragraph 8 of the standard requires obtaining APRA approval for policy types not explicitly covered while previously the actuary had discretion to apply appropriate principles. This is likely to unduly constrain new product development.

Paragraph 9 of the standard requires consideration of reasonable expectations of policy owners which was not previously required. It is sufficient that surrender values are based on policy documentation (including promotional material) without including this additional and hard to define concept.

Paragraph 10 of the standard appears to apply only for the purposes of the capital standards. As it is currently drafted, it could be misconstrued to apply to payments to policyholders.

Paragraph 10(d) appears to introduce new requirements for fixed term/rate business and funeral bond business. It is unclear why these changes are required as the termination value is subject to the minimum of a risk free best estimate liability in the calculation of adjusted policy liabilities in any event (albeit at a different level of grouping).

The previous standard provided guidance on treating premium increases as new business that is omitted from the new standard. We acknowledge that the new standard contains the following wording "A contractual increase in regular premiums must be treated as if it was a separate policy." However, it is unclear what the term contractual refers to as all increases in regular premiums meet the terms of a life insurance contract and in that sense are contractual. We also note that premium increases due to aging could be a separate policy by this definition.

We also have some minor recommendations to improve clarity.

Recommendation

We recommend that Paragraph 8 be removed.

We recommend that Paragraph 9 deletes the reference to reasonable expectations of policy owners.

We recommend that Paragraph 10 be prefaced by "For the purpose of calculating capital adequacy," to make its purpose clear.

We recommend that Paragraph 10(d) be adjusted to remove the new requirements for fixed term/rate business and funeral bond business.

It may be simpler to list Risk Business (other than long term risk business) and Funeral Plan business in paragraph 40 and then delete paragraphs 12 and 13.

We recommend that it be stated that policies that have no or zero minimum termination value also have a zero minimum paid-up value.

We recommend that the guidance on premium increases be changed to refer to an increase in premium due to an increase in benefits.

LPS 370 – Cost of Investment Performance Guarantees

This standard requires that a life company must ensure that the investment performance guarantee factor of a statutory fund does not exceed 5%. It is unclear how a life company can ensure this when the fair value of the guarantee may change due to market movements or policyholder behaviour both of which are beyond the control of a life company. Also it is unclear as to how a life company could respond to remedy any such breach.

We understand that this requirement exists within the Life Act and has been in place many years presumably to restrict the volume of guaranteed policies written within an investment linked fund.

In our discussions with APRA, we understand that arranging for appropriate hedging could be an appropriate response. However, for this to be effective, the cost of guaranteed would have to be determined after an allowance for the value of associated hedges.

In our discussions with APRA, it was suggested that one response would be to move the impacted policies to a new statutory fund that is not an investment linked fund. However, we note that the process of arranging such a transfer would take significant time and may result in other issues arising (e.g. would the transfer be in the best interests of the impacted policyholders).

<u>Recommendation</u>

Ideally, the Life Act would be modified to remove this requirement and instead leave this as a prudential standard alone. Assuming this is not possible in the short term, we recommend that the following text be added after Paragraph 7:

"A life company must not take any action that would result in the investment performance guarantee factor exceeding 5%. It is recognised that a life company is not responsible for market movements or policyholder behaviour (e.g. the lapsing of non-guaranteed policies) that may result in the investment performance guarantee factor exceeding 5% and may be powerless to respond to such movements. In such circumstances, it is sufficient for the life company to cease writing new policies with investment performance guarantees and to take any other reasonable actions to reduce the factor to below 5%."

In addition, we recommend that the cost of guarantees be defined net of the value of associated hedges.

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I would like to thank APRA for the opportunity to make a submission on the response paper and the draft prudential standards and we welcome the collaborative approach that APRA has taken.

We are available to discuss the points discussed in this letter with you in more detail if you wish.

Kind regards

Robert Daly
Appointed Actuary