

# *Insurance Insights*

– a selection of PwC thought pieces on various hot topics for the insurance industry over the past 12 months

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*A moment's insight is sometimes worth a life's experience*

Oliver Wendell Holmes

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# APRA's Insurance Capital Review

## Overview

Over the course of the last 12 months there has been extensive consultation between the insurance industry, interested stakeholders and APRA in regards to the evolving regulatory regime in Australia. The proposals are entering a new round of consultation and the impacts on insurers will vary. In this section, we recap the facts, as well as provide our thoughts on the hot topics.

In May 2010, APRA released a discussion paper outlining a proposal to review the capital standards for life and general insurers. The review process which began in 2009, intends to “make its capital requirements more risk-sensitive and to improve the alignment of its capital standards across the industries”<sup>1</sup>. The aim is to maintain a broadly consistent approach to the determination of capital for general insurers and authorised deposit-taking institutions as well as to achieve harmonisation of the regulatory framework between life and general insurers.

At the time of this publication APRA has:

- released a discussion paper outlining the proposed changes (May 2010) and three technical papers outlining in greater detail certain aspects of the proposed changes (July – September 2010)
- invited insurers to participate in a Quantitative Impact Study (QIS) of the proposed changes (August – October 2010)
- released a response paper with further updates to the proposals in response to submissions and outcomes of the QIS (March 2011)

The majority of insurers participated on the voluntary QIS, the results of which indicated that overall there would be substantial increases in the capital requirements across both industries. Key themes that emerged from the responses were the complexity of the proposals, the pro-cyclicality of some of the capital charges and the overall level of the proposed capital requirements.

In light of these responses, APRA have revised a number of proposals and will be inviting insurers to participate in a second round QIS in mid 2011, before a further response paper and the release draft prudential standards. Final prudential standards are expected to be developed and released in 2012, with the effective date of new standards aiming to begin at 1 January 2013.

<sup>1</sup> APRA discussion paper, *Review of capital standards for general insurers and life insurers* 13 May 2010

Current prudential standards that deal with the measurement of an insurer's capital adequacy are presented in the insurance sector chapters in this publication. The sections below detail the proposed changes to the capital standards.

### *Influence of international developments*

APRA has noted in the discussion paper (May 2010) that this review also takes into account international regulatory developments. Consideration of international standards and guidance has the benefit of improved harmonisation and comparability with other regimes, in particular for companies that are subsidiaries or branches of foreign-owned insurers.

Some areas which APRA has reviewed include:

- standards and guidance adopted by the International Association of Insurance Supervisors (IAIS)
- developments in the Basel Committee for Banking Supervision (BCBS), in particular Basel III proposals for quality of capital
- the development of Solvency II in Europe

There exists a wide diversity of international insurance markets and as such there is no single international reference point for detailed insurance capital standards. It is APRA's intention to continue monitoring international developments, with a view to maintaining broad consistency with the direction of these developments.

## Impacts for General Insurers

The proposed capital requirements for general insurers remain relatively unchanged from the current framework for calculating required capital. However, there have been some significant changes to the methods used to determine some of the components of required capital.

### *Key developments*

#### **Focus on more risk sensitive approach**

- The factor based investment risk capital charge has been replaced with an asset risk capital charge, based on subjecting the balance sheet to a series of stress tests and assessing the required capital under the different scenarios.
- Stress tests would be carried out under various modules including real interest rates and inflation assumptions.
- The stress tests will require more complex calculations and will have implications on the balance sheet compilation.
- The modules and stress tests have been refined after responses from the first QIS, with the revised proposals being simpler and specifying lower stresses.

## Limits on asset exposures

- Proposed changes to limits on exposures to single counterparties or groups of counterparties.
- Responses raised concerns over exposure to big four banks and APRA has made bank exposure limits more generous in the revised proposals. However, consideration will still need to be made about exposure to banks and as a result, insurers may need to diversify bank exposures and limit exposures to parents.

## New capital charge for operational risk

- Introduction of an explicit capital charge for operational risk has increased capital requirements. The calculation of this capital charge, based on the size of the insurer, has been modified in the revised proposals but still remains a relatively blunt measure.

## Explicit recognition of diversification

- Recognition of diversification benefits across asset and insurance risk through the introduction of the “aggregation benefit”. This may add extra complexity in the calculation of the prescribed capital amount.
- APRA has indicated that it will not place limits on the diversification benefits implicit in risk margins, although it will be closely monitoring levels adopted by insurers.

## Significant changes to charges for catastrophe risk

- Proposal to move to a 1 in 200 year whole of portfolio loss for vertical reinsurance cover.
- New capital requirement to address the risk of multiple events in a year.
- Requirement for one full reinstatement of catastrophe covers to be prepaid or contractually agreed at the commencement of the treaty year.

# Impacts for Life Insurers

The proposed changes will have significant impacts on the overall approach for the calculation of capital for life insurers.

## Key developments

### Significant change to the capital framework

- The previous dual requirements of solvency and capital adequacy will now be replaced with a single measure, more consistent with the requirements for general insurers.
- Prudential Capital Requirement (PCR) will now consist of a prescribed capital amount (quantitative measure) and a supervisory adjustment determined by APRA.
- Prescribed capital to cover insurance risk, insurance concentration risk, asset risk, asset concentration risk and operational risk.
- Insurance risk to include a specific allowance for losses from extreme events, such as a pandemic.

## Change to risk free discount rate

- The risk free discount rate will now be consistent across all insurers and will be set to the spot yield curve for Commonwealth Government Securities.
- This will have implications for the value of policyholder liabilities for those insurers currently using alternative measures in their capital reporting.
- This definition may also be amended for financial statement reporting.

## Capital charge linked to operational risk

- The effective management of operational risk will be considered by APRA in determining any supervisory adjustment.
- This will provide an incentive for insurers to strengthen their operational risk management and there may be lessons to be learned from ADIs.
- Operational risk capital charge will be calculated as some function of the size of the life insurer.

## Individual asset risk assessments and a standardised correlation matrix

- Surplus capital will now be exposed to asset risk capital charges.
- Separate asset stress tests may uncover correlations and offsets previously hidden in the resilience reserve calculation, providing greater transparency.
- A standardised correlation matrix may result in a substantial difference from the current resilience reserve.

## Challenges for insurers

Whilst APRA has responded to the concerns raised by insurers as part of the first QIS, the proposed changes will still introduce additional complexities in the calculation of required capital. The proposed changes will require insurers to revisit optimisation of capital including consideration of optimal reinsurance programmes and investment mandates.

### *Internal Capital Adequacy Assessment Program (ICAAP)*

APRA has proposed to adopt a three pillar supervisory approach, consisting of:

- Pillar 1 – quantitative calculations for capital requirements
- Pillar 2 – the supervisory review process
- Pillar 3 – disclosure requirements

In particular, Pillar 2 also proposes the requirement for an insurer to develop and maintain an Internal Capital Adequacy Assessment Program (ICAAP). This would involve each insurer having a process for assessing its overall capital adequacy and having a strategy for maintaining capital levels, which would be reviewed by APRA.

The intention is for insurers to explicitly take a more comprehensive approach to capital management, addressing:

- Board and management oversight;
- Comprehensive assessment of risks;
- Development of target capital policy; and
- Monitoring, reporting and review.

As part of the proposals, not only will insurers be required to maintain a prudential capital requirement, the regulatory minimum amount of capital to be held, APRA also expects that an insurer's own target capital policy be set as part of the ICAAP.

### *Challenges for determining optimal investment strategy*

Insurers may wish to consider whether there is a need to revisit their optimal investment strategy in light of the proposed changes to the required capital component arising from the asset capital charge. The risk appetite for the insurer and return objectives of their investments will need to be balanced against the impact on regulatory capital. Furthermore, there will be a need to consider separate investment strategies for surplus assets versus those held to support liabilities, as well as the benefits of holding a diversified portfolio of assets compared to a simple portfolio.

Other considerations in light of the proposals include:

- Insurers will need to consider how well investments match the liability profile, both in currency and duration. There is now a capital cost for holding long duration assets where they exceed the average duration of the liabilities.
- The investment strategy will need to be flexible in responding to changes in market conditions. The investment policy which minimises regulatory capital in good times when yields are high will not necessarily be the optimal position in times of low yields.
- The calculation of the asset risk charge will be more complex, and result in the need for systems which enable informative decision making and communication of the implications of various investment strategies at the senior executive level. Scenario testing under varying market conditions will be necessary when considering forward projections of capital positions.

## Next steps

APRA will open a second round of QIS and this represents a final opportunity for insurers to assess the impact of the proposed changes on the required capital before final proposals and draft prudential standards are released.

It is expected that the change to the new capital framework will impact each insurer differently. It is therefore important that each insurer takes the appropriate measures to understand the impact that the proposals will have on their capital requirements and their overall strategy in the new environment.

These changes will mean calculating capital requirements will be more complex but will aim to be more risk sensitive. APRA does not intend to increase overall capital requirements, but as a result of these changes there will be some winners and losers.

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# *Insurance contract accounting Exposure Draft*

## **State of Play**

The International Accounting Standards Board (IASB) released the long awaited exposure draft (ED) on Insurance Contracts on 30 July 2010 culminating several years of debate between themselves and the FASB.

The worldwide insurance market has now had time to digest the content of the standard, and as expected the scale of the proposed changes has prompted much debate. The comment period ended on 30 November 2010, and the insurance sector has certainly been busy putting pen to paper to have its voice heard with some 248 submissions to the IASB.

The IASB has worked hard to digest the responses and is currently moving forward at a rapid pace, essentially meeting fortnightly to consider the issues and resolve them where appropriate. In recent weeks we have seen tentative approval of significant changes to the ED proposals which arguably gives a good indication of the IASB's passion to issue a final standard. There are challenges though as evidenced by the divide on certain topics between the FASB and IASB, and between the participants themselves. This, with the known changes in the IASB's composition from 1 July mean that there remains a significant risk that the revised deadline of 31 December 2011 will not be met.

## **What are the current key issues?**

The main issues arising out of the ED and the IASB's recent activity are set out below.

### ***1. Contract Boundary***

The EDs wording which required "re-pricing at the individual contract level" has prompted strong responses from the Life, GI and Health insurers alike. This is a result of products such as CTP in the Australian GI space and many health products which may need to be modeled over the policyholders' expected lifetimes rather than the current annual practice.

In reconsidering this issue the IASB has relaxed the definition such that in certain circumstances the contract boundary will be when a product can be fully re-priced at the portfolio level. This is a positive step for Australia, but the detailed application guidance will need to be reviewed carefully to ensure that all the expected benefits are realised.

## 2. Risk Margin

There is a very clear split between the US and the rest of the world on the risk margin debate.

The US responses show strong opposition to the identification of a separate risk adjustment and residual margin, and support the composite margin approach as favored by the FASB. That said, many US companies do not consider either alternative to be an enhancement to the current insurance accounting model and so have shown little support for change of any form.

The Australian market clearly favours both a risk adjustment and residual margin as this is most similar to the current accounting under AASB 1023. There is broad opposition, especially from Life insurance participants, to the locking of the residual margin thus preventing any re-measurement for future changes in assumptions and expected cash flows.

There remains however concern as to the comparability, consistency and reliability that can be achieved in determining a risk adjustment. In response to the feedback the IASB has held education sessions and will be revisiting the approach in coming months.

## 3. Level of measurement

There are three key concerns emerging in relation to the unit of account.

- **Diversification:** The majority of comment letters, especially from Australia, argue that diversification should be allowed at the entity level since to not allow for diversification distorts the reality of insurance which ultimately rests upon making profits from diversifying risks.
- **LAT Testing:** There is strong opposition certainly among the Australian market that to require this at the portfolio level by date of inception as this fails to recognise how insurers price risk in practice, and moreover will create heavy strain on resources and time to track policies in such a manner.
- **Multiple levels of account:** There is general consensus that the level of account for different aspects of the standard should be aligned as currently the myriad of levels at which different adjustments, and tests must be applied are inappropriate in certain aspects and over burdensome with little benefit in others.

## 4. Short Duration contracts

The most critical issue raised is the definition of “short duration” in the ED which uses “approximately 12 months” to determine what fits into this bucket. It is considered by the wider industry that the IASB’s intention was to capture GI risks which are generally considered short term contracts however the current definition is too prescriptive to achieve this goal.

## 5. Presentation & Disclosure

Overall the presentation and disclosure requirements are viewed by the wider industry as being arduous, burdensome and will likely cause significant resource and time constraints for questionable benefit for users of the accounts. In addition there was general dislike for the proposed 'summarised margin' presentation of the income statement with most preferring the inclusion of more volume based disclosures in this primary statement.

## 6. Acquisition Costs

The Life insurance industry is most vocal as expected on the issue of acquisition costs given the potential for significant upfront expensing of costs which are neither incremental at the contract level nor considered direct in nature. In recent deliberations on this topic, the IASB has moved to determine such costs at the portfolio level. A change that shows the IASB is listening and one that has been generally welcomed by the industry.

## 7. Transition

Many participants and nearly all of the Australian market are not supportive of the current proposals which will essentially remove all future profits out of the in force book, distort current and future earnings and potentially disadvantage the industry from a capital markets perspective. Most companies who have responded to the IASB has requested the option to apply the new standard retrospectively in some way and thereby estimate the appropriate residual margin for the in force book.

Overall, it is clear that the ED refocused the minds of the industry and stimulated great debate in all corners of the globe. Significantly different points of view and preferred positions exist and bringing these to a workable common ground will be a great challenge. But, it is clear that the IASB are committed to the program and with some of the recent changes, it is also clear that they are listening to the feedback.

With so much at stake with the program and much work yet to be completed, it is too early to tell what the exact impacts will be on the Australian insurers. What is clear is that the journey to the revised 31 December 2011 deadline will be interesting and one that those with a vested interest should be following closely.

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## Attracting and retaining top finance talent

### Talent management is a major industry issue

The war for talent continues, as shown by recent PwC global survey findings that CEOs recognise their current strategies for managing talent no longer fit: 83% of CEOs say they will make a change to their talent strategy and a majority of CEOs (66%) fear talent shortages will constrain their organisation's growth.

One of the most pressing issues the insurance industry faces is a serious skills shortage. The average age of insurance industry workers is higher than other industries and the oldest of the baby boomer generation are turning 65.

Compounding this issue is widespread employee disengagement and an increasing number of employees actively seeking work outside their current employer and industry in the post-GFC environment<sup>1</sup>. In fact, research shows that companies that have downsized by 10 per cent will subsequently experience voluntary turnover rates of more than 50 per cent<sup>2</sup>.

We have heard from our clients in the insurance industry that talent management is a key priority for their business. A recent PwC survey and discussion forum with a number of Insurance CFOs raised a series of talent management issues that are challenging for both the insurance industry as a whole and individual businesses.

This paper highlights some of the key challenges and asks some questions that may help insurers navigate their way through them.

<sup>1</sup> Chandler Macleod Group (2010) "Post GFC Candidate Study Report."

<sup>2</sup> Colin Beames (2009) "Transforming Organisational Human Capital: How to Emerge Stronger from the GFC."

# Key challenges

## *Insurance industry brand*

The sense among the forum participants was that the reputation of insurance companies as employers of choice trails behind other sectors including the banks, that it is not a top destination for university graduates, and that the insurance industry does not do enough to promote itself as a desirable career destination. The industry's brand is also affected by the negative perception of the industry's response to their customers following recent natural disasters. For these reasons, participants felt that there is a need to focus on the employee value proposition as an industry as much as on an individual organisation basis.

## *The challenges of promoting diversity*

Whilst participants cited some strong examples of individual initiatives that their organisations had implemented there was still wide debate about the lack of progress in ensuring appropriate representation and diversity at the different levels of the organisation. Recent public debate about the potential for quotas (around gender diversity) to be introduced was much discussed with some practical reservations highlighted. Notwithstanding these reservations, there was consensus on the need to think differently if the industry is to optimise on the talent available.

## *Career paths and development opportunities*

A challenge particularly for the smaller insurance companies is creating career paths and on-the-job development opportunities in lean structures and with limited budgets. This is a view held by 50% of participants<sup>3</sup> who face the challenge of developing the right capabilities in the organisation to deliver for customers. Whilst the larger companies have more resources to invest in their people and the ability to provide lateral transfers and secondments, there remains a need for more thought on how to bring talent on and create a genuine learning environment.

## *Bring in versus growing*

Most companies are seen by their employees to favour external hires into key roles over promoting 'their own' from within (as agreed by 65% of participants<sup>3</sup>). Whilst the injection of talent from outside has benefits for all, developing a pipeline of talent internally is a cost-effective way to engage employees and leverage the experience and knowledge that the organisation has invested in through existing employees. Achieving a balance between the two strategies, and ensuring appropriate communication are critical considerations.

## *Balancing strong performers with promoting new talent*

Another significant challenge, particularly in smaller organisations, is the need to balance retaining strong performers who do not wish to progress beyond their current role with ensuring that this does not block the progress of emerging talent. There is a clear trade off here and the difficulty of this balancing act was widely recognised.

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<sup>3</sup> PwC Insurance CFO Survey (March 2011)

# How insurers can succeed

Every insurance business is different and there is no one solution that fits all when it comes to optimising talent management. However, many of the challenges faced by insurers in this space are also common to other industries. From our experience, below are a few key considerations for insurers who want to improve their outcomes from managing their talent.

## 1. Differentiate to attract quality

The ability to be differentiated in attracting quality people is more challenging than ever, given different generational motivations. The success of an employee value proposition rests on being responsive to the various motivations and needs of changing workforce demographics. Therefore, insurers should reach beyond the traditional approach of articulating the unique offerings of their organisation, and incorporate the strengths that the Insurance industry brand offers. This would involve insurance organisations working together to devise an industry strategy to attract top talent. Key considerations include career development, global mobility and flexible work arrangements.

## 2. Invest time in understanding your employees

Understanding what makes your people tick is key to maintaining employee engagement. When it comes to motivation, research shows that financial incentives may not always be the most effective. Instead, career development opportunities has come to be amongst one of the most important factors for employees. A key question is: How do we as insurance organisation develop talent and create a genuine learning environment? One effective approach is to develop collaborative networks at the industry level to provide development opportunities across organisations e.g. graduate programs, middle-manager industry-wide projects, and Executive-sponsored mentoring for high potentials. However, the programs would need to be carefully managed to ensure shared outcomes were achieved, with control over 'competition' to attract talent to specific organisations.

## 3. Identify and retain your key talent

Like professional services firms, insurance companies are knowledge worker organisations that need to focus on attracting and retaining talent. However, too often companies focus on retaining star performers or leadership talent, overlooking 'pivotal roles' – that is, jobs that have an outsized ability to create (or destroy) the value customers expect. As agreed by the majority of participants, there are benefits in engaging pivotal roles to ensure they are motivated enough to deliver consistent performance, while also improving overall business performance. To achieve this, insurers can identify pivotal roles in the business in which to place 'stars' by analysing how much impact each role has on customer and shareholder value. Targeted development strategies can then be developed to ensure the 'right' people are recruited and retained across different roles.

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## *Data is the ‘life blood’ of business decisions – are you in control?*

Data in all its aspects forms the ‘life blood’ of insurance. Whether that data be qualitative or numerical, primary or derivative, internally or externally sourced, its availability, accuracy, completeness, maintenance and smooth, secure flow is essential for:

- meeting customer promises, such as pricing and discounts;
- supporting pricing decision-making;
- underpinning product development and maintenance;
- ensuring value is achieved out of new system initiatives;
- supporting actuarial valuations and capital management; and
- measuring business performance against strategy, objectives and key performance indicators.

However, the many processes, systems and data flows in the information chain add complexity. So too do the different stakeholders, as customer and financial data passes from the point of origin to its ultimate use in decision-making, often via many organisational and functional/team boundaries. Each stakeholder is likely to have their own sets of processes, systems and data repositories, with the weakest link in the chain determining the data quality outcome.

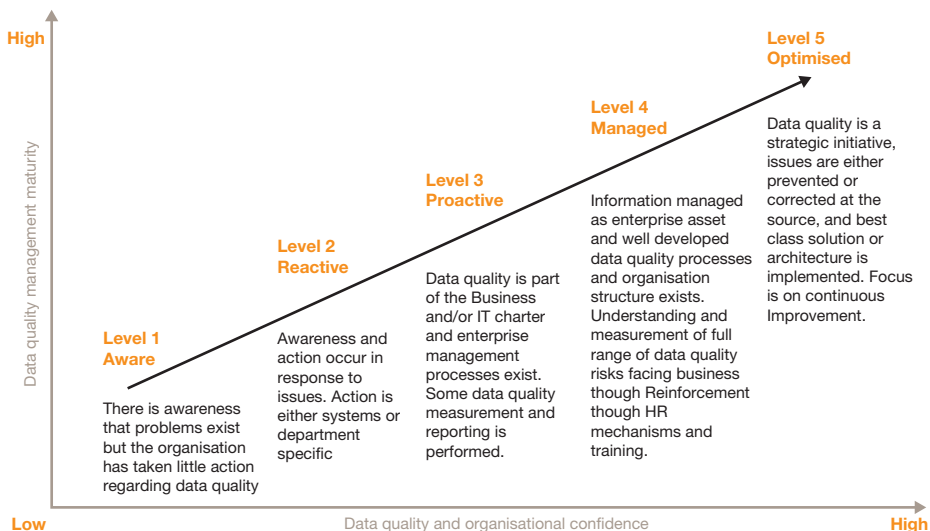
### **A tightening Australian regulatory environment**

Scrutiny from regulators continues to increase, with tighter regulations for corporate governance and risk management.

APRA continues to evolve its data collection and reporting requirements for authorised general and life insurers and for general insurance intermediaries that are AFSL holders. While these arrangements do not impose audit requirements in relation to the data, organisations are expected to have adequate risk management systems to ensure their data is sufficiently complete, reliable and verifiable.

Evidence from other industries and jurisdictions, in particular the US and UK superannuation and pension industry, demonstrates the significant impact data quality issues can have on business operations. Also, when we consider the rigour that ADIs are required to apply over data quality in developing, managing and reporting their regulatory and economic capital frameworks, it becomes obvious that different industry sectors are approaching data quality in different ways. Perhaps this is a portent of things to come.

**Figure 1: Maturity model**



## The benefits of being in control

### *Being in control of data produces a combination of benefits:*

**Current value** – Protecting current value and reputational risk by ensuring that customer and financial data is subject to appropriate governance, risk management and control, all supported by clear accountabilities.

In addition, insurance organisations are continuing to invest in data mining and business intelligence solutions. If the investment in these tools is to be maximised, their use must be encouraged, which in turn requires organisations to build trust in the quality of the data involved. Any data issues, whether real or anecdotal, will raise questions about the state of data quality and potentially undermine confidence in those tools.

**Improved business performance** – Supporting effective management and optimised performance by ensuring the integrity of the data used to monitor and manage business performance as well as that used to make key business decisions.

**Future value** – Helping to deliver future value in the context of the data used to develop the business strategy.

# Managing data quality through a data quality control framework

Because of the complex and multi-participant nature of the industry, issues with data will continue to arise unless a systematic, proactive and sustainable solution is established.

A simple structure that sets out the internal controls necessary to manage data quality, across the end-to-end data lifecycle, offers such a solution. A suggested structure is outlined in the framework in Figure 2.

## *How do you compare?*

The diagram in Figure 1 sets out the characteristics associated with different levels of maturity in terms of an effective data quality management capability. A target state of at least 'managed' is recommended, and can be achieved by adopting a pragmatic control framework.

Given this complexity, can you be sure that you are in control of the quality of your data? Are you comfortable with your responses to the questions below?

## *Critical data*

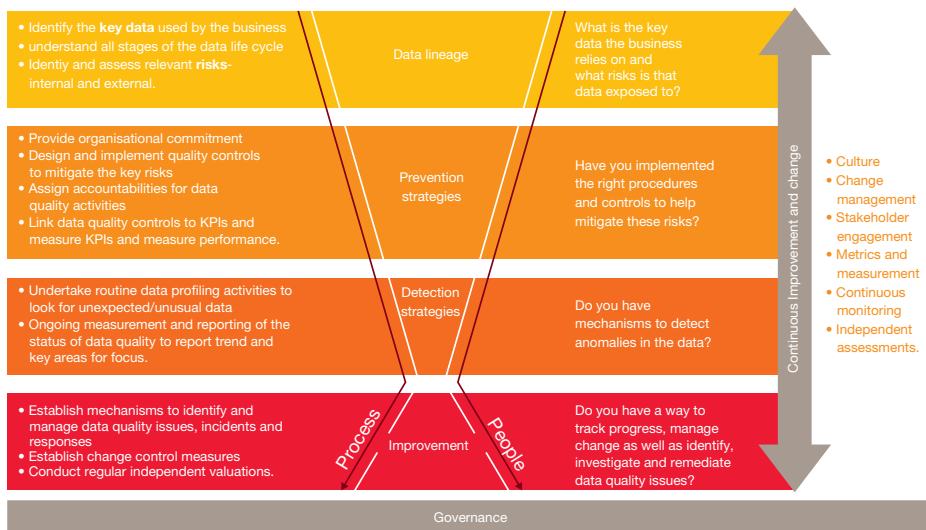
- What is the key data that your business relies on?
- What would be the impact, both quantitative and qualitative, of poor data quality on the organisation's (or business unit's) objectives and strategy?
- Do you understand the path your most important data travels through, the transformations that occur and the key risks and controls along that path?
- Have the volumes of your data flows or the complexities of data structures and rules increased?
- Do you depend on other parties for data to support and manage your business?
- If so, do you have a 'data provider' governance model that serves to ensure a desired level of quality?
- Are there numerous underwriting and claims processes and IT systems as a result of past mergers or acquisitions? Is data collected from many different IT systems?
- Do data responsibilities cross organisational and functional/team boundaries?
- Are roles, responsibilities and accountabilities clearly defined?

## *Status of data quality*

- What are the key risks relating to your data quality?
- Do you have the right controls in place to mitigate those risks? Are you confident of the current state of those controls?
- How do your data quality controls compare with good practice?
- Do you understand the profile of your data and where anomalies and issues might lie?
- Do you have mechanisms to detect anomalies in the data?

- Have you assessed the efficiency and cost-effectiveness of your current data and systems architecture and processing?
- Do you have a way to measure and report on data quality as well as to identify, investigate and remediate data quality issues?
- Do you actively monitor and independently assess the effectiveness of your data quality controls?
- Do you place reliance for data quality on controls in the actuarial process?

**Figure 2: A framework for managing data quality**



## Conclusion

- Data is the lifeblood of an insurance organisation, but there are many challenges and risks in getting the data right. Typically many parties, processes, systems and data flows exist, with the weakest link in the chain determining the ultimate data quality.
- Being in control of your data will help you protect current value and reputational risk, support the improved performance of the business, and deliver future value.
- Issues with data will continue to arise unless a solution is adopted which establishes the right governance, risk management and controls over the key data used by the business.

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## Unclaimed monies

### Know your obligations and be prepared

The State Revenue Offices have recently ramped up their investigations into the compliance by businesses with the unclaimed monies legislation. This focus has included insurance companies. Knowing your obligations and setting up appropriate compliance procedures prior to an audit will reduce the risk of penalties and interest arising from failing to properly administer unclaimed monies held by your organisation.

Key questions	Key findings
What are unclaimed monies?	The definition of 'unclaimed monies' varies from jurisdiction to jurisdiction and there is no uniformity in the unclaimed monies legislation. Broadly, unclaimed monies refer to any amount of money (which could include principal, interest, dividends, bonuses, profit, salaries, wages, etc) that are legally payable to a person and that remains unpaid for a specified period of time. The specified period varies in each jurisdiction but can be as short 12 months.
Who administers the relevant unclaimed monies legislation?	Each State and Territory has legislation which imposes an obligation on businesses to remit any unclaimed monies to the State or Territory government. The unclaimed monies legislation is administered in each State or Territory by either the Public Trustee, State Treasury or the Revenue Offices.
What are your obligations?	While the specific requirements in each jurisdiction differ, the unclaimed monies legislation in each State or Territory generally requires businesses to: <ul style="list-style-type: none"> <li>• Prepare and maintain a register of unclaimed monies held by the business;</li> <li>• Make the register available for viewing by the general public and/or publish the register in the Government gazette (on an annual basis);</li> <li>• Lodge the register with the relevant administration body for publication in the Government Gazette or Government website (on an annual basis); and</li> <li>• Prepare a return and remit any unclaimed monies held by the business (on an annual basis) to the administration body.</li> </ul>

### **Key questions**

What are consequences for the failure to comply?

### **Key findings**

Penalties and interest can be imposed for failure to meet the obligations under the relevant unclaimed monies legislation. For example, penalties can apply for failing to keep, advertise, or refuse inspection of a register, failure to remit unclaimed monies to the relevant administration body, failure to amend or update a register, etc.

Penalties for each offence can be as high as \$100,000.

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## What are some of the practical issues?

### **Key questions**

Obligations in multiple states relating to the same unclaimed monies

### **Key findings**

As there is no uniformity of legislation, practical issues may arise in complying with the relevant obligations in each Australian jurisdiction, particularly where a business operates in more than one Australian jurisdiction. Due to the definition of unclaimed monies, a single amount of unclaimed monies held by a business may be required to be remitted in several different jurisdictions.

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Obligation to keep a register in each relevant State or Territory

If the business operates in multiple jurisdictions, there will also be a requirement to:

- publish the register in each relevant jurisdiction; and
- make the register in each jurisdiction available for inspection by the administration body and the general public.

This will add to the administrative and compliance costs for the business. These costs, can be reduced depending on the specific nature of the unclaimed monies held and the operations of the business.

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## Conclusion

Knowing your obligations and being prepared will assist you in ensuring that you comply with your obligations and reduce the risk of potential penalties being imposed as a result of an investigation or audit by the relevant administration bodies.

With the relevant analysis and consideration, an efficient and practical compliance program can be developed to meet your unclaimed monies obligations in all relevant Australian jurisdictions.

## What are the potential opportunities for insurers?

In our experience many entities, particularly insurance entities, may have monies owed to them due to the miscalculation of indirect taxes.

That is, as errors in systems, processes and data entry coding are unavoidable in many large organisations, significant unrealised cash savings may exist in areas such as GST, Stamp Duty and Fire Service Levy.

Typically such opportunities are overlooked as insignificant, however, when multiple years of transactions are considered, the potential 'prize' can grow significantly. Generally the window of opportunity on most taxes is at least the last four years' of transactions, and therefore, this opportunity should not be dismissed lightly.

In order not to miss out on any cash savings available to you, please contact your PwC insurance specialist to arrange for our dedicated insurance indirect tax specialists to help you explore this opportunity.

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## *Maximising GST efficiencies in general insurance claims*

### Recognising the effect of GST inefficiencies on your bottom line

GST compliance is a real issue at the claims payment level. It has an identifiable and potentially significant cost that can and should be monitored. However, most claims review processes fail to actively consider GST compliance matters. Consequentially, we typically observe avoidable errors and inefficiencies that remain unrecognised year on year.

The 'set and forget' approach to GST compliance adopted by most organisations does not adequately recognise the complexity of the GST law for the insurance industry. It is difficult to "systemise" the GST rules for all claims payment scenarios. Nuances in the law or slight changes in fact scenarios can lead to different GST outcomes.

Through further attention to a number of key considerations, GST compliance processes can be significantly improved to increase efficiencies and reduce the risk of unfavourable audit activity by the Australian Taxation Office (ATO).

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## GST and insurance claims processes – Best practice

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### Key questions

### Key findings

Have you considered  
How insurance  
Claims processes  
impact GST  
compliance?

Claims managers spend significant time and resources on improving systems and processes to gain operational efficiencies and reduce overall claims costs. These improvements are generally achieved through changing elements within a claims process. Where systems or processes are changed and new steps introduced/deleted, there is the potential to significantly impact GST compliance.

For example, failures to have in place or adhere to claims lodgement scripting in a call centre can result in significant GST compliance risks that are often unidentified. Similarly, another example is where changes are made to the emergency repairs criteria. This is particularly evident after extreme weather events, and other periods of high claims activity. Resources are placed under significant levels of stress and standard processes may be abandoned in favour of higher claims processing volumes or better customer experience.

Whether it be introducing a new process, system changes or changes to arrangements, etc insurance claims managers must maintain robust systems and processes. This will ensure the GST implications of its claims and recoveries are appropriately realised.

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Have you realised  
all the indirect tax  
savings in your  
insurance claims  
function?

In addition to the very real risk of GST compliance errors, in our experience, claims environments usually contain opportunities to realise GST savings.

While considerable effort is usually made to reduce claims costs resulting in special project teams being established, base line monitoring performed, etc, little ongoing effort usually occurs in relation to identifying GST savings. This is despite the fact that a 10% GST component exists on most claims costs.

Investing time to review the GST efficiency of existing claims processes should be actively considered by most insurers as there are usually untapped opportunities available.

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Did you know the  
GST treatment of  
premiums can impact  
the claims system and  
processes?

The ability to claim GST credits (input tax credits (ITCs) or decreasing adjustments (DAs)) in respect of insurance payments is reliant on the GST treatment of the insurance premium paid by the customer. Accordingly, where insurers use separate underwriting and claims systems it is important to ensure the systems are configured to properly interface from a GST perspective.

That is, it is crucial to identify the correct GST treatment of each insurance policy, not only for underwriting purposes, but also to ensure compliance can be maintained in the event of a claim. A particular example of this is where a policy such as travel insurance may cover both on-shore and offshore risks. Correct classification of the policy will be crucial to ensuring the correct GST treatment is applied to the policy.

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## Key questions

Are you paying too much GST on recoveries?

## Key findings

Whilst GST applies to most insurance recoveries made on Personal Insurance claims, there are a number of circumstances where this is not the case. Equally, there are limited situations where GST is payable on recoveries on Commercial Insurance claims. Do you know if your systems get this right?

In our experience, systems and processes in recoveries departments are rightly focused on operational efficiencies – Such as the number of open files. Another transaction based risk such as GST, receives little or no attention on the assumption that existing processes are accurate.

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Do your claims leakage reviews or reinsurance recovery reviews consider GST issues?

Claims leakage reviews and reinsurance recovery reviews are crucial to operational effectiveness in the way they monitor and manage the cost of claims. However, it is important for insurers to be aware that the overall 'cost' of insurance claims is reliant on the way they are treated for GST purposes. In our experience, few insurers maximise the opportunity to leverage from these existing review processes to address GST compliance matters.

In the same way that fraudulent claims or inefficient reinsurance arrangements are direct costs that have an immediate impact on the bottom line, GST errors can have a significant effect on the cost efficiency of the overall claims process. Therefore, given there are significant resources being spent to address claims leakage, in our view it is appropriate to consider if these existing processes can or should include a GST component.

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## Conclusion

Proper attention to staff training and adequate system rules are necessary to ensure GST is not under or over paid. However, to rely on these controls alone is fraught with danger. After all, how do you know if staff training is being followed?

The answer lies in ensuring the insurance claims function has in place a tailored GST compliance monitoring framework that leverages existing claims review processes and realises GST opportunities as they arise.

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## *TOFA: What should I consider to make the right decision?*

### TOFA: what decisions do I need to make?

A key consideration for general insurers is whether they should make the fair value election to align the tax treatment with the accounting treatment.

The new Taxation of Financial Arrangement regime (TOFA) applies from 1 July 2010 for 30 June balancing taxpayers or from 1 January 2011 for 31 December balancing taxpayers, provided certain threshold financial requirements are met. Broadly, TOFA impacts the tax timing of financial arrangements. The way it does this depends on the choices that are made by the insurer. The choices include the following:

- a. Whether to early adopt TOFA (ie from 1 July 2009 for June balancing companies or from 1 January 2010 for 31 December balancing companies)
- b. Whether to make the transitional election (ie bring pre-TOFA financial arrangements into TOFA)
- c. Whether to make any of the tax timing elections (ie Fair Value, Financial Reports, Foreign Exchange, and Hedging elections).

If none of the elective methods are adopted, the default methods will apply (ie compounding accruals or realisation).

### What is the fair value election?

Broadly, in order to make the fair value election:

- You must prepare a financial report in accordance with the accounting standards (or comparable accounting standards under a foreign law);
- The financial report is audited in accordance with the auditing standards (or comparable auditing standards made under a foreign law); and
- Under the accounting standards the financial arrangements are fair valued through the income statement.

The fair value election allows insurers to align the accounting treatment with the tax treatment in respect of applicable financial arrangements.

## What kind of things should I consider?

- Making the election will bring unrealised gains/losses to tax. What is the impact on cash flows, tax payments and franking?
- Is there a correlation between market value movements in investments and movements in claims reserves which may reduce volatility?
- Is there an impact on the capital requirements of the insurer?
- What (if any) system changes will be required?
- Are compliance benefits meaningful? (Consider the benefits of aligning tax and accounting treatments, and maintaining one consistent tax treatment for financial arrangements.)
- Is there a timing benefit of making the fair value election and the transitional election?
- Is there still some uncertainty in the law? For example, it is unclear whether the eligibility criteria can be met by branches of foreign insurers.
- What is the impact on the financial statements?
- How does this election compare with the default methods?
- Does it make it more difficult to influence the effective tax rate?
- Is the impact on tax planning, such as choosing which investments to realise before year end, a concern?

## Conclusion

The decision whether to make a fair value election will depend on the circumstances of each insurer. Where for example, the volatility on tax payments and cash flows can be mitigated, there may be some attractiveness in aligning tax with accounts. However, it is important to bear in mind that the elective timing methods are irrevocable, so the decision to elect should be carefully considered. Even if the tax timing election is not made in the first applicable income year, the decision to make the election is still open in future years should it become more attractive.

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