APRA

Prudential Practice Guide

LPG 260 — Conflicts of Interest under Section 48

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About this guide

The *Life Insurance Act 1995* (the Act) sets out requirements for life company directors in relation to the priority to be accorded to the interests of statutory fund policy owners.[1] This prudential practice guide assists life companies in complying with those requirements in relation to conflicts of interest and, more generally, outlines APRA's views on conflicts of interest.

Subject to the requirements of the Act, life companies have the flexibility to manage conflicts of interest in the way most suited to achieving their business objectives.

Not all of the practices or examples outlined in this prudential practice guide will be relevant for every life company and some aspects may vary depending upon the size, complexity and risk profile of the life company.

[1] A reference to a life company in this PPG should be taken to include a reference to a friendly society, unless otherwise indicated.

General information

1. The principal object of the Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry. In that context, APRA recognises that it is in the interests of both shareholders and policy owners that life companies are profitable, ensuring their viability and competitiveness.

2. Section 48 of the Act imposes a duty on directors of a life company to give priority to the interests of policy owners referable to a statutory fund of that life company where those interests conflict with the interests of shareholders.
This duty is in addition to the general duties of directors under the *Corporations Act 2001* (the Corporations Act) and is significantly more stringent.

3. Each director individually owes this duty to policy owners and prospective policy owners of policies referable to a statutory fund. The duty is owed to the interests of those policy owners as a group and is not limited to owners of participating policies. A director may be personally liable to compensate a life company for losses resulting from a breach of the s. 48 duty by that director.

4. Policy owners cannot waive their right to have their interests given priority under s. 48 nor can life company directors avoid their s. 48 obligations by disclosing to the policy owners that shareholder interests will be given priority. Directors must give priority to the interests of policy owners of a statutory fund regardless of the potential benefit to shareholders.

5. Directors will need to carefully consider how to give priority under s. 48 when the policy owner is a related company (for example, if the policy owner is a related RSE licensee). The requirements of s. 48 still apply in relation to such policy owners but these relationships may give rise to additional conflicts of interest.

Policy owner risk appetite

6. The policy owners referable to the various statutory funds of a life company may have different risk appetites from those of shareholders. This will typically be driven by the different incentives faced by policy owners and shareholders – specifically, the extent to which policy owners and shareholders stand to either gain or lose as a result of risks incurred by the life company.

7. It is up to the directors of a life company to infer the risk appetite of the policy owners referable to the statutory funds of that life company and act accordingly.[2] Where the directors consider that policy owners of a particular statutory fund have a different risk appetite from that of shareholders, s. 48 of the Act will be relevant to decision-making as potential conflicts of interest may arise.

Examples of circumstances where there are potential conflicts of interest

8. This section lists a number of circumstances in which there may be conflicts of interest. This list is not intended to be exhaustive. It sets out some factors which may need to be considered by life company directors. The question of whether a conflict exists is always one for the individual judgement of directors. In many of the examples, there may be benefits to policy owners which offset the detriment to their interests. Directors will need to make a full assessment of the impacts of a proposal on policy owners, including both direct and indirect impacts, in order to satisfy themselves that they have fulfilled their duties under s. 48.

9. Under s. 78 and 79 of the Act, income or outgoings need to be apportioned in certain circumstances. Section 80 of the Act requires that such apportionment be equitable and

[2] The Product Disclosure Statements for the relevant statutory fund life contracts will be relevant in this regard.

be subject to the Board of the life company first receiving the appointed actuary's written advice. In considering the actuary's advice, and in subsequently confirming the basis of apportionment, the requirements of s.48 will be relevant where the apportionment indirectly apportions the income or outgoings between the interests of shareholders and policy owners.

10. This will particularly be the case where the apportioned amount relates to participating business. For example, allocation of an expense to the participating business of the company indirectly results in that expense being substantially borne by policy owners, whereas an allocation to other business would be borne by shareholders. The directors need to satisfy themselves that the equity and appropriateness of the apportionment basis in such cases is suitably objective or well justified.

11. The apportionment of investment income will typically be linked to the allocation of the interest of the business segments in the underlying asset giving rise to that income. Section 48 considerations may arise if:

    (a) the underlying asset is supporting both retained profits and policy liabilities; or

    (b) the benefits to policy owners, under one or more of the business segments having an interest in the asset, are dependent on the performance of the asset.

12. In this context, policy owners' interests are not confined to participating business or policy owners' retained profits, but may arise in respect of investment linked or non-participating investment account business as well. For example, implicit apportionment of income between policy owners' and shareholders' interests may arise on the allocation of an underlying asset between policy liabilities and shareholders' retained profits in relation to investment linked business. The same might also apply to the apportionment of tax or other outgoings in such circumstances whereby it might be absorbed in unit prices if allocated to policy liabilities, but incurred by shareholders if allocated to retained profits.

13. Potential conflicts may also arise within the management of participating business where, for example:

    (a) the investment profile of the business is altered as part of the capital management strategy. Consideration needs to be given to whether the profit sharing arrangements remain appropriate in such circumstances. If shareholders' interests were to be enhanced by a reduction in the provision of shareholder capital, with no change to the shareholders' share of profit, consideration would need to be given to whether that enhancement was at the expense of policy owners.

    (b) distribution of policy owners' retained profits is deferred for a substantial period of time, particularly in circumstances where significant lines of participating business are now closed to new business. Consideration needs to be given to whether the use of such retained profits to provide capital support in the interim is potentially favouring shareholders' interests over those of policy owners, and how such retained profits might be best utilised while satisfying the requirements of s. 48 of the Act.

14. Potential conflicts of interest may arise when a life company is considering the transfer of assets from one statutory fund to another, for example, for capital management purposes (which would be primarily to the benefit of shareholders) if policy owner interests are not duly considered. This consideration would ordinarily involve ensuring that the transfer is made on an arm's length basis – at a price and under conditions consistent with those available in the market.[3]

15. Where a life company purchases a block of investments and allocates them to different statutory funds and/or to the management fund or general fund, conflicts of interest can arise if there is potential for selective allocation of investments to the benefit of shareholder interests over policy owner interests. The directors of a life company would typically ensure that processes are in place to ensure that allocations of investments give the required priority to policy owner interests. These issues are particularly relevant where consideration is given to retrospective allocations and transfers of assets.

[3] Note also subsection 45(2) of the Life Act.

16. Similarly, investment transactions with related parties can result in conflicts of interest. Section 48 would be relevant when directors are determining the terms and conditions under which such transactions would be undertaken. A life company would typically conduct investment transactions with related parties on an arm's length basis.
17. In relation to outsourced arrangements into which a life company may enter with related parties, s. 48 will be relevant in a number of ways:
    (a) if the related party service provider is performing unsatisfactorily, the directors of the life company may need to have regard to s. 48 as they formulate their response. It is not likely to be reasonable under s. 48 to continue the arrangement without taking steps to ensure the problem is rectified. This may reach a point where directors would end the outsourced arrangement if the problems are not ultimately rectified. Directors would ordinarily give consideration to ensuring that they contract with related parties on terms that allow them to take action to comply with s. 48 in the circumstances outlined above;
    (b) in circumstances where the costs of the outsourcing agreement will be borne by the policy owners (in whole or part) the directors of a life company would typically take steps to ensure that those costs are broadly in line with those available in the market. Section 48 would be relevant where life company directors are considering entering into an agreement that includes concessional conditions for a related party without counterbalancing benefits. Concessions such as these tend to favour the interests of shareholders over those of policy owners; and
    (c) where the administration of participating business is outsourced to a related party on fixed terms the potential benefits from future efficiencies would shift from policy owners to shareholders, along with the associated risks. There is a possibility that the relationship between costs and benefits for the policy owners may not, on balance, be in their interests.
18. Directors may reasonably take the view that policy owners intended that their funds would be invested in, or controlled by, related parties where it was clear that this would be the case at the point policy owners contracted with the life company. Many life companies operate under group structures where various components of the service to policy owners are undertaken by different group entities. In these circumstances, it may be reasonable to assume that policy owners were aware that outsourcing with related parties would take place and made an informed decision to enter into the policy contract. This does not, however, release the life company from its obligation to manage and monitor the outsourced arrangement.
19. Where the life company becomes aware that an error has occurred which has affected policy owner interests, the directors would need to have regard to s. 48 in making decisions on how to correct the error. APRA would ordinarily expect that the directors would initially consider policy owner interests, rather than firstly acting to minimise shareholder exposure at the expense of policy owners. Directors would therefore act, initially, on the basis that policy owners should be compensated for adverse impacts of the error. It may become apparent, after due consideration, that compensation is not necessary, but this would not be the presumption in the first instance.

Managing conflicts of interest[4]

20. It is impossible for the directors of a life company to avoid all conflicts of interest. There is a natural tension between the interests of policy owners and those of shareholders. Good practice is for a life company to properly manage conflicts as they arise.

21. To this end, a life company would typically have procedures in place to identify decisions which involve a conflict of interest. A prudent director may wish to be satisfied that there are systems and processes in place to ensure that all conflicts of interest within the scope of s. 48 are identified and properly managed. In some cases this will necessarily involve the conflict being brought to the attention of the Board of directors. It may also be appropriate to seek relevant independent expert advice such as legal or actuarial advice to ensure that directors are fully informed of their obligations and can gain a level of comfort that the nature of the interests has been properly characterised.

22. Directors of a life company would typically cause to be produced clear records of discussions leading to a decision where a conflict of interest is involved. These records would show the factors taken into account by the directors in reaching the decision and would aid the directors in demonstrating compliance with the Act when necessary.

[4] *LPG 510 Governance* provides guidance to directors on how to comply with their duties under the *Corporations Act 2001*. *LPG 510 Governance* states that where directors have a material personal interest in a matter, they should not be present while that matter is being discussed at a meeting nor vote on the matter.

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