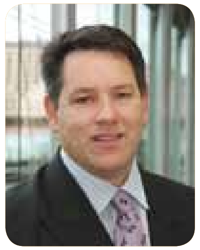
Life Insurance

2

PRICEWATERHOUSECOOPERS



Introduction

Tony Cook

It is arguable the life insurance industry in Australia has emerged from the recent financial storm in a stronger position than when it went in:

- while some balance sheets took pain, none failed, enhancing the industry's reputation for strength, prudence and security;
- while profitability remains subdued for those companies where the portfolio contains a high proportion of investment business, FUM growth is returning and risk product volumes continue their seemingly unstoppable growth;
- while regulatory change confronts and challenges the industry. it also brings with it opportunities for agile companies to innovate and to improve their offerings and competitive position; and
- while investment may have been subdued, some companies grabbed the opportunity presented by challenging times to acquire other businesses or to innovate to meet emerging customer needs.

The industry is often its own worst critic when it comes to innovation and embracing change. However it is right to acknowledge how well it has taken advantage of the opportunities presented by these unprecedented times. This is seen best in the:

- innovation of new guaranteed income stream products to meet the needs of an aging population with adversion to market and longevity exposure;
- innovation of new technologies designed to help reach more potential insurance customers more cost effectively than ever before;
- innovation of new distribution channels and growth of the group insurance market to better reach previously untapped markets; and
- rapid emergence of merger and acquisition activity following the onset of the crises.

At the same time there is no room for complacency. There remain the challenges of developing solutions to reach the underinsured population, of improving retention, and of influencing and responding to the emerging regulatory changes. This last challenge arises in no small part from a real or perceived failure of the regulatory protections and industry structures to meet customer needs under the stress of the recent crises.

Arguably all three challenges share a common issue. Does the industry understand its current and potential customers well enough and does it know how to engage them effectively? Failure on this front will inhibit its ability to solve the underinsurance and retention problems and will inhibit its ability to influence and respond to regulatory change from the high ground. Meeting customer needs will ultimately deliver long term success for the industry, which is a better outcome than looking to protect short term industry interests.

The customer has always been king. Success will go to those companies who can embrace this most effectively.

2.1 Statistics

Top 15 life insurers

		Ranking Measure: Net insurance premium revenue						Performance: Investment revenue	
	Entity	Year end	Current $m	Current Rank	Prior $m	Prior Rank	% Change	Current	Prior
1	AMP Life	12/09	969	1	913	1	6%	6,835	-12,863
2	The Colonial Mutual Life Assurance Society (CBA)	06/09	955	2	804	2	19%	-1,009	-617
3	ING Life (ANZ)[1]	12/09	875	3	777	3	13%	3,681	-6,283
4	National Mutual Life Association (AXA)	12/09	847	4	552	5	53%	1,412	3,161
5	MLC (NAB)[2]	09/09	812	5	749	4	8%	908	-9,175
6	TOWER Australia	09/09	529	6	486	6	9%	80	-313
7	American International Assurance Company Australia	11/09	514	7	368	9	40%	69	-27
8	Suncorp life companies[3]	06/09	460	8	179	15	157%	-724	575
9	Swiss Re Life & Health Australia	12/09	423	9	420	7	1%	42	29
10	RGA Reinsurance Company of Australia	12/09	420	10	386	8	9%	20	58
11	Westpac Life[4]	09/09	316	11	258	12	22%	292	-1,785
12	MetLife Insurance	12/09	289	12	264	11	9%	29	10
13	Munich Reinsurance Company of Australasia	12/09	264	13	200	13	32%	33	73
14	Hannover Life Re of Australasia	12/09	207	14	313	10	-34%	24	89
15	Norwich Union Life Australia[5]	09/09	155	15	186	14	-17%	520	-818

		Performance: Result after tax		Financial Position: Net policy liabilities		Solvency coverage		Financial assets held at FV		Net assets		Total assets	
	Entity	Current $m	Prior $m	Current $m	Prior $m	Current	Prior	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m
1	AMP Life	521	461	65,575	60,760	1.8	1.6	65,865	60,956	2,743	2,565	70,868	76,802
2	The Colonial Mutual Life Assurance Society (CBA)	202	80	14,256	16,706	2.1	2.2	15,340	17,757	1,394	1,093	16,106	18,345
3	ING Life (ANZ)[1]	231	194	28,827	24,073	2.3	1.8	25,186	21,419	1,965	1,835	31,484	26,695
4	National Mutual Life Association (AXA)	164	-95	12,608	12,095	1.9	1.2	12,853	12,293	1,345	981	15,647	16,589
5	MLC (NAB)[2]	184	392	46,899	49,346	1.6	1.7	47,952	50,367	2,016	2,502	48,875	52,639
6	TOWER Australia	81	76	1,960	2,128	2.5	2.5	2,285	2,518	572	492	3,067	3,171
7	American International Assurance Company Australia	43	13	551	460	1.7	1.4	815	674	273	231	1,174	906
8	Suncorp life companies[3]	109	68	4,998	4,066	2.3	2.7	6,873	5,805	1,207	286	7,728	6,062
9	Swiss Re Life & Health Australia	87	-40	704	730	3.0	1.7	1,038	933	302	227	1,133	1,074
10	RGA Reinsurance Company of Australia	47	67	302	260	2.4	2.5	611	524	302	258	1,087	705
11	Westpac Life[4]	134	204	10,332	10,555	2.7	2.1	10,994	11,159	789	720	11,452	11,609
12	MetLife Insurance	59	35	116	103	5.4	5.9	380	414	338	378	644	663
13	Munich Reinsurance Company of Australasia	4	28	263	246	1.8	1.4	596	565	161	148	942	873
14	Hannover Life Re of Australasia	33	39	595	592	2.8	3.6	766	713	225	192	978	966
15	Norwich Union Life Australia[5]	69	39	3,779	3,561	5.18	2.98	4,557	4,035	610	541	4,970	4,658

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

Notes: Policy liabilities are net of all reinsurance recoveries and also include life investment policy liabilities.

Investment revenue includes unrealised gains/losses and are net of investment management expenses.

A weighted average based on net assets is used to estimate overall solvency ratio where there are more than one entity within the group.

1 ING Life was acquired by ANZ Banking Corporation on 30 November 2009.

2 The National Australia Bank acquired Norwich Union Life on 1 October 2009. As the insurer was acquired post year end, Norwich Union continues to be shown separately in this table.

3 Suncorp life companies comprise of Suncorp Life & Health and Asteron Life. Suncorp acquired the Promina group in March 2007. As it had an 18 month period to 30 June 2008, information for Asteron Life was not included in the prior year table.

4 Westpac acquired St George Life on 1 December 2008. Comparative figures are for Westpac only.

5 Norwich Union changed its balance date to 30 September 2009 to align with that of National Australia Bank. Consequently the figures provided for Norwich in the current period are for 9 months.

2.2

Key developments

APRA regulatory changes

Remuneration review

On 30 November 2009, APRA released its prudential requirements on remuneration for life insurance companies. The revised prudential standard LPS 510 and the associated prudential practice guide PPG 551 came into effect on 1 April 2010. APRA requires that a Board Remuneration Committee, with appropriate composition and charter, be established, and a suitable Remuneration Policy be in place. (See section 2.6 for further comments on APRA remuneration requirements.)

Enhancements to prudential framework for life companies

On 4 March 2010, APRA released final prudential standards on enhancements to the prudential framework for life insurance companies.

Legislation was passed in 2009 that gave APRA power to regulate non-operating holding companies (NOHCs) of life insurance companies, including the power to determine prudential standards for life NOHCs. APRA will apply to these NOHCs the same governance and fit and proper standards that currently apply to NOHCs of authorised deposit-taking institutions (ADIs) and general insurers.

APRA also made some limited amendments to the audit and actuarial requirements for life companies. These amendments clarify APRA's requirements and align them more closely with those for ADIs and general insurers.

As a result of these enhancements, the following prudential standards were revised and will take effect from 1 July 2010:

- Prudential Standard LPS 510 Governance (LPS 510);
- Prudential Standard LPS 520 Fit and Proper (LPS 520);
- Prudential Standard LPS 310 Audit and Related Matters (LPS 310); and
- Prudential Standard LPS 320 Actuarial and Related Matters (LPS 320).

See section 2.6 for further comments on these revised standards.

Release of life insurance data

On 6 November 2009, APRA issued a discussion paper for consultation with the life insurance industry on what life insurance data could be released publicly by APRA. As part of this consultation, APRA has also released two proposed new statistical publications, a Half Yearly Life Insurance Bulletin and an Annual Friendly Society Bulletin.

The proposed new life industry publication would supplement APRA's current Quarterly Life Insurance Performance Statistics, while the proposed Annual Friendly Society Bulletin would be APRA's first publication of friendly society data.

These two new publications would provide an overview of both sectors of the life insurance industry based on annual returns received over a 12-month period. Data will be provided both at an aggregate level and for individual life insurers and friendly societies.

Capital review

In May 2009, APRA began a project to review the capital standards for life insurance. The intention is not to rebuild the standards from first principles but rather to adjust the current standards. The objectives of this project are to:

- Improve the risk sensitivity and appropriateness of the standards;
- Improve the alignments of the standards between industries; and
- Consider the standards in light of international developments.

Key areas identified for review include:

- Asset concentration;
- Diversification;
- Investments in subsidiaries;
- Liquidity risk;
- Operational risk;
- Quality of capital (tier 1 / tier 2, etc);
- Risk free rates;
- Life catastrophe risk;
- Resilience reserve;
- Internal models;
- Risk products capital requirements;
- Surrender values;

APRA has engaged the industry as part of this review and intends to release a public discussion paper in mid 2010.

Regulatory review

Ripoll Inquiry into financial products and services in Australia (the Ripoll review)

On 25 February 2009, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire on the issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses.

The report was released on 24 November 2009. It considered in depth a number of themes, issues and debates for the financial services sector – in particular the financial planning industry, and concluded with eleven major recommendations for regulatory reform. These recommendations will now be considered by the government, along with recommendations from the forthcoming Cooper review, to shape the future landscape of advice.

Refer to Chapter 6 for more details on the Ripoll Inquiry.

The Super System Review (the Cooper review)

In May 2009, the Australian Government announced a comprehensive review of Australia's superannuation system: the Super System Review. The review focused on the governance, efficiency, structure and operation of Australia's superannuation system. It aims to achieve an outcome that is in the best interests of members and which maximises retirement incomes for Australia.

The review was carried out in three phases:

- **Phase One:** Governance;
- **Phase Two:** Operation and efficiency; and
- **Phase Three:** Structure.

Each phase commenced with the release of an issue paper calling for submissions and is followed by the release of a preliminary report. The final report will be delivered to the Government by 30 June 2010.

The preliminary report for Phase One was released on 14th December 2009. The key recommendation from this report is to introduce a new member-oriented model – a choice architecture model – which classifies members into three main types: universal, choice and self-managed.

The proposed model allows for the application of different governance models including regulation and member protection to each individual member segment.

It will enable the precise allocation of costs to members, and movement towards segments offering increasing choice can only arise where member needs are better met, and members are well informed of the nature of the risks involved.

The preliminary report for Phase Two was released on 22nd March 2010. The Review Panel proposed a package of measures, collectively called "SuperStream", to enhance the current superannuation "back office" operation and efficiency. "SuperStream" includes:

- improving the quality of data when members enter the system using industry-wide standards;
- better use of technology, including 'straight-through processing' (i.e. without human intervention);
- e-commerce solutions to replace paper;
- extending the use of the tax file number as a primary identifier throughout the system;
- easier consolidation of multiple member accounts; and
- eliminating redundant processes, leading to simpler rollovers and consolidations.

The public submission for Phase Three review was closed on 19 February 2010 and the preliminary report is expected to be released in May 2010.

Product rationalisation of life insurance products and Management Investment Schemes

On 14 December 2009, the Treasury released a Proposals Paper for public consultation, which sets out a proposed product rationalisation framework for life insurance products and Managed Investment Schemes. This Proposals Paper follows on from an Issues Paper on product rationalisation published in June 2007.

The main objectives of the proposed framework include:

- Beneficiaries receive an appropriate level of protection of their interests.
- Beneficiaries receive financial products with at least equivalent rights and benefits, or compensations in cases where losses are suffered.
- Neither beneficiaries nor providers suffer adverse tax consequences.
- Product rationalisation transfer mechanisms and requirements are efficient, practical and sufficiently flexible.
- Industry is provided with an appropriate level of certainty that product rationalisation transfers are not open to subsequent challenge after completion.
- Regulators are provided with appropriate powers of supervision and intervention.

Public comments on the proposed framework and mechanisms were due on 26 February 2010. The Panel is now assessing the submissions from the public before reporting to the Government. However, at the time of writing, there has been no indication of an estimated start date for the proposed framework.

Australia's future tax system review (the Henry tax review)

The Australia's Future Tax System Review was established by the Rudd Government in 2008 to examine Australia's tax and transfer system and make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century. The final report from the Henry Tax Review together with the government's response was released on 2 May 2010. Refer to Section 2.8 for further details.

Other industry initiatives

Australia insurance industry launch of Lifewise to address underinsurance

The Lifewise campaign was launched by IFSA and Australia's insurance industry in May 2009 to address the growing concerns of underinsurance in Australia's life industry. It aims to encourage Australians to take appropriate steps to protect themselves from financial hardships which can arise from accident, sickness and death. The campaign features a straight-talking website and "how much is enough" insurance needs calculator to educate and help Australians manage their financial risks.

Lifewise is expected to be a three to five year campaign with a range of activity planned for the coming financial year including further research, working closely with all Lifewise supporters and online consumer campaigns.

IFSA Superannuation Member Charter

In November 2009, IFSA members endorsed the IFSA Superannuation Member Charter. The Charter presents a pro-active, self-regulatory and far-reaching industry reform which empowers super fund members to make informed comparisons and to determine how they pay for advice.

Under IFSA's Superannuation Member Charter, commitments have been made in four key areas:

- Increased transparency and control to payments to advisers
  - superannuation members must agree to the amount they pay for the advice they receive and method of payment. Payment may cease where members wish to cease their relationship with that adviser, and members will not be asked to pay for advice they do not receive
- Enhanced competition through more informed choice
  - members will have access to investment options performance information online every quarter and these are calculated in a consistent manner
  - investment performance information will relate to an actual investment option they are able to invest in
- Improved regulation of the superannuation industry
- Partnership approach between industry, regulators and government

The Charter will be implemented by all IFSA members through compliance with IFSA's Standards, which will come into effect on 1 July 2010.

2.3

Regulation and supervision

Australian Prudential Regulation Authority

APRA is the single Commonwealth authority responsible for licensing and prudential regulation for all life insurance companies. APRA is also empowered to appoint an administrator to provide investor or consumer protection in the event of financial difficulties experienced by life insurance companies.

APRA's powers to regulate and collect data from the 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.

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.

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 2.4
LPS 1.04 Valuation of Policy Liabilities	Discussed below
LPS 2.04 Solvency Standard	See section 2.4
LPS 3.04 Capital Adequacy Standard	See section 2.4
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 2.4
LPS 7.02 General Standard	Discussed below
LPS 220 Risk Management	See section 2.5
LPS 230 Reinsurance	See section 2.5
LPS 231 Outsourcing	See section 2.5
LPS 232 Business Continuity Management	See section 2.5
LPS 310 Audit and Related Matters	See section 2.6
LPS 320 Actuarial and Related Matters	See section 2.6
LPS 350 Contract Classification for the Purpose of Regulatory Reporting	Discussed below
LPS 510 Governance	See section 2.6
LPS 520 Fit and Proper	See section 2.6
LPS 900 Consolidation of Prudential Rules No. 15, 18, 22, 27 and 28	Discussed below
LPS 902 Approved Benefit Fund Requirements	Discussed below

Probability and Impact Rating System

APRA's primary objective is to minimise the probability of regulated institutions failing and to ensure a stable, efficient and competitive financial system. APRA uses its Probability and Impact Rating System (PAIRS) to classify regulated financial institutions in two key areas:

- The probability that the institution may be unable to honour its financial promises to beneficiaries – depositors, policyholders and superannuation fund members; and
- The impact on the Australian financial system should the institution fail.

As part of its role as a prudential regulator, APRA uses PAIRS to assess risk and to:

- determine where to focus supervisory effort;
- determine the appropriate supervisory actions to take with each regulated entity;
- define each supervisor's obligation to report on regulated entities to APRA's executive committee, board and, in some circumstances, to the relevant government minister;
- provide a risk diagnostic tool; and
- ensure regulated entities are aware of how APRA determines the nature and intensity of their supervisory relationships.

The PAIRS Supervisory Attention Index rises as the probability of failure and the potential impact of failure increase, ranging from "Low" to "Extreme". These ratings are not publicly available, and are used only to identify potential issues and seek remediation before serious problems develop.

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.

Valuation of policy liabilities

The prudential standard LPS 1.04 Valuation of Policy Liabilities 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 – Minimum Surrender Values and Paid-up Values 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 in the situation of terminating (or making paid-up) life insurance policies prior to their full term, by providing for a minimum amount; and
- Protect the interests of remaining policy owners, by both:
  - ensuring that the costs of termination are being appropriately borne by the surrendering policy owners; and
  - providing a base which is used in the determination of the solvency requirement for a statutory fund.

Cost of investment performance guarantees

LPS 5.02 – Cost of Investment Performance Guarantees prescribes the principles and methodology for calculating the cost of investment performance guarantees if 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 – 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

The prudential standard LPS 350 – Contract Classification for the Purpose of Regulatory Reporting 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.

Consolidation of Prudential Rules No. 15, 18, 22, 27 and 28

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

This prudential standard LPS 902 – Approved Benefit Fund Requirements 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. In particular, it sets out the requirements for:

- the content of approved benefit fund rules;
- the allocation of an approved benefit fund surplus (depending on the classification of the approved benefit fund); and
- the provision of seed capital.

Australian Securities and Investment Commission

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.

Most insurers require an AFSL, and as such, a dual licensing system exists with overlapping requirements under both ASIC and APRA.

Australian Financial Services Licence

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. Specific provisions under the Corporations Regulations require that financial services licensees have in place the following:

- Documented procedures to monitor, supervise and train representatives;
- "Responsible officers" (senior management responsible for day-to-day business decisions) with minimum standards of knowledge and skills in financial services;
- Adequate resources (financial, technological and human) to provide services covered by the licence. These requirements do not apply to APRA-regulated entities (such as registered insurers), but do apply to any non-APRA-regulated subsidiaries;
- Adequate risk management systems (AS4360, the Australian Standard for Risk Management, acts as a guide to minimum requirements). These requirements do not apply to APRA-regulated entities, but do apply to any non-APRA-regulated subsidiaries;
- Adequate compliance framework (AS3806, the Australian Standard on Compliance Programs, acts as a guide to minimum requirements);
- Internal and external dispute resolution procedures (where dealing with retail clients);
- Adequate compensation requirements (where dealing with retail clients as described in Section 912B). This typically is achieved through membership of a guarantee fund or obtaining professional indemnity insurance cover; and
- Register of representatives, i.e. directors and employees of the insurer and its related bodies corporate, as well as authorised representatives and insurance brokers.

Once ASIC has granted an AFSL pursuant to Section 913B of the Corporations Act, any variations to authorisations and conditions of the licence can be made electronically via the ASIC website.

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.

Ongoing notification obligations

Licence holders are required to meet ongoing notification obligations, which include requirements to notify ASIC about:

- Breaches and events;
- Changes in particulars (form F205 for change of name of corporate entities, form FS20 for all others);
- Authorised representatives (forms FS30, FS31, FS32);
- Financial statements and audit (forms FS70 and FS71); and
- Appointment/removal of auditor (forms FS06, FS07, FS08 and FS09).

Section 989B of the Corporations Act also outlines ongoing financial reporting and audit obligations. A licensee is required to prepare and lodge an audited profit and loss statement and a balance sheet within three months of the end of its financial year.

ASIC has released Class Order 06/68 which grants relief to local branches of foreign licensees from preparing and lodging accounts in accordance with Section 989B of the Corporations Act. This relief is only available where the foreign licensee lodges accounts, prepared and audited in accordance with the requirements of its local financial reporting jurisdiction with ASIC once every calendar year.

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.

2.4 Solvency and capital adequacy

Overview

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 the solvency of the company. More specifically, to ensure that under a range of adverse circumstances, the company would be expected to be in a position to meet obligations to policyholders and other creditors in the context of a fund closed to new business, and which is either operating in a run-off situation or is to be transferred to another insurer.
- 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 Solvency Standard broadly comprises the following components:

- Solvency liability – A calculation of the value of the guaranteed policy liabilities on the basis of 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 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

LPS6.03 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

APRA PS 3 Prudential Capital Requirement 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.

According to APRA, 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. PS 3 will, generally, result in capital over and above that needed to comply with LPS 6.03 only to the extent that:

- the amount of capital established by LPS 6.03 is less than that prescribed by PS 3; and
- the type of capital used in satisfying LPS 6.03 does not comply with the prescribed form of capital required by PS 3.

Subject to approval from APRA, statutory funds must not be invested in related companies other than subsidiaries. The following assets are inadmissible for solvency purposes:

- An asset with a value that is dependent upon the continuation of the business;
- Holdings in an associated entity which is an institution itself subject to legislated minimum capital requirements; and
- Assets which breach asset concentration thresholds.

Investment policy

There are no absolute restrictions on investments that may be held by life insurance companies subject to some capital requirements for certain assets as discussed previously in this section.

Under Section 1017E of the FSR Act, which applied from 11 March 2002, where monies received cannot be applied to the issue of a product within one business day of receipt (i.e. unmatched cash), then the monies must be held in a trust account.

2.5

Management of risk and reinsurance

Risk Management

The prudential standard – LPS220 Risk Management 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.

The review process must be conducted in an effective and comprehensive manner by operationally independent, appropriately trained and competent persons. Satisfactory internal audit procedures and/or external audit arrangements must be implemented to ensure compliance with, and the effectiveness of, the framework.

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.

Risk Management Strategy

The RMS must include:

- details of the insurer's approach to risk management;
- policies and procedures to be adopted in dealing with various risk management matters;
- a description of the relationships within the risk management framework between the Board, Board committees and senior management;
- managerial roles and responsibilities for the framework;
- a description of the approach adopted in ensuring relevant staff have an awareness of the framework and instilling an appropriate risk culture across the company; and
- a description by which the framework is reviewed including coverage and timing of these reviews.

Risk Management Declaration

The Board of each life company must also provide APRA with a declaration on risk management for each financial year. This declaration involves stating, to the best of the Board's knowledge and belief, having made the appropriate enquiries, that:

- there are systems in place to ensure compliance with the Life Act, the Regulations, prudential standards, actuarial standards, the Prudential Rules, reporting standards, the Financial Sector (Collection of Data) Act 2001, authorisation conditions, directions and any other requirements imposed by APRA;
- the processes and systems surrounding the production of financial information are effective;
- an RMS is in place which has been developed in accordance with the requirements of LPS 220; and
- the systems that are in place for managing and monitoring risks, and the risk management framework, are appropriate to the company, having regard to such factors as the size, business mix and complexity of its operations.

Outsourcing

Prudential Standard – LPS 231 Outsourcing and Prudential Practice Guide – PPG 231 Outsourcing aim 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;
- 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

The prudential standard LPS 232 – Business Continuity Management 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

The prudential standard LPS 230 – Reinsurance aims to ensure that reinsurance arrangements of a life companies 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:

- whether the company's reinsurance arrangements during the financial year and the way in which it administered those arrangements were adequate and effective; and
- whether the company's reinsurance arrangements during the financial year have been accounted for in accordance with the prudential standards in force under section 230A of the Life Insurance Act.

Reinsurance management framework

Prudential Standard LPS 220 Risk Management requires a life company to have in place a risk management framework, including risk management policies, controls and procedures which identify, assess, monitor, report on and mitigate all material risks likely to be faced by the life company. This risk management framework must also address risks arising out of reinsurance arrangements.

Prudential Practice Guide LPG 240 Life Insurance Risk and Life Reinsurance Management provides guidance to assist life companies in complying with the requirements of LPS 220 in relation to insurance risk and reinsurance management. LPG 240 also outlines prudent practices in relation to good life insurance risk and reinsurance management.

2.6

Governance and assurance

Audit and actuarial requirements

APRA has made enhancement to the prudential framework for life companies. The existing prudential standard – LPS 310 Audit and Actuarial Requirements was amended and restructured into two separate standard LPS 310 Audit and Related Requirements and LPS 320 Actuarial and Related Requirements. The amendments clarified APRA's audit and actuarial requirements and 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. This advice is designed to assist the Board and senior management in carrying out their responsibility for the sound and prudent management of the life company.

Governance

In LPS 510 – Governance, 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. The requirements 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 an eligible foreign life insurance companies, i.e. 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 review of, and making 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.
- The members of the Board Remuneration Committee must be available to meet with APRA on request.

Fit and proper

In LPS 520 – Fit and Proper, APRA 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 certain auditors and actuaries; and
- information must be provided to APRA regarding responsible persons and the regulated institution's assessment of their fitness and propriety.

2.7 Financial reporting

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 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. A summary of these changes is provided within Chapter 5 (Financial Reporting Update).

The following table outlines the key accounting standards for life insurers and their applications:

AASB 4 Insurance Contracts (Last updated April 2009) AASB 1038 Life Insurance Contracts (Last updated October 2009)	Prescribes the accounting methods to be used for reporting on: • 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 Financial Instruments: Disclosures (Last updated February 2010) AASB 132 Financial Instruments: Presentation (Last updated October 2009) AASB 139 Financial Instruments: Recognition and Measurement (Last updated December 2009)	Applies to the financial instrument component of life investment contracts Prescribes the accounting methods to be used in recognising, measuring, presenting and disclosing financial assets and financial liabilities.
AASB 118 Revenue (Last updated May 2009)	Applies to the service element of life investment contracts

Life insurance contracts

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.

Key accounting principles of 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
Recognition of embedded value	Not recognised

Life investment contracts

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.

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 accounting principles of life investment contracts:

Principle	Requirement
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
Recognition of embedded value	Not recognised

AASB 1038 Applications

The key applications of AASB 1038 to life insurance financial reporting are summarised below.

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. 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.

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 considered to be material to the calculations:

- Investment earnings;
- Inflation;
- Taxation;
- Expenses;
- Mortality and morbidity reinsurance; 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	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

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.

Changes in assumptions which directly affect profit in the year in which they occur are:

- Changes in the discount rate due to a change in market conditions; and
- Changes that lead to capitalised losses or reversal of previous capitalised losses.

All other changes in best estimate assumptions result in the profit margin being recalculated. This results in future profits calculated using the revised best estimate assumptions re-spread in accordance with the profit carrier. When expected future losses are identified at a reporting date, these are recognised as an immediate loss at that date.

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.

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 elements (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.

A 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 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 expenses 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 Investment Property
Property, plant and equipment (including owner- occupied property)	Revaluation model under AASB 116 Property, Plant and Equipment, 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 the parent entity controls the 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 requires specific life insurance contract disclosures. The key requirements are summarised below.

1. A life insurance company is required to disclose "information that identifies and explains the amounts in its financial report arising from life insurance contracts", including:
   - Accounting policies for life insurance contracts and related assets, liabilities income and expenses;
   - Assets, liabilities income, expense and cash flows arising from life insurance contracts;
   - The process used to determine the assumptions that have the greatest effect on life insurance balances, including, where practicable, quantified disclosure of those assumptions;
   - The effect of changes in assumptions used to measure life insurance assets and life insurance liabilities, showing separately the effect of each change that has a material effect on the financial report; and
   - Reconciliations of changes in life insurance liabilities and reinsurance assets.
2. A life insurer must disclose the process they have adopted to determine which assets back their life insurance or life investment contract liabilities.
3. The following split of expenses must be disclosed by life insurers:
   - Outwards reinsurance expense;
   - Operating expenses:
   - Claims expense;
   - Policy acquisition expenses, separated into material components including commission;
   - Policy maintenance expenses; and
   - Investment management expenses

   The basis for the apportionment of operating expenses must also be disclosed between:
   - Life insurance contract acquisition;
   - Life insurance contract maintenance;
   - Investment management expenses;
   - Life investment contract acquisition;
   - Life investment contract maintenance; and
   - Other expenses.

4. The following disclosures should be made in respect of amount, timing and uncertainty of cash flows from life insurance contracts:
   - Objectives in managing risk and policies for mitigating risk;
   - Contract terms and conditions which have a material effect on the amount, timing and uncertainty of cash flows;
   - Information about insurance risk (before and after risk mitigation by reinsurance), including:
     a. The sensitivity of profit and equity to changes in variables (for material effects);
     b. Insurance risk concentration;
     c. Interest rate risk and credit risk disclosures, detailing:
        (i) Exposure to interest rate risk by class of asset and liability, including details of contractual repricing or maturity dates and effective interest rates, where applicable; and
        (ii) Exposure to credit risk for each class of financial asset or other credit exposure, including the maximum credit risk exposure and significant concentrations of insurance risk.

Annual and quarterly reporting

Corporations Act 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.

APRA reporting

Life insurance companies and friendly societies are required to submit quarterly non-audited returns (LRF 100.0 – LRF 340.2) and annual returns (LRF 100.0 – LRF 430.0, only LRF 100.0, LRF 120.0 – LRF 340.2 are audited) 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. The major differences are outlined in LPS 350 Contract Classification for the Purpose of Regulatory Reporting to APRA.

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

1. Annual Auditors Report

   All annual audited returns must be submitted in conjunction with the annual auditor's report, as required under Prudential Standard LPS 310 Audit and Actuarial Requirements.

2. 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 after the end of the period as at which the report is made.

3. Reinsurance Report

   LPS 230 Reinsurance requires each life company to give APRA a reinsurance report relating to the financial year of the company within 3 months after each financial year.

4. 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.

Key dates

Annual

Audited financial statements under Corporations Act 2001
Within three months of balance date for a disclosing entity or registered scheme and within four months of balance date for anyone else.

APRA Annual Returns LRF 100.0 – LRF 430.0
(only LRF 100.0, LRF 120.0 – LRF 340.2 are audited)
Within four months of balance date

Financial Condition Report
Within three months of elected balance date

Reinsurance Report
Within three months of balance date

Risk management declaration
On or before the due date of annual returns

Quarterly

APRA Quarterly Returns LRS 100 – 340.2
Within 20 business days of quarter-end

2.8

Taxation

General developments

The Government has continued with ambitious plans for significant tax reform. The comprehensive review of Australia's tax system, otherwise known as the Henry Review has been completed and the final report released to the public on 2 May 2010 together with the Government's response. Despite the 138 recommendations in the Henry Report, the Government has only made a handful of announcements, although there may be further announcements in the May budget.

The Government proposes to reduce the company income tax rate from 30 per cent to 29 per cent for the 2013-2014 income year and to 28 per cent from the 2014-2015 income year and introduce certain changes to the superannuation system including a staged increase in the Superannuation Guarantee payment from 9 per cent to 12 per cent. The superannuation changes will increase the amount of funds held within superannuation, and this should have a flow on benefits for life insurers. These initiatives are to a large extent funded by the Resource Super Profits Tax of 40 per cent.

The Henry Report also contains the following recommendations which will impact the life insurance industry:

- The abolition of specific taxes on insurance products, including stamp duties and fire service levies, which is consistent with the recommendations in the "Australia as a Financial Centre: Building on our Strengths" report released by the Australian Financial Centre Forum. The Government has not ruled out this recommendation, although any changes will need agreement from the State Governments.
- Government support for the development of a longevity insurance market within the private sector, for example by issuing long-term securities and by releasing data needed to create and maintain a longevity index. The further development of the longevity insurance market could help reduce the risk that self funded retirees will exhaust their superannuation balances and need to turn to Government pensions. This would of course only work if the products were seen as attractive by retirees or were compulsory. The report recommends against making the purchase of these products compulsory.
- No restrictions on people wanting to purchase longevity products from a prudentially regulated entity. While the global financial crisis has seen the development of some longevity products outside of insurance, this recommendation has the potential to broaden the types of entities offering such products, providing further competition to life insurers.

Some other key tax developments during the year are listed below.

- The new Taxation of Financial Arrangements (TOFA) measures which provide a comprehensive regime for the tax treatment of gains and losses arising from financial arrangements have been legislated. The TOFA measures will apply to eligible taxpayers for the income year beginning on or after 1 July 2010 unless the taxpayer chooses to have the rules apply for income years beginning on or after 1 July 2009 (i.e. the "early adopt" election). Taxpayers have a choice as to how TOFA will apply to their financial arrangements.
- New tax consolidation measures were introduced into Parliament on 10 February 2010 to refine the existing rules. Some of the relevant changes proposed include clarification of the treatment of intra-group transactions of a consolidated group that have a life insurance company member and clarification of the income tax treatment of rights to future income.
- The Federal Government has proposed a reform of Australia's foreign source income anti-tax deferral (attribution) rules. The proposal includes a rewrite of the Controlled Foreign Companies (CFC) rules and the repeal of the Foreign Investment Fund (FIF) rules. The FIF rules will be replaced with a specific, narrowly defined anti-avoidance rule that applies to offshore accumulation or roll-up funds.
- The new International Dealings Schedule - Financial Services 2010 (the IDS-FS 2010) was released by the ATO. The IDS-FS 2010 is the ATO's newly proposed tax return schedule for large (> $250m turnover) financial services taxpayers to replace the Schedule 25A and Thin Capitalisation Schedule and provide additional information in relation to financial arrangements. For the 2010 income year the IDS-FS is optional. However, the IDS-FS will be mandatory for affected taxpayers for the 2011 year.
- On 14 December 2009, Treasury released a Proposals Paper as the next step in consultation with stakeholders on product rationalisation for managed investment trusts and life insurance companies. It is proposed that some form of tax rollover relief would be provided to legitimate rationalisations.
- Legislation was enacted which allows tax rollover relief for the merging of superannuation funds. The relief also includes transfers to and from pooled superannuation trusts and life insurance companies.
- The Queensland Government has introduced amendments to the insurance duty provisions to expand the definition of insurer to ensure that stamp duty is payable on life insurance riders issued by life companies. The amendments were introduced to remove the potential restriction on the Queensland Revenue Office imposing duty on general insurance policies that were issued by life insurance companies. These amendments have effect from 14 January 2010.
- During 2009 (subsequent to the release of last year's "Insurance Facts and Figures Publication"), the Australian Government announced its support for 41 of 46 recommendations that were made by the Board of Taxation in relation to its review of the Administration of the GST System. Generally these changes are aimed at reducing the administrative burden of complying with the GST legislation and represent the most significant package of GST reform in 10 years.

While many supported recommendations were identified as applying from 1 July 2010, the legislative process has only started for some of the recommendations with either Exposure Drafts or Bills being introduced and debated in Parliament during 2010. We expect some but not all of the current proposed changes to be passed by parliament prior to 1 July 2010 with the effective date of the changes ranging from 1 July 2000 to 1 July 2010 (that is, some changes are likely to apply retrospectively). Many of the changes have general application to business taxpayers and it is important for each organisation to consider the impact of each of the proposed or finalised changes.

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 – generally being for income from assets backing superannuation policies, 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 increases 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.

It should be noted that the 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.

Also note that 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. This means that life insurance companies will not be entitled to recover all the GST included in the price paid for acquisitions of goods and services from suppliers, which has a consequential direct impact on their net costs and profitability. 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.

The effect of this is that, 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.

Stamp duty rates – life insurance products

As at March 2010	Life insurance	Term or temporary insurance
NSW, QLD, TAS, ACT, NT	0.10% of sum insured	5% of first year's premium
VIC	0.12% of sum insured	5% of first year's premium
SA	1.5% of premium	1.5% of premium
WA	No duty payable	No duty payable

The lodgement of returns and payment of duty needs to occur:

- New South Wales, Australian Capital Territory, Tasmania and Northern Territory – within 21 days after the end of each month.
- Victoria – within 14 days after the end of each month.
- South Australia – annual licence to be applied for by 31 January of each year. Payment upon application.
- Queensland – within 14 days after the end of each month (or such other period as the Commissioner may determine).

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).

As at March 2010	Class	Rate
VIC, WA, NT	Life Insurance Rider	10% of premium
TAS	Life Insurance Rider	8 % of premium

Some states, such as South Australia, have adopted the view that life insurance riders should be characterised as general insurance. However, the correct interpretation of policies and riders will depend on the terms of the specific insurance contracts. Some states have issued revenue rulings dealing with life insurance riders. These rulings should be considered when determining the current rate of duty payable on life insurance riders.

Life insurance levy

Life Insurance Supervisory Levy Imposition Act 1998

Financial Institutions Supervisory Levies Collection Act 1998

This annual levy is based on a percentage of the value of assets of a life insurance company at a specified date. The unrestricted and restricted levy percentage, the specified date, and the minimum and maximum restricted levy amount for each financial year are determined by the Federal Treasurer (2009/2010: unrestricted levy of 0.001823 per cent of assets; restricted levy of 0.00920 per cent of assets; minimum restricted levy: $470; maximum restricted levy: $910,000).

This publication is designed to provide an overview of the accounting, tax and regulatory environment relating to insurance in Australia. Information contained in this booklet is based on the law and Government announcements as at 16 April 2010.

The information presented in this publication should be used as a guide only and does not represent advice. Before acting on any information provided in this publication, readers should consider their own circumstances and their need for advice on the subject. PricewaterhouseCoopers insurance experts will be pleased to assist – please contact your usual PwC contact or one of the experts listed at the end of this publication.

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