
Life Insurance

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Introduction

Tony Cook

This year, the life insurance industry has seen strong growth in new business sales, particularly with group and direct business, volatile mortality and morbidity experience and more emphasis on risk management than ever before.

The group market is competitive and concentrated with just a few significant insurance players and continued super fund consolidation, resulting in fewer, larger, groups. As super schemes are increasingly offering their members additional life and TPD protection, the size of the insurance prize is increasing significantly, resulting in intense competition for these groups and a further squeeze on margins. Successful companies in the group market are offering slick and integrated back office processes, tailored tools, and comprehensive services to their clients.

Given these developments, players in the group market should consider whether their risk management practices for this business are keeping pace with the growing pricing, operational and strategic risks.

The direct insurance business is experiencing high growth rates, attractive profits, an increasing number of players and products, and increased competition. This business is in general quite young with lapse rates still developing and the associated risks such as operational, reputational and strategic, consequently growing. Technological innovation is a key

differentiator in the direct market with increasing use of e-underwriting, smart phone apps, and tele-underwriting.

Life insurers are still clearly focused on the value of excellent claims management and active retention management to bottom line results and the value of inforce. Claims management is using increasingly scientific tools and strategies to improve claims outcomes and customer experience. Retention management is getting more air time as the long term impact of retention on results is better understood, with a number of life insurers dedicating funding and resources to tackle this complex issue.

The retail market continues to experience strong growth in sales. Companies are looking at their distribution channels in light of potential changes on the back of FOFA as well as addressing the changes in customer purchasing habits and attitudes. For example, the use of mobile technology such as social networking sites and mobile apps to attract and connect with new customers in the retail market is an emerging trend with interesting potential.

Australia had funds under management (FUM) of \$1.8 trillion at the end of 2010, up \$500 billion from \$1.3 trillion in 2005. During this same period FUM with life insurers decreased marginally from \$238 billion to \$233 billion, and market share decreased from 18% to 13%. The long running trend for life insurers to be increasingly focused on risk business continues.



Statistics

Top 15 life insurers

Entity	Year end	Ranking Measure:					Performance:			
		Net Insurance Prem Rev					Investment Revenue		Result after tax	
		Current \$m	Current Rank	Prior \$m	Prior Rank	% Change	Current \$m	Prior \$m	Current \$m	Prior \$m
1 MLC (NAB)	09/10	1,230	1	812	5	51%	2,261	908	355	184
2 AMP Life	12/10	1,003	2	969	1	4%	3,157	6,835	576	521
3 The Colonial Mutual Life Assurance Society (CBA)	06/10	979	3	955	2	3%	1,514	(1,009)	388	202
4 The National Mutual Life Association of Australasia (AXA)	12/10	884	4	847	4	4%	779	1,333	147	164
5 OnePath Life (formerly ING Life) (ANZ)	09/10	652	5	875	3	-25%	419	3,681	116	231
6 TOWER Australia	09/10	597	6	529	6	13%	107	80	112	81
7 AIA Australia	11/10	590	7	514	7	15%	70	69	42	43
8 Suncorp life companies	06/10	483	8	460	8	5%	640	454	190	56
9 Swiss Re Life & Health Australia	12/10	467	9	423	9	10%	53	42	22	87
10 RGA Reinsurance Company of Australia	12/10	461	10	420	10	10%	36	20	35	47
11 Westpac life companies	09/10	340	11	316	11	8%	348	292	170	134
12 Munich Reinsurance Company of Australasia	12/10	310	12	264	13	17%	36	33	16	4
13 MetLife Insurance	12/10	284	13	289	12	-2%	36	29	48	59
14 Hannover Life Re of Australasia	12/10	228	14	207	14	10%	51	24	28	33
15 General Reinsurance Life Australia	12/10	166	15	142	-	17%	12	7	13	7

Source: Published annual financial statements or APRA annual returns for Australian life insurance operations.

Where applicable, comparatives have been updated to be in line with updated comparatives in current year financial reports.

Performance:		Financial Position:							
Net Policy Liabilities		Solvency Ratio		Financial Assets Held at FV		Net assets		Total assets	
Current \$m	Prior \$m	Current	Prior	Current \$m	Prior \$m	Current \$m	Prior \$m	Current \$m	Prior \$m
53,964	46,899	1.8	1.6	55,491	47,952	2,839	2,016	57,187	48,875
66,342	65,619	1.7	1.8	66,215	65,865	2,944	2,743	71,450	70,868
13,161	14,256	2.2	2.1	14,523	15,340	1,406	1,394	15,097	16,106
12,587	12,995	2.0	1.9	12,855	12,863	1,318	1,345	14,890	15,647
28,682	28,827	1.6	2.3	26,968	26,666	1,874	1,965	31,499	31,481
1,826	1,960	2.6	2.5	2,481	2,285	709	572	3,221	3,067
640	563	1.5	1.7	886	815	305	273	1,359	1,174
5,424	5,382	2.4	2.7	6,357	4,359	1,364	328	7,337	4,652
843	704	2.5	3.0	1,048	1,038	297	302	1,246	1,133
345	302	1.9	2.4	697	611	332	302	1,197	1087
10,244	10,332	3.6	2.7	11,012	10,944	850	789	11,390	11,452
296	263	5.0	1.8	699	596	198	161	1,042	942
137	116	3.8	5.4	422	380	354	338	676	644
642	595	3.2	2.8	831	766	252	225	1,035	978
191	176	10.5	15.4	283	249	91	81	345	316

- Notes:
1. The MLC group of companies comprises MLC Limited, MLC Lifetime Limited and Norwich Union Life Australia Limited. Norwich Union was acquired by the National Australia Bank on 1 October 2009. Comparative figures for MLC do not include Norwich Union.
 2. AXA was acquired by AMP on 8 March 2011. As the acquisition was subsequent to the latest reported year ends, the results of AMP and AXA are presented separately.
 3. During the year, ING Life changed its name to OnePath Life. Following its acquisition by the ANZ Bank, OnePath Life has reported a 9 month period to 30 September 2010 to align with the year end of its parent. The 9 month results are reported for the current period in the table above versus the 12 months results reported as its comparative.

Key developments in 2010/11

Topic	Summary of development/nature of impact
<p>Future of Financial Advice (FOFA)</p>	<p>FOFA reform proposals are expected to be issued shortly with pending legislation being introduced in the Spring 2011 sitting of Parliament. While risk commissions on group insurance are likely to be banned, commissions on retail life insurance products will likely not be.</p> <p>A review similar to FOFA was conducted in the UK (Retail Distribution Review (RDR)) resulting in a new framework for the retail investment market with effect from the end of 2012. The RDR will result in commissions on investment products and pension being banned. The review decided against banning commissions on pure risk sales on the grounds that such commissions don't represent a conflict of interest.</p> <p>FOFA reforms could result in independent financial advisors (IFAs) gravitating to insurers with automated and/or telephone underwriting in place as the increased efficiency in using these channels should reduce the IFA's operating costs.</p>
<p>APRA capital changes (LAGIC)</p>	<p>A discussion of APRA's proposed changes and the current status of LAGIC and ICAAP is included in chapter 1.</p>
<p>APRA focus on risk appetite</p>	<p>While risk appetite has been an issue of interest for APRA for some time, a recent speech by Ian Laughlin set out APRA's views and expectations of insurance companies, and in particular its expectations of the Boards of those companies. In this regard, APRA expects companies to comply with its risk appetite requirements with effect from 2012.</p> <p>APRA expects Boards of insurers to be more actively involved in the development and monitoring of risk appetite and how this is being embedded within the business from an operational perspective. This is likely to raise some debate on where Board and management responsibilities start and end.</p> <p>Effective implementation and monitoring of risk appetite is not merely a "tick the box" compliance exercise, but should involve effective communication of risk appetite, related tolerances and the "living out" of the strategy in business behaviours, processes, systems and controls.</p>

Topic	Summary of development/nature of impact
Insurance contracts exposure draft	A discussion of the impact of the insurance contracts exposure draft is included in section Chapter 1.
Prudential framework enhancements	<p>Four revised life prudential standards came into effect from 1 July 2010:</p> <ul style="list-style-type: none"> • LPS 310 – Audit and Related Matters • LPS 320 – Actuarial and Related Matters • LPS 510 – Governance • LPS 520 – Fit and Proper <p>The old LPS 310 was restructured into LPS 310 and LPS 320. The changes were implemented to more effectively align the requirements for life insurers with those of general insurers and ADIs.</p> <p>The scope of LPS 510 and LPS 520 was extended to include registered NOHCs of life insurance companies.</p> <p>The changes were aimed at providing better protection to life insurance policyholders by ensuring adequate governance procedures and that persons in positions of responsibility are fit and proper.</p>

Regulation and supervision

Australian Prudential Regulation Authority

APRA is the single Commonwealth authority responsible for licensing and prudential regulation for all deposit-taking institutions, life and general insurance companies, superannuation funds and friendly societies. APRA is also empowered to appoint an administrator to provide investor or consumer protection in the event of financial difficulties experienced by life or general insurance companies.

APRA's powers to regulate and collect data from the life insurance industry stem principally from the following acts:

- Life Insurance Act 1995 (the Life Act);
- Financial Sector (Collection of Data) Act 2001;
- Financial Sector (Shareholdings) Act 1998;
- Insurance (Acquisitions and Takeovers) Act 1991; and
- Financial Sector (Transfers of Business) Act 1999

As supervisor of life insurance companies, APRA administers the Life Act. The objective of the Life Act is to “protect policy owners and promote financial systems by encouraging a viable and competitive Australian life insurance industry with financially sound participants and fair trading practices”.

APRA supervises life insurance companies authorised under the Life Act with a view to maximising the likelihood that these companies will be able to meet their obligations to policyholders. Prudential requirements for life insurance companies are set out in prudential standards and in prudential rules.

An entity can not issue life insurance products without being authorised by APRA and only incorporated entities can be authorised under the Life Act. The Life Act does not apply to Eligible Foreign Life Insurance Companies (EFLIC), as defined under the Life Act, in relation to life insurance business carried on outside Australia. The prime responsibility for oversight of the Australian operations of an EFLIC rests with its local management and Compliance Committee. While a foreign life company's home regulators will play a role in supervising the EFLIC, to protect the interests of Australian policyholders, an EFLIC is required to maintain statutory funds in relation to its life insurance business in Australia and have its local operations subject to APRA's prudential supervision.

The requirements on the composition, operation and duties and responsibilities of an EFLIC are set out in Attachment B of Prudential Standard LPS 510 – Governance. There are no special restrictions on the number, size or mix of operations of foreign-owned subsidiaries or EFLIC's operating in the Australian market.

Although APRA is responsible for the prudential regulation of insurers, it is not responsible for product disclosure standards, customer complaints or licensing of financial service providers (including authorised representatives and insurance brokers) as these responsibilities fall to the Australian Securities and Investments Commission (ASIC) under its Australian Financial Services Licence (AFSL) regime. Most insurers require an AFSL, and as such, a dual licensing system exists with overlapping requirements under both ASIC and APRA.

Since its establishment in 1998, APRA has been working to harmonise the regulatory framework of regulated institutions. The aim is to apply similar principles across all prudential regulation and to ensure that similar financial risks are treated in a consistent manner whenever possible.

Regulatory framework

Similar to the general insurance regulatory framework, there is a three-tier regulatory system for life insurers:

- Tier 1 – The Life Act contains the high-level principles necessary for prudential regulation;
- Tier 2 – Prudential standards detail compliance requirements for companies authorised under the Life Act; and
- Tier 3 – Prudential Practice Guides accompany most prudential standards, providing details of how APRA expects them to be interpreted in practice.

Probability and Impact Rating System

Since October 2002, APRA has been applying risk assessment and supervisory response tools known as the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS). These supervisory tools are the centrepiece of APRA's risk-based approach to supervision and assist APRA in:

- making better risk judgments;
- quickly and consistently taking supervisory action where necessary;
- strengthening the ability of supervisors to take effective action; and
- improving oversight and reporting on problem entities.

APRA uses the Probability and Impact Rating System (PAIRS) risk assessment process to:

- determine APRA's assessment of the Probability that a regulated entity will fail; and
- measure the impact of the potential consequences of that failure.

Australian Securities and Investments Commission (ASIC)

ASIC is the single Commonwealth regulator responsible for market integrity and consumer protection functions across the financial system. It is responsible for:

- Corporate regulation, securities and futures markets;
- Market integrity and consumer protection in connection with life and general insurance and superannuation products, including the licensing of financial service providers; and
- Consumer protection functions for the finance sector.

Australian Financial Services Licence (AFSL)

The Corporations Act requires all sellers of insurance products to retail clients, including registered insurers and brokers, to obtain an AFSL. To obtain a licence, the applicant must meet the obligations under Section 912A and demonstrate that they will provide financial services efficiently, honestly and fairly. Insurers that are regulated by APRA are exempted from the financial obligations of an AFSL as their financial position is separately monitored by APRA through quarterly statistical reporting.

Ownership restrictions

The Financial Sector (Shareholdings) Act limits shareholdings to 15 per cent of an insurer, unless otherwise approved by the Federal Treasurer. The Insurance (Acquisitions and Takeovers) Act complements this legislation by requiring government approval for offers to buy more than 15 per cent of an insurer.

Supervision and compliance

APRA's supervisory objectives are met in two main ways:

- maintaining a regulatory framework within which insurance companies must operate
- requiring the submission of financial and other returns, insurer declarations and independent reports, so that APRA can monitor the financial position of the insurer and its ability to meet policyholder claims as they fall due.

In addition to companies' reporting and other obligations, the Life Act grants powers to APRA to monitor and investigate life insurance companies, including the power to appoint a judicial manager. A judicial manager acts in a similar manner to the administrator of a financially troubled company and, in accordance with Section 175 of the Life Act, is appointed by a judge to whom he or she must report the recommended course of action for the insurer.

The financial and other returns are described later in this chapter. The main features of the prudential standards which set out the mandatory elements of the regulatory framework are outlined below.

Table 2.1 – Life insurance prudential standards

Prudential standard	Explanation
PS 3 Prudential Capital Requirement	See section 3.4
LPS 1.04 Valuation of Policy Liabilities	Discussed below
LPS 2.04 Solvency Standard	See section 3.4
LPS 3.04 Capital Adequacy Standard	See section 3.4
LPS 4.02 Minimum Surrender Values and Paid-up Values	Discussed below
LPS 5.02 Cost of Investment Performance Guarantees	Discussed below
LPS 6.03 Management Capital Standard	See section 3.4
LPS 7.02 General Standard	Discussed below
LPS 220 Risk Management	See section 3.5
LPS 230 Reinsurance	See section 3.5
LPS 231 Outsourcing	See section 3.5
LPS 232 Business Continuity Management	See section 3.5
LPS 310 Audit and Related Matters	See section 3.6
LPS 320 Actuarial and Related Matters	See section 3.6
LPS 350 Contract Classification for the Purpose of Regulatory Reporting	Discussed below
LPS 510 Governance	See section 3.6
LPS 520 Fit and Proper	See section 3.6
LPS 600 Statutory Funds	Discussed below
LPS 700 Friendly Society Benefit Funds	Discussed below
LPS 900 Consolidation of Prudential Rules No. 15, 18, 22, 27 and 28	Discussed below
LPS 902 Approved Benefit Fund Requirements	Discussed below

Valuation of policy liabilities (LPS 1.04)

This standard prescribes a set of principles and associated actuarial methodology for the valuation of policy liabilities for life insurance contracts. The valuation of policy liabilities for life investment contracts is presented to generally comply with the requirements of the relevant accounting standards.

Minimum surrender values and paid-up values (LPS 4.02)

This standard prescribes a set of principles and an actuarial methodology for the calculation of minimum surrender values and paid-up values for the purpose of the solvency standard, and for payment on actual surrender at the policy owner's request. The objective of this prudential standard is to protect the interests of surrendering policy owners when terminating life insurance policies and to protect the interests of remaining policy owners.

Cost of investment performance guarantees (LPS 5.02)

This standard prescribes the principles and methodology for calculating the cost of investment performance guarantees where they are provided in association with investment-linked contracts. As prescribed in the Life Act, the cost of investment performance guarantees must not exceed 5% of the policy liabilities of the fund in which the business is written.

General standard (LPS 7.02)

The General Standard covers:

- Introduction of the prudential standards 1.04 to 6.03;
- Application of the standards to friendly societies;
- Instruction on how to use the prudential standards;
- History of the development of the prudential standards;
- Dictionary for the terminology used in the prudential standards 1.04 to 6.03; and
- Counterparty grade for investment assets, for the purposes of the solvency and capital adequacy standards.

Contract classification for the purpose of regulatory reporting (LPS 350)

This standard stipulates the basis on which contracts written by life companies are to be classified for the purpose of regulatory reporting to APRA and for the valuation of contracts in accordance with the prudential standards relating to actuarial matters.

The purposes of LPS 350 are:

- to distinguish between those contracts that meet the definition of a life insurance contract under Australian Accounting Standard AASB 1038 Life Insurance Contracts and those that do not;
- to identify key components of contracts written by life companies (insurance component, financial instrument, service component, discretionary participation feature and embedded derivatives); and
- to stipulate the circumstances in which such components must be unbundled for regulatory reporting purposes and for the valuation of contracts in accordance with Prudential Standard LPS 1.04 – Valuation of Policy Liabilities.

Statutory Funds and Friendly Society Benefit Funds (LPS 600 and LPS 700)

These standards aim to ensure that the operations of statutory and benefit funds are restructured to be fair and equitable for policy owners and members.

The requirements outlined in LPS 600 include the operations of statutory funds and the restructure of statutory funds. LPS 700 broadly covers the rules and operation of benefit funds and the restructure and termination of benefit funds.

Consolidation of Prudential Rules No. 15, 18, 22, 27 and 28 (LPS 900)

LPS 900 consolidates the following Prudential Rules:

- Prudential Rules No. 15 Consequences of Transfer of Policy Between Statutory Funds (s 55(2)&(3));
- Prudential Rules No. 18 Single Bank Account for Statutory Funds (s 34(4));
- Prudential Rules No. 22 Non-Participating Benefit (s 15(3));
- Prudential Rules No. 27 Starting Amount (s 61(1)); and
- Prudential Rules No. 28 Distribution of Shareholders' Retained Profits (Australian Participating) (s 62(5)).

Approved benefit fund requirements (LPS 902)

This standard is designed to ensure that the establishment, structure, and operation of an approved benefit fund by a friendly society are fair and equitable for its members.

Solvency and capital adequacy

We note that APRA are currently reviewing the capital standards for life and general insurers with a view to issuing revised draft prudential standards in late 2011. Further discussion on the proposed standards can be found in Chapter 1.

Overview of current prudential standards

APRA prudential standards establish a two-tier capital requirement for the statutory funds of life companies:

- Tier 1 (Solvency Requirement) requires a minimum capital requirement to ensure that under a range of adverse circumstances, the company would be able to meet obligations to policyholders and other creditors in the context of a fund closed to new business which is either operating in a run-off situation or is to be transferred to another insurer; and
- Tier 2 (Capital Adequacy Requirement) is intended to secure the financial strength of the company to ensure that the obligations to, and reasonable expectations of, policyholders and creditors are able to be met under a range of adverse circumstances in the context of a viable ongoing operation.

The key elements of the prudential standards that prescribe these capital requirements are outlined below.

Solvency (LPS 2.04)

The Solvency standard broadly comprises the following components:

- Solvency liability – A calculation of the value of the guaranteed policy liabilities applying assumptions that are generally more conservative than best estimate assumptions;
- Other liabilities – The value of the liabilities of the statutory fund to other creditors but excluding subordinated debt arrangements;
- Expense reserve – To provide for the loss of contribution from non-commission acquisition charges, which occurs upon closing a statutory fund to new business;
- Resilience reserve – To allow for adverse movements in investment markets and obligor defaults to the extent they will not be matched by corresponding movements in the liabilities; and
- Inadmissible assets reserve – To cover risks associated with holdings in associated financial entities and concentrated asset exposures.

Capital adequacy (LPS 3.04)

The Capital Adequacy standard broadly comprises:

- Capital adequacy liability – A calculation of the value of liabilities on the basis of assumptions that are generally more conservative than the solvency liability assumptions;
- Other liabilities – The value of the liabilities of the statutory fund to other creditors but excluding subordinated debt arrangements;
- Resilience reserve – Similar to the solvency requirements, except movements are more adverse;
- Inadmissible assets reserve – As per the solvency requirements, except it does not apply to otherwise sound assets that depend on the continuation of the business; and
- New business reserve – To provide for a fund to continue meeting its solvency requirement assuming the planned level of new business over the next three years.

Management capital (LPS 6.03)

The Management Capital standard prescribes the minimum capital requirement to be held outside the statutory funds to ensure that under adverse circumstances the company would be able to meet its trading commitments and adequately service its policyholders.

Prudential capital requirement (PS 3)

The Prudential Capital Requirement standard complements LPS 6.03. The standard indicates that the minimum capital value is \$10 million for life insurers (nil for friendly societies). This capital must be maintained as excess assets and at least 50 per cent must be in the form of eligible assets.

A life insurance company will need to independently comply with the requirements of the Prudential Standard PS 3 and the Prudential Standard LPS 6.03; however the two requirements are not additive.

Management of risk and reinsurance

Risk Management

This standard aims to ensure that a life company maintains a risk management framework and strategy that is appropriate to the nature and scale of its operations. A life company's systems, processes, structures, policies and people involved in identifying, assessing, mitigating and monitoring risks are referred to as a life company's risk management framework.

The key requirements of LPS 220 include:

- maintaining a risk management framework that identifies, assesses, monitors, reports on and mitigates all material risks faced by the company;
- having a written 3 year business plan approved by the board;
- Maintaining a risk management strategy which outlines the company's risk appetite and its strategy for managing risk;
- having its risk management framework subject to review by persons independent to the operation of the company; and
- supplying APRA with an annual declaration on risk management approved by the board.

Risk management framework

The risk management framework must include:

- a Risk Management Strategy (RMS);
- risk management policies, controls and procedures which identify, assess, monitor report on and mitigate all material financial and non-financial risks;
- a written business plan (which must be reviewed annually);
- clearly defined managerial responsibilities and controls for the framework; and
- a review process to ensure the framework remains effective.

APRA has also released a prudential practice guide – LPG 200 Risk Management, to assist life companies in complying with those requirements under LPS 220, and more generally, to outline prudent practices in relation to risk management frameworks. Additionally, prudential practice guide LPG 240 Life Insurance Risk and Life Reinsurance Management provides guidance with the requirements of LPS 220 in relation to insurance risk and reinsurance management.

Outsourcing

This prudential standard, along with Prudential Practice Guide PPG 231 Outsourcing, aims to ensure that all outsourcing arrangements involving material business activities entered into by a life company are subject to appropriate due diligence, approval and on-going monitoring.

The key requirements of LPS 231 include:

- having a policy relating to outsourcing of material business activity;
- internal audit must review any proposed outsourcing of a material business activity and regularly review and report to the Board or Board Audit Committee on compliance with the life company's outsourcing policy; having sufficient monitoring processes in place to manage the outsourcing of material business activities;
- having a legally binding agreement in place for all material business activities with third parties, unless otherwise agreed by APRA;
- consulting with APRA prior to entering into agreements to outsource material business activities to service providers who conduct their activities outside Australia; and
- notifying APRA after entering into agreements to outsource material business activities.

Business continuity management

This prudential standard aims to ensure that each life company implements a whole of business approach to business continuity management, appropriate to the nature and scale of its operation.

The key requirements of LPS 232 include:

- developing and maintaining a business continuity management policy;
- conducting a business impact analysis;
- maintaining a business continuity plan and testing it at least annually; and
- notifying APRA of any major disruptions to business operation.

Reinsurance

This standard aims to ensure that reinsurance arrangements of a life company are subject to minimum standards of independent oversight. It addresses the regular reporting of reinsurance arrangements to APRA, and APRA's oversight of financial reinsurance contracts.

The key requirements of LPS 230 are:

- a life company must give APRA a report on its reinsurance arrangements for a financial year within 3 months after the end of each financial year; and
- a life company must not enter into reinsurance arrangements of a certain type unless approval has been granted by APRA. These are primarily contracts that contain elements of financial reinsurance. Such contracts and details surrounding the application for approval are outlined in attachment B of LPS 230.

The reinsurance report must set out the particulars of each reinsurance contract or group of reinsurance contracts in force between the company and a reinsurer during the financial year. The report must also set out the opinion of the company's appointed actuary on the adequacy, effectiveness and regulatory accounting of the company's reinsurance arrangements.

Governance and assurance

Audit and actuarial requirements

These standards were made effective on 1 July 2010. The two standards clarify APRA's audit and actuarial requirements and have aligned them more closely with those for ADIs and general insurers.

The key requirements of LPS 310 include:

- a life company must make arrangements to enable its Auditor to undertake his or her role and responsibilities;
- the Auditor must audit certain returns of the life company to APRA and provide a report to the Board of the life company;
- the Auditor must review other aspects of the life company's operations on an annual basis and provide a report to the Board of the life company;
- the Auditor may also be required to undertake other functions, such as a special purpose review; and
- a life company must submit to APRA all reports required to be prepared by its Auditor under the standard.

The key requirements of LPS 320 include:

- a life company must make arrangements to enable its Appointed Actuary to undertake his or her role and responsibilities;
- the Appointed Actuary must provide an assessment of the overall financial condition of the life company and advise on the valuation of its policy liabilities on an annual basis. In particular, the Appointed Actuary must prepare a Financial Condition Report and provide this report to the company;
- a life company must submit the Financial Condition Report to APRA;
- the Appointed Actuary may also be required to provide advice to the life company on certain life policies; and
- the Appointed Actuary may be required to conduct a special purpose review and provide a report to APRA and the life company.

Both LPS 310 and LPS 320 aim to ensure that the Board and the senior management of a life company are provided with impartial advice in relation to the life company's operations, financial condition and internal controls.

Governance

APRA has undertaken a further review of the prudential framework around risk appetite, which is expected to impact the level of Board involvement in this area at life insurance companies. Further discussion is provided in the Key Developments section of this chapter and Chapter 1.

In this standard APRA sets out the minimum foundations for good governance of regulated institutions (comprising life companies and registered NOHCs). It aims to ensure that regulated institutions are managed in a sound and prudent manner by a competent Board of directors, which is capable of making reasonable and impartial business judgements in the best interests of the regulated institution and which gives due consideration to the impact of its decisions on policyholders.

The key requirements of this standard include:

- specific requirements with respect to Board size and composition;
- requiring the chairperson of the Board to be an independent director;
- requiring that a Board Audit Committee be established;
- requiring regulated institutions to have a dedicated internal audit function;
- certain provisions dealing with independence requirements for auditors consistent with those in the Corporations Act 2001;
- requiring the Board to have a Remuneration policy that aligns remuneration and risk management;
- requiring that a Board Remuneration Committee must be established; and
- requiring the Board to have a policy on Board renewal and procedures for assessing Board performance.

In November 2009, APRA released its prudential requirements on remuneration for life insurance companies, specifically relating to the alignment of remuneration with risk management. The requirements were incorporated into the existing prudential standard LPS 510 and came into effect on 1 April 2010.

APRA's prudential requirements on remuneration for life insurance companies were incorporated into the existing prudential standard LPS 510 and came into effect on 1 April 2010.

APRA's key requirements on remuneration include:

- a regulated institution (including eligible foreign life insurance companies (EFLIC)) must establish and maintain a written Remuneration Policy;
- the Remuneration Policy must outline the remuneration objectives and the structure of the remuneration arrangements, including but not limited to the performance-based remuneration components;

- the Remuneration Policy must be approved by the Board, or for an EFLIC, by the Compliance Committee with delegated authority from the Board;
- the Remuneration Policy must form part of a regulated institution's risk management framework required under Prudential Standard LPS 220 Risk Management;
- the Remuneration Policy must be provided to APRA on request;
- a regulated institution (other than an EFLIC) must, unless otherwise approved in writing by APRA, have a Board Remuneration Committee that complies with the requirements of LPS 510;
- the Board Remuneration Committee must conduct regular reviews of, and make recommendations to the Board on, the Remuneration Policy; make annual recommendations to the Board on the remuneration of the CEO, direct reports of the CEO, other persons whose activities affect the financial soundness of the regulated institution, other person specified by APRA and any other categories of persons covered by the Remuneration Policy; and
- the members of the Board Remuneration Committee must be available to meet with APRA on request.

Fit and proper

This standard sets out minimum requirements for the regulated institutions (comprising life companies and registered NOHCs) in determining the fitness and propriety of individuals to hold positions of responsibility.

The key requirements of this standard are that:

- a regulated institution must have and implement a written fit and proper policy that meets the requirements of the standard;
- the fitness and propriety of a responsible person must generally be assessed prior to initial appointment and then re-assessment annually (or as close to annually as practicable);
- a regulated institution must take all prudent steps to ensure that a person is not appointed to, or does not continue to hold, a responsible person position for which they are not fit and proper;
- additional requirements must be met for the Appointed Auditor and the Appointed Actuary; and
- information must be provided to APRA regarding responsible persons and the regulated institution's assessment of their fitness and propriety.

Accounting Standards

AASB 1038 *Life Insurance Contracts* prescribes the accounting treatment for life insurance contracts. It also mandates the use of certain options available in other accounting standards. AASB 1038 applies to life insurance companies and friendly societies that issue life insurance contracts (life insurers).

There have been no significant changes relating to AASB 1038 during the year, however there are a number of developments within the General Reporting Framework which will affect insurance companies. Life insurers should discuss these general developments with their accounting advisers and auditors where required.

The IASB is aiming to release a revised insurance contract accounting standard during 2011 which will impact life insurers in future periods. Refer to Chapter 1 for further details.

The following table outlines the key current accounting standards specifically impacting life insurers:

Accounting Standard	Application
AASB 4 <i>Insurance Contracts</i> (Last updated October 2010)	Prescribes the accounting methods to be used for reporting on:
AASB 1038 <i>Life Insurance Contracts</i> (Last updated October 2010)	<ul style="list-style-type: none"> • Life insurance contracts; • Certain aspects of life investment contracts; • Assets backing life insurance liabilities or life investment contract liabilities; and • Disclosures about life insurance contracts and certain aspects of life investment contracts.
AASB 7 <i>Financial Instruments: Disclosures</i> (Last updated June 2010)	Applies to the financial instrument component of life investment contracts
AASB 132 <i>Financial Instruments: Presentation</i> (Last updated October 2010)	Prescribes the accounting methods to be used in recognising, measuring, presenting and disclosing financial assets and financial liabilities.
AASB 139 <i>Financial Instruments: Recognition and Measurement</i> (Last updated October 2010)	

Definitions and Key Principles

Life Insurance contract

An insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Under AASB 1038, a life insurance contract is an insurance contract, or a financial instrument with a discretionary participation feature, regulated under the *Life Insurance Act 1995* (Life Act), and similar contracts issued by entities operating outside Australia.

AASB 1038 addresses key accounting issues by requiring:

- Profits to be recognised appropriately over the life of an insurance contract in line with the services provided;
- Calculation of best estimate policy liabilities; and
- Application of fair value principles.

Key principles of accounting for life insurance contracts:

Principle	Requirement
Basis for valuing policy liabilities	Policy liabilities are calculated as the present value of the best estimate of expected future net cash flows, plus future profit margins
Basis for valuing investments backing life insurance contract liabilities	Investments are valued at fair value through profit or loss where permitted
Basis for valuing controlled entities	Controlled entities are valued in accordance with AASB 127 Consolidated and Separate Financial Statements, at cost or fair value
Deferral of acquisition costs (DACs)	All acquisition costs are deferred and amortised over the period of expected benefit. DACs are to be deducted from policy liabilities

Life investment contract

A life investment contract is a contract which is regulated under the Life Act but which does not meet the above definition of a life insurance contract.

Key principles of accounting for life investment contracts:

<i>Principle</i>	<i>Requirement</i>
Basis for valuing policy liabilities	Valued at fair value in accordance with AASB 139. In practice, this will likely be on an accumulation basis, but may be adjusted to take account of demand deposit features
Basis for valuing investments backing life investment contract liabilities	Investments are valued at fair value through profit or loss where permitted
Deferral of acquisition costs (DACs)	Only those costs which are incremental and directly attributable to securing the life investment contract can be deferred. DACs are recognised as a separate asset and are tested for impairment at each balance date

AASB 1038 Applications

The key applications of AASB 1038 to life insurance financial reporting are summarised in the following paragraphs.

Profit recognition – Life insurance contracts

Planned profit margins and life insurance contract liabilities (referred to as policy liabilities) are calculated separately for each ‘related product group’ using best estimate assumptions at each reporting date. Profit margins are released over the financial year during which services are provided and revenues relating to those services are received. The balance of the planned profits is deferred by including the amount in the value of policy liabilities.

AASB 1038 requires the use of the prospective method (projection basis) to value policy liabilities (including planned profit margins and other components) at each reporting date unless, using the retrospective method (accumulation basis), the results are not materially different. To ensure planned margins are recognised during the financial year in which the relevant services are provided, policy liabilities include a component relating to those margins.

This methodology, which is commonly known as the “margin-on-services” method, results in reported shareholders’ profits comprising:

- the release of planned profit margins on policies in force at the beginning of the year;
- the release of planned profit margins on new business written during the year;
- the impact of differences between assumed and actual experience during the year including mortality, disability, expenses, lapses, inflation, taxation, reinsurance and investment returns;
- loss recognition (or reversal of past recognised losses) as appropriate; and
- investment earnings on shareholders’ capital and retained profits.

Changes in the assumptions underlying the policy liabilities are spread over future years during which the services to policyholders are rendered, except those for related products groups on which future losses are expected. A record of cumulative losses is kept for each related product group and profit margins are maintained at zero until cumulative losses are fully reversed. The effect of a change to assumed discount rates caused by changes in investment market conditions or where calculation errors occur results in a revenue or expense being recognised in the current financial year.

The income statement includes all premium and policy-related revenue, investment revenues, fair value gains and losses, all claims (including surrenders), and all expenses and taxes, whether they relate to policyholders or shareholders. The change in the value of policy liabilities (including the change of unvested policyholder benefits and discretionary additions/bonuses vested in policyholders during the financial year) is shown as an expense before arriving at the shareholder profit.

Profits or losses may emerge on acquisition depending on whether establishment fees are more or less than the related expenses. Losses may also emerge if expected future income is not considered adequate to cover acquisition expenses.

Valuation of life insurance policy liabilities

Under AASB 1038 the best estimate liability is calculated as the present value of expected future benefit payments, plus expenses, less future receipts. The following factors are generally considered to be material to the calculations:

- Discount and inflation rates
- Profit carriers;
- Inflation;
- Taxation;
- Expenses;
- Mortality and morbidity; and
- Policy discontinuance.

The best estimate liability will normally be determined using projection methods, and the value of future profits calculated as the present value of future profit margins.

A profit margin is determined using a profit carrier, which is a financially measurable indicator of either the expected cost of the services provided to the policyholder or the expected income relating to the services.

Profit carriers are selected and profit margins determined at policy commencement to enable an appropriate emergence of profit over the term of the benefits or services provided. The selection of a profit carrier is critical in determining the timing of profits released. More than one profit carrier may be selected for a product, although the practical implications of selecting multiple carriers should be considered relative to the materiality of the results. Typical profit carriers are identified below:

Product	Typical profit carrier
Yearly renewable term	Premiums or claims
Level premium term	Claims
Group life	Premiums or claims
Disability income	Claims
Immediate annuities	Annuity payments
Traditional non-participating	Death claims
Traditional participating	Value of bonuses

Revenue recognition – Life investment contracts

Revenue from investment contracts arises either from explicit fees charged to investment contract holders or from the earning of the management services element (MSE) inherent in the valuation of the investment contract liability.

Explicit fees are measured as the fair value of the consideration received or receivable and are earned in the income statement as the services are provided to the contract holder. This would normally be on a straight line basis over the life of the investment contract but other earning patterns may be more appropriate if they better reflect the provision of services.

An MSE arises when the sum of consideration received or receivable exceeds the fair value of the investment contract liability upon initial recognition. This deferred revenue is recognised as a liability on the balance sheet and earned as the management services are provided, as per the explicit fees above.

Incremental costs that are directly attributable to the acquisition of an investment contract are deferred and recognised as an asset if they can be identified separately, measured reliably, and if it is probable that they will be recovered.

An incremental cost is one that would not have been incurred if the life insurer had not acquired the life investment contract. The asset represents the insurer's contractual right to benefit from providing ongoing services, and is amortised as the insurer recognises the related revenue.

Valuation of investment contract liabilities

Investment contract liabilities are valued at fair value in accordance with AASB 139. As there is generally no active market for investment contract liabilities, these should be valued using an appropriate valuation technique which would normally involve a discounted future cash flow analysis.

For investment contracts with a demand feature, or surrender value, AASB 139 stipulates that the fair value of the liability cannot be less than the current surrender value.

Accounting for investments

AASB 1038 requires life insurers to measure all assets backing life insurance and life investment contracts at fair value through profit or loss as at the reporting date where this option is available. Changes in the fair value must be recognised in the income statement as either income or expense in the financial year in which the changes occur. Where there are choices available in other standards for the measurement of assets, AASB 1038 requires the following to be applied to those assets determined as backing life insurance and life investment contracts.

Type of asset	Measurement basis
Financial assets	Fair value through profit or loss in accordance with AASB 139
Investment property	Fair value using the fair value model under AASB 140 <i>Investment Property</i>
Property, plant and equipment (including owner-occupied property)	Revaluation model under AASB 116 <i>Property, Plant and Equipment</i> , being fair value less any subsequent accumulated depreciation and subsequent accumulated impairment losses (revaluation movements through equity)

Statutory Funds

AASB 1038 requires life insurers to recognise in its financial report all of the assets, liabilities, and expenses of each statutory fund. It recognises that the interests of policyholders and shareholders are intertwined and form the basis of a single entity. Where a parent entity controls a life insurance subsidiary, the parent in turn controls the assets and liabilities of the statutory funds and the policyholders' interests.

Benefit funds of friendly societies are treated in the same way as life insurance company statutory funds.

Acquired life insurance contracts

When purchasing a life insurance company or a portfolio of life insurance contracts, a life insurer must value the insurance assets and insurance liabilities assumed at fair value. They are permitted, but not required, to split the fair value into two components:

- i. a liability measured in accordance with the insurer's accounting policies for life insurance contracts; and
- ii. an intangible asset, representing the difference between the fair value of the insurance contracts acquired and the liability recognised in (i).

The intangible asset is exempt from the recognition and measurement requirements of both AASB 138 Intangible Assets and AASB 136 Impairment of Assets. It is not exempt from the disclosure requirements. The subsequent measurement has to be consistent with the measurement of the related liability, i.e. it will be amortised over the life of the liabilities, consistent with the profit recognition on those contracts.

Disclosure requirements

AASB 1038 incorporates extensive disclosure requirements in respect of the accounting policies, balances, sensitivities to key assumptions, risk exposures and risk management associated with the insurer's insurance contracts.

Annual and quarterly reporting

In general, a public company must file its annual shareholder accounts (financial statements) with ASIC within four months of year-end (within three months for disclosing entities or registered schemes). Small proprietary companies are normally exempted. The financial statements prepared under the *Corporations Act 2001* must be independently audited by an Australian registered auditor.

Life insurance companies and friendly societies are required to submit quarterly returns (LRF 100 – LRF 340.2) and annual returns (LRF 100 – LRF 430) to APRA under the *Financial Sector (Collection of Data) Act 2001*. The returns should be submitted using the online 'Direct to APRA' (D2A) software, or on paper where this is not possible. The quarterly returns are due 20 business days after the end of the reporting period. The annual returns are due four months after year-end.

The reporting requirements for the returns are broadly consistent with the requirements for financial statements under the accounting standards issued by AASB. Areas of potential difference are outlined in LPS 350 Contract Classification for the Purpose of Regulatory Reporting to APRA, and relate to discretionary participation features and participating benefits, and the unbundling of contracts into insurance, investment and service components.

In addition, a life insurer which holds an AFSL is required to submit the forms FS 70 (completed by the insurer) and FS 71 (completed by the appointed auditor) annually to ASIC.

Other reports due to APRA

i. Annual Reporting by Appointed Auditor

The annual returns must be submitted in conjunction with the annual auditor's report, as required under Prudential Standard LPS 310 Audit and Related Matters. The Appointed Auditor provides an audit opinion (reasonable assurance) over annual returns LRF 100 to LRF 340.2. In addition, the Appointed Auditor provides a separate review report (limited assurance) over prudential compliance and systems, processes and controls relating to APRA financial reporting during the year.

ii. Financial Condition Report

LPS 310 requires life companies and friendly societies to give to APRA a copy of a financial condition report prepared by the appointed actuary within 3 months of the end of the reporting period.

iii. Reinsurance Report

LPS 230 Reinsurance requires each life company to give APRA a reinsurance report within 3 months of the end of the reporting period.

iv. Risk Management Declaration

LPS 220 Risk Management requires the Board to provide APRA with a Risk Management Declaration relating to each financial year of the life company. The Risk Management Declaration must be signed by two directors and submitted to APRA on, or before, the due date of the annual returns.

Life insurance taxation

General developments

As in the previous income year, the Government has continued with numerous initiatives for significant tax reform across a wide range of topics from corporate tax rates to controlled foreign company rules.

Some key tax developments during the year relevant to life insurance are summarised below.

- The new consolidation measures proposed in February 2010 have been enacted by Tax Laws Amendment (2010 Measures No 1) Bill 2010 (TLAM No 1 2010). Many amendments apply retrospectively, some as early as 1 July 2002, and may change previous tax positions of consolidated groups, presenting both an opportunity and a risk.

All consolidated and multiple entry consolidated (MEC) groups should be examining whether there is scope to benefit from the key opportunities emanating from the new measures, which include a deduction for the tax cost setting amount (TCSA) of certain rights to future income. Many life insurers have found they may be eligible to claim substantial benefits under these rules, and these benefits generally relate to acquisitions. However, the Government announced in 30 March 2011 that the rules are to be reviewed, with the possibility of them being narrowed in application.

Under the current rules, any amended assessments for “old” years need to be processed by the ATO by 30 June 2012.

- Superannuation rollover rules (facilitating restructures of life company superannuation business), are set to expire on 30 June 2011. The industry continues to lobby to have the expiration date deferred.
- The Taxation of Financial Arrangements (TOFA) measures which provide a comprehensive regime for the tax treatment of gains and losses arising from financial arrangements now apply to eligible taxpayers for the income year beginning on or after 1 July 2010. Taxpayers have a choice as to how TOFA will apply to their financial arrangements. Additionally, the ATO continues to work through the extensive list of issues raised in connection with the practical application of the legislation to various arrangements, such as swaps and hedges, as well as grapple with some base level issues relevant to the application of the tax-timing methods.
- The Foreign Account Tax Compliance Act (“FATCA”) has been enacted and will apply to payments made after 1 January 2013. FATCA is designed to stop US tax avoidance known as “round tripping”, where US persons invest offshore and then into onshore US investments, reducing US tax. FATCA will apply to Foreign Financial Institutions (“FFIs”) and Non Financial Foreign Entities (“NFFEs”). Both are very broad terms and

include providers of vanilla investment products, e.g. trustees of certain but not all superannuation funds and unit trusts, and these products will fall within the meaning of a “foreign account”. These US rules impact Australian life insurers investing in the US.

- The International Dealings Schedule – Financial Services (IDS-FS) is the ATO’s proposed tax return schedule for large financial services taxpayers to replace the Schedule 25A and Thin Capitalisation Schedule and provide additional information in relation to financial arrangements. Amongst other things, the schedule requires disclosure of certain international dealings with unrelated parties. All general and life insurers are required to lodge the IDS-FS 2011 in replacement of the previous Schedule 25A and Thin Capitalisation schedule.

Taxation of life insurers

The rules governing how life companies are taxed are contained in Division 320 of the Income Tax Assessment Act 1997 (ITAA97). Broadly, these rules seek to tax most underwriting profits and fee income at the normal corporate rate, whereas investment income is taxed at varying rates, zero percent for income from assets backing pension portfolio amounts, 15% for assets backing superannuation amounts in accumulation phase and 30% for other investment income.

Classes of income

The income of a life insurance company is effectively divided into three classes: the Ordinary Class, the Complying Superannuation Class or First Home Saver Account (FHSA) Class (both being taxable) and a Segregated Exempt Assets (SEA) Class. The complying superannuation/FHSA class, formerly known as the Virtual Pooled Superannuation Trust (VPST) class, is established for the company’s complying superannuation policies.

Life insurance companies must establish a segregated asset pool for their immediate annuity policy liabilities, which is the SEA Class. All other classes of policies and any shareholder capital will form part of the Ordinary Class.

The classification of income and gains among the various classes of income (assessable and exempt) is not determined by reference to statutory funds and the mix of policy liabilities (in the case of mixed statutory funds). Rather, the life insurance company must segregate its assets by allocating these as supporting certain (tax) classes of policies it has issued.

Life insurance companies pay tax on income derived in the Ordinary Class at the rate of 30 per cent and are ordinarily taxed at a rate of 15 per cent on income derived from complying superannuation/FHSA assets. Any income derived from the SEA Class is exempt from tax.

A life insurance company remains a single entity for taxation purposes. However, the effect of the rules outlined above is that for taxation purposes, the company is effectively divided into three pools, with each segment representing a particular class of business.

A life insurance company can also form part of a tax consolidated group, in which case the head company will be deemed to be a life insurance company.

Assessable income

The assessable income of a life insurer includes fee income and underwriting profits of a life insurer as well as its investment income and realised gains on the disposal of assets.

Assessable income also specifically includes life insurance premiums “paid” to the company, reinsurance amounts received, refunds of reinsurance paid under a contract of reinsurance and amounts received under a profit-sharing arrangement under a contract of reinsurance. In an Interpretative Decision, the ATO states that premium income should be recognised on an accruals basis.

Amounts representing a decrease in the value of the net risk components of risk policy liabilities and taxable contributions transferred from complying super funds or approved deposit funds (ADFs) are also included in assessable income.

Specified rollover amounts, fees and charges imposed in respect of life insurance policies but not otherwise included in assessable income and taxable contributions made to retirement savings accounts provided by that company also form part of the life company’s assessable income.

Furthermore, most transfers of assets from one class to another will have a tax consequence. It is therefore necessary to carefully review and record each transfer to ensure its appropriate tax treatment.

Disposal of investments

Whether a profit or gain realised on the disposal or transfer of an investment is liable to tax (and the rate of tax) depends on the class of income to which it relates.

Gains and losses realised on certain complying superannuation/FHSA assets are determined by reference to the general capital gains tax provisions (which is consistent with the treatment of disposals of investments by superannuation funds).

The legislation also provides that a “deemed disposal” will arise where there is a transfer between the asset pools of an asset other than money. For tax purposes, an assessable gain may arise for the “transferor” asset pool.

A different rule, being a deferral mechanism, applies where an asset transfer results in a loss for tax purposes.

Similar to the tax treatment for general insurers, investments in the Ordinary Class are usually held on revenue rather than on capital account. Accordingly, profits on the disposal of such investments would be included in assessable income as ordinary income. However, this treatment may be modified under the TOFA rules.

Profits and losses on the disposal of investments held in the SEA Class are not taxable or deductible.

Each year, a life company is required to carry out a valuation of its complying superannuation/FHSA liabilities and SEA liabilities. Where the valuation of the corresponding asset pool exceeds the respective value of these liabilities (plus a reasonable provision for tax), the company must transfer the excess out of that asset pool. Where the valuation indicates a shortfall, the company may transfer assets into the pool. Such transfers will have the taxation consequences outlined above.

Management fee income

Where a life insurance company imposes fees and charges on policies included in the asset pools representing the complying superannuation/FHSA and SEA classes, it is required to transfer an amount equal to those fees and charges out of these pools. This will give rise to an assessable amount in the Ordinary Class, as well as a deduction in the complying superannuation/FHSA Class, but no deduction in the SEA Class.

This requirement ensures that any fees and charges imposed by the life insurance company are taxed at the prevailing corporate tax rate.

Investment income

A life insurer is required to separately calculate the investment income from each of its asset pools. This means adequate accounting records must be maintained to separately identify each of these pools, which will differ from the normal statutory fund basis of asset allocation.

Allowable deductions

The current tax provisions are based on the principle that a deduction is allowed for expenses of a revenue nature to the extent they are incurred in gaining or producing assessable income.

A life insurance company is allowed certain specific deductions. These include certain components of life insurance premiums (see below), the risk component of claims paid under life insurance policies, the increase in the value of risk policy liabilities, certain reinsurance premiums and amounts transferred to the SEA Class.

Premiums are fully deductible if they are transferred to the SEA Class, or if they are for policies providing participating or discretionary benefits. Part of the premium may be deductible if they are transferred to the complying superannuation/FHSA Class.

The deductible component of premiums in respect of ordinary non-participating investment policies would normally be determined by an actuary.

In relation to risk-only policies, such as term insurance policies, deductions will be allowed for the increase in the value of those policy liabilities over the financial year (conversely, decreases will be assessable). An actuary would generally assist in calculating these assessable and deductible amounts.

Allocation and utilisation of losses

A life insurance company remains a single entity for tax purposes but in effect will be divided into three separate taxpayers, each representing a separate class of business. The idea of notional separate taxpayers for each class of business limits the way in which tax losses and capital losses can be used by a life company.

Capital losses from complying superannuation/FHSA assets can be applied only to reduce capital gains from complying superannuation/FHSA assets or carried forward to be used in a later year against capital gains derived in the complying superannuation/FHSA Class. Similarly, capital losses from Ordinary Class assets can be applied only to reduce capital gains from Ordinary Class assets or carried forward to be used in a later year against future capital gains generated by that class.

Ordinary Class revenue losses can only be applied against Ordinary Class assessable income. Similarly, complying superannuation/FHSA revenue losses can only be applied against complying superannuation/FHSA assessable income.

No assessable gains or deductible losses (including capital gains and losses) will arise from the SEA pool.

Certain types of income, including SEA income and income from the disposal of units in a pooled superannuation trust, are classified as “non-assessable non-exempt income”. As a result, tax losses incurred by a life insurance company will not be wasted against these non-assessable non-exempt income amounts before being offset against assessable income.

Imputation credits

A life insurance company is entitled to franking credits in its franking account for the payment of tax on income and/or the receipt of franked dividends attributable to Ordinary Class business. This means that no franking credits are recorded in a life insurance company’s franking account for tax paid on income from assets held in the complying superannuation/FHSA Class and SEA Class or franked dividends received from assets held in those classes. In this way, the imputation rules for life insurers are consistent with other non-life corporate taxpayers.

A life insurance company is generally entitled to a tax offset for imputation credits attached to dividends received from assets held in the Ordinary Class and complying superannuation/FHSA Class. Excess imputation credits are refundable to the complying superannuation/FHSA Class. As the SEA Class does not generate taxable income, any imputation credits generated by the assets in this class are also refundable.

There are special rules for life insurance companies which enable the offset of a franking deficit tax liability against the income tax liability attributable to shareholders business in the Ordinary Class. These rules complement the normal franking deficit provisions which apply to all companies.

Reinsurance with non-residents

Where a life insurance company reinsures all or part of any risk associated with disability policies with a non-resident, a deduction will not be allowed in respect of those premiums and an amount will not be assessable in respect of any recoveries.

The company’s net risk liabilities include so much of the risk component as is reinsured with the non-resident reinsurer.

However, a life insurance company may elect that this principle does not apply in determining its taxable income, in which case the insurer becomes liable to furnish returns and to pay tax at the relevant rate (30 per cent) on 10 per cent of the gross premiums paid or credited to these non-resident reinsurers during the year. Where the election has been made, the company’s net risk liabilities do not include the risk component which is reinsured with the non-resident reinsurer.

Goods and Services Tax

Under the Australian GST legislation, some classes of insurance are treated differently, leading to different implications for insurers and insured parties.

The provision of life insurance is usually an “input taxed” supply (known as “exempt supplies” in other jurisdictions), as the supply of an interest in certain life insurance businesses is defined to be a “financial supply” which, in turn, is input taxed for GST purposes. As a result, while life insurers are not required to account for GST on premium income derived from life insurance businesses, they are usually denied full input tax credits on the expenses incurred in making supplies of life insurance.

However, life insurers may be entitled to recover a reduced input tax credit on certain specified expenses. These are known as “reduced credit acquisitions” and are specifically listed in the GST Regulations. The current rate of reduced input tax credits is set at 75 per cent of the GST included in the price of particular expenses.

GST classification of life insurance will be different if the supply is made in relation to a risk located outside of Australia, in which case the supply of these policies may be GST-free. Such a scenario will also result in a need to closely examine the expenses related to the life insurance operation to determine the extent to which input tax credits are available. It is common for life insurance entities to develop and apply a GST apportionment methodology in order to calculate their entitlement to input tax credits incurred.

The meaning of life insurance from a GST perspective is linked to certain provisions of the Life Insurance Act 1995. The GST regulations also stipulate that a supply that is incidental to another financial supply will itself be input taxed, subject to certain criteria being met. Certain products can be declared by APRA to be life insurance, and others will qualify as life insurance due to being related businesses (e.g. certain disability insurance).

In summary, as noted above, the consequence of input taxed classification is that input tax credits are not available for expenditure incurred in connection with making input taxed supplies of life insurance. However, the GST law also contains provisions which allow financial supply providers to claim reduced input tax credits on certain acquisitions.

Investment activities

Investment activities are, like life insurance businesses, input taxed in many cases, as they are classified as financial supplies for GST purposes.

While GST will not be payable on the supplies made, not all of the GST incurred as part of the price paid for expenses associated with investment activities will be recoverable unless one of the following exceptions applies:

- The expense relates directly to the purchase or sale of securities or other investments in an overseas market.
- The expenses incurred by the insurer for the purpose of making input taxed financial supplies do not exceed the “financial acquisitions threshold” (which is a “de minimus” test to ensure that entities that do not usually make financial supplies are not denied input tax credits on making financial supplies that are not a significant part of their principal commercial activities).

- The financial supply is a borrowing and the borrowing relates to supplies which are not input taxed.

Where the above exceptions apply, the insurer retains the entitlement to fully recover the GST incurred on related costs. However, where the exceptions do not apply, the insurer will have to use an appropriate apportionment methodology to determine the extent to which it is entitled to recover GST incurred on general costs.

It should be noted that where acquisitions made by an insurer for the purpose of its investment activities are “reduced credit acquisitions”, the insurer is entitled to claim a reduced input tax credit equal to 75 percent of the GST included in the price of the expense.

Stamp duty

Stamp duty on life insurance (other than term life) is generally calculated on the sum insured. The rates of duty vary in each state and territory. Generally, temporary or term life insurance is subject to duty at the rate of 5 per cent of the first year’s premium.

Western Australia no longer imposes stamp duty on life insurance policies entered into after 1 July 2004. Policies entered into prior to this date continue to be subject to life insurance duty at the same rate as New South Wales, Queensland, Tasmania, Australian Capital Territory and Northern Territory. However, life insurance riders which are categorised as a separate policy of general insurance will continue to be subject to duty at general insurance rates in Western Australia.

Life insurance riders

A life insurance rider is dutiable in all states and territories. In New South Wales and the Australian Capital Territory, the amount of duty payable on a life insurance rider is five per cent of the first year’s premium paid for the rider. In Queensland, a life insurance rider is treated as Class 2 general insurance and duty at the rate of five per cent of the premium to the extent that the premium paid for the rider is payable.

In Victoria, Western Australia, Tasmania and the Northern Territory, a life insurance rider will be subject to the applicable life insurance rate unless the rider is characterised as a separate policy of general insurance, in which case duty is payable at the general insurance rate applying in the relevant jurisdiction (see table below).

<i>As at March 2011</i>	<i>Class</i>	<i>Rate</i>
VIC, WA, NT	Life Insurance Rider	10%
TAS	Life Insurance Rider	8 %

