Institute of Actuaries of Australia Briefing Session

SEBPC Update 2

Matthew Burgess
John Ward
Brad Jeffrey

Self Insurance Practice Guideline

What is a Practice Guideline?

- New form of Actuarial Guidance
- Not Mandatory
- Should consider disclosure of material variations

Why was the SI PG developed?

- In 2005 APRA stated its intention to closely monitor SI in super funds
- APRA Conditions
  - no new SI for Public Offer funds
  - permit SI for non-Public Offer funds subject to risks being adequately documented in RMPs and ongoing actuarial oversight
  - adequate, segregated insurance reserves identifiable in accumulation funds’ accounts
- APRA asked Institute to prepare Guidance

APRA Update

- "APRA considers that prudentially regulated life insurance companies offer the best mechanism for superannuation funds to provide death and disability benefits to fund members. APRA discourages funds from self-insuring such benefits because of concerns related to inadequate and unsegregated reserves and unrealistic pricing of the risks…During the RSE licensing transition period, APRA maintained the policy of permitting self-insurance by non-Public Offer funds, provided that the management of self-insurance risks was adequately documented in the fund's Risk Management Plan. APRA will be reviewing the information on self-insurance obtained during the licensing process to further refine its prudential approach to this risk."

- APRA Insight Issue One 2007

APRA Update

- Maintains belief that external insurance is best
- Continues to discourage funds from self-insuring
- Concerns still inadequate reserves & unrealistic pricing
- Public Offer: material death/disability benefits to be externally insured
- Non-Public Offer : SI risks to be adequately documented in Risk Management Plan
- Continues to review/refine its prudential approach

Progress of SI PG

- Drafted by actuaries involved in SI
- Exposure draft of SI Professional Standard in late 2005
- A few comments received and incorporated
- Soon to be finalised as Self Insurance Practice Guideline
- We believe that the main features have been adopted already

Who does the SI PG affect?

- Provides guidance to actuaries advising super funds with SI arrangements
  - does not regulate
  - cannot impose requirements on funds, trustees or employers
- Not limited to funds seeking APRA licence
  - applies to any actuarial involvement with SI
- SI not appropriate to smaller funds

Actuarial oversight of SI

- Minimum
  - quantify self insurance
  - assess potential risk to benefits and funding
  - identify self insurance costs
  - analyse claims experience
  - adequacy of reserves
- Generally also
  - identify who bears the funding obligation
  - risks associated with funding obligation
  - assess the need for conservatism
  - impact of these on advice/recommendations

Important Concepts

- Insurable Benefit
  - lump sum amount
  - death/disablement benefit less member's share of assets
  - treatment of benefits paid by instalment (e.g. SCI)
- Self Insurance
  - insurable benefit less external insurance of that benefit
  - full or partial SI
- Unintended Self Insurance
  - due to funding deficit or if external insurance unavailable
  - immaterial => long term oversight not required

Self Insurance Analysis

- Calculate SI liabilities
  - Total SI, Distribution of SI
- Past claims experience (numbers, amounts)
- Estimate IBNR claims
- Review expenses
- Change to claim assessment process?
- Estimate future SI claims & volatility
- Estimate future expenses
- Identify funding sources
- Calculate existing insurance reserve

Self Insurance Risks

- Pricing risk – that premiums don't cover expected claims
- Experience risk – claim volatility, trends
- Catastrophe risk – impact of single large event
- Selection risk – member options, underwriting
- Risk Tolerance – impact on funding/members

Pricing/Funding, Reserving/Surplus & Design used to manage risks

Example Only – Not Guidelines

At 31 December 2007	
Fund assets	$2,000 million
Total Insured Benefits	$4,000 million
Expected Annual Claims	$4 million
Maximum Sum Insured of any Member	$3 million
Average Death Sum Insured	$200,000
Average TPD Sum Insured	$200,000
Number of Self-Insured Members	20,000
Largest Location as a % of Members	10%
Reserve (After IBNR)	$7 million

Example Only – Not Guidelines

Sum Insured	% of Sum Insured
$0 - $100,000	5% (4,000 members)
$100,000 - $200,000	36% (10,000 members)
$200,000 - $500,000	36% (5,000 members)
$500,000 - $1 m	9% (600 members)
$1m to $2m	11% (340 members)
$2m to $3m	4% (60 members)

Pricing

- Long term viability depends on adequate pricing
- DB funds
  - SI analysis feeds into funding assumptions
  - Pricing in funding recommendations
  - May be separate pricing for additional voluntary insurance
- Accumulation funds
  - Adequacy: period, subsidies, reserves
  - Pricing decisions / pricing restrictions

Reserves

- DB funds
  - Segregated reserves not required
  - May be reserve for additional voluntary insurance
- Accumulation funds
  - Accepted practice is segregated reserve maintained
- "Segregated"
  - Clearly identified amount
  - Specifically for funding SI risks
  - No cross subsidies with non insured members
  - No cross subsidies between pools of risk

Types of Reserves

- Insurance Reserve
  - Accumulation over time, with interest, of premiums and/or contributions less claim payments and cost of administration, underwriting and claim assessment
- May be subdivided into:
  - Premium Reserve
  - Pricing Reserve – funding to support pricing decisions
  - IBNR Reserve – to meet estimated IBNR claims

Assessing Adequacy of Reserves

- Net of IBNR Reserves
- Impact of identified SI risks
- Risk tolerance – ability to
  - increase premiums charged to members
  - increase employer contribution rate
  - transfer assets from other reserves (e.g. surplus)
  - temporary funding by other assets
  - immediate and long term consequences
  - SIS Regulation 7.2 28 day allocation requirement
- Often expressed as a multiple of annual claims

Example Only – Not Guidelines

- Annual Claim Size Distribution

$$\text{Normal}\left(\Sigma_{i=1,n}\ qi \times SIi\ ,\ \Sigma_{i=1,n}\ qi \times (1 - qi) \times SI_i^2\right)$$

n insured lives (must be large)

SI is sum insured for death or TPD

qi is probability of death or TPD for individual i in next year

- No good for catastrophes because assumes independent claims
- Lots of alternative approaches

Ongoing Management

- Frequency of Reviews – depends on
  - Type/size of fund
  - Relative size of SI risks
  - Expected claim volatilities
  - Adequacy of existing SI reserve
  - At least every three years (or less if APRA requires)
- Advice
  - Why current SI reserve position
  - Impact on overall fund financial position
  - Means of restoring reserves to targeted levels

First Home Saver

History

- Labor announce plan before election
- Liberals follow with a variation
- Government announced changes 4/2/08
- Discussion paper issued 8/2/08
- Further changes announced 13/5/08
- Legislation expected before July
- Commencing date ~~1/7/08~~ 1/10/08

Who can operate them?

- Banks
- Building Societies
- Credit Unions
- Life Insurers
- Friendly Societies
- RSE Licensees with public offer licence
  - Must be separate from super in separate trust

Who can take up an account?

- Must be at least 18 and less than 65
- Must provide TFN
- Must NOT have previously purchased or built a home in Australia to live in – so investment properties OK
- ~~Must be an Australian resident~~
- Must not previously have had a FHSA

Contributions

- Can be made by account holder or other person
- Can only be post tax contributions
- ~~Minimum initial contribution of $1,000~~
- ~~Maximum annual contribution $10,000~~
- Maximum account balance of $75,000

Government contributions

- Government contribution following end of year on up to $5,000 pa contributions
  - 17% of contribution - maximum of $850
  - ~~Low income earners: 15% of contributions~~
  - ~~Higher income earners: (MTR-15)% of contribution~~
- Generally paid to FHSA account
- Only if Australian resident

Investment

- Investment income taxed at 15% - as per super
- Banks/building societies/credit unions – deposit accounts only
- RSE Licensees/Life insurers/Friendlies – wider range of options but these may be limited

Withdrawal from account

- Tax free if:
  - Withdrawn to purchase/build first home AND
    - Must have contributed minimum of $1,000 pa for at least 4 financial years AND
    - Live in home (rules apply)
  - Withdrawn after age 60
- Full account must be withdrawn

Withdrawal from account - cont

- Can/must be transferred to super
  - To access under financial hardship
  - If account not used to purchase first home
  - On ~~death,~~ or on reaching 60/65
- Special provisions on bankruptcy/relationship breakdown
- No other withdrawals allowed???
- Cannot open a new account

Problems for RSE licensees

- Providing through a separate trust will result in additional establishment and ongoing costs
- Will RSE licensees be prepared to establish a separate trust?

Problems for account holders

- Lack of access to savings
  - May want to purchase home before 4 year eligibility satisfied
  - May decide that they cannot afford a home
  - May move overseas
- Potential investment option limitations
- Will advantages offset these disadvantages?

No TFN Contributions for DB Members

Anti Detriment Payments

No TFN Contributions for DB Members

- S 295-610(1) defines No-TFN contributions income
- Key expression:
  "It is a contribution made to the fund … to provide superannuation benefits for an individual …"
- Are contributions in respect of a defined benefit interest caught?
- Uncertainty, confusion and lack of guidance from ATO

No TFN Contributions for DB Members

- One view (quite common in industry) is that DB conts are not
- Recent indication that ATO now thinking they are, based on apportioning actual conts paid
- Guidance being sought from Treasury
- Concerns:
  - Too late to find out now
  - Calculation basis
  - Can’t recoup from exited members
  - Legal arguments

Anti Detriment Payments

- Initial premise
  - compensate for introduction of taxable contributions from 1 July 2008, i.e. Tax Office not better off by taking tax that reduces death benefits to dependents
- Legislation quite simple:

$$\frac{\text{Notional payment reduction due to contributions tax}}{\text{Complying superannuation tax rate}}$$

  - but not necessarily helpful
- Guidance in the accompanying Explanatory Memorandum to the original legislation

Explanatory Memorandum

- If DB fund, actuary to work out payment reduction; or
- If not DB fund, auditor to work out payment reduction; or
- Use following formula for payment reduction:

$$\frac{0.15P}{T - 0.15P} \times A \times \frac{T}{T + \text{Future Service Days}}$$

i.e. effective tax rate X accrued benefit (grossed up for tax incurred)

Explanatory Memorandum

- For accumulation funds, specific ATO guidance finally issued in ID 2006/290
- Due to *Better Super*, formula for accumulation funds updated in ID 2007/219
- The update produces a generous outcome!
- *Better Super*, though, slightly narrowed eligibility
- Note – doesn't apply to terminal illness benefits
- What about DB funds?