IMF Country Report No. 19/49

AUSTRALIA

FINANCIAL SECTOR ASSESSMENT PROGRAM

February 2019

TECHNICAL NOTE—INSURANCE SECTOR: REGULATION AND SUPERVISION

This Technical Note on Insurance Sector: Regulation and Supervision for Australia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on June 26, 2018.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

AUSTRALIA

FINANCIAL SECTOR ASSESSMENT PROGRAM

January 22, 2019

TECHNICAL NOTE

INSURANCE SECTOR: REGULATION AND SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Australia. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary

ACCC	Australian Competition and Consumer Commission
AICRC	Asset Concentration Risk Charge
ADI	Authorized Deposit-taking Institution
AFS	Australian Financial Services
ALM	Asset and Liability Management
APRA	Australian Prudential Regulatory Authority
APS	Australian Public Service
APSC	Australian Public Service Commission
ASIC	Australian Securities and Investments Commission
ASIC Act	Australian Securities and Investments Commission Act 2001
ASX	Australian Securities Exchange
ATT	Administrative Appeal Tribunal
CCI	Consumer Credit Insurance
CFR	Council of Financial Regulators
CIO	Credit and Investments Ombudsman
DAC	Deferred Acquisition Cost
DCI Team	Deposit Takers Credit and Insurers Team
DMF	Discretionary mutual fund
FA	Financial adviser
FATF	Financial Action Task Force
FOS	Financial Ombudsman Service
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSCODA	Financial Sector Collection Data Act
FSI	Financial System Inquiry
FSG	Financial Services Guide
GPS	General Insurance Prudential Standards
IAAust	The Institute of Actuaries of Australia
IAIS	International Association of Insurance Supervisors
IA	Insurance Act
ICAAP	Internal Capital Adequacy Assessment Process
ICP	Insurance Core Principle
ICRC	Investment Concentration Risk Charge
IFRS	International Financial Reporting Standards
IMB	Internal Model-Based
LAGIC	Life and General Insurance Capital Review
LIA	Life Insurance Act 1995
LMI	Lenders' Mortgage Insurance
LPS	Life Insurance Prudential Standards
MCR	Minimum capital requirement

MOCE	Margin Over the Current Estimate
MoU	Memorandum of Understanding
MMoU	Multilateral MoU
NOHC	Non-operating holding company
NPP	New Policy Proposal
ORSA	Own Risk and Solvency Assessment
PCA	Prudential Capital Amount
PCR	Prescribed Capital Requirement
RDA	Market Risk and Models team
PDS	Product Disclosure Statement
PHIA	Private Health Insurance Act 2007
PHIAC	Private Health Insurance Administration Council
RBA	Reserve Bank of Australia
RDA	Risk and Data Analytics
RMS	Risk Management Strategy
ROE	Return on Equity
SCT	Superannuation Complaints Tribunal
SOE	Statement of Expectation
SOI	Statement of Intent
SPV	Special Purpose Vehicle
SRC	Supervision and Resolution Committee
Treasurer	Australian Treasurer
ULP	Unit-Linked Policy

EXECUTIVE SUMMARY

The insurance industry in Australia has undergone significant structural change since the last FSAP. The insurance industry is relatively small compared to the banking sector. Assets held by insurers represented only about 7 percent of total financial system assets as at the end of 2017. Since the last FSAP in 2012, many large Australian life insurers have been sold by domestic conglomerate groups and purchased by foreign insurance groups. The industry is concentrated and focused on life/wealth management products, related to superannuation products.[1] The top five insurers accounted for more than 80 percent of total life industry assets as at the end of 2017.

Despite the negative impact of the low interest rate environment, the life insurance industry retains sufficient loss absorption capacity. A unique feature of the Australian life insurance market is the high share of investment linked and protection type products. In addition, insurers can adjust the premium annually for long term protection products, which provides additional loss absorption flexibility in the event of an adverse scenario. The duration of assets and liabilities are broadly matched with some entities using derivatives for hedging. The industry average solvency ratio (at the entity level) is high and appears to be relatively resilient even under a risk sensitive solvency standard.

The Australian authorities have made significant progress in updating the regulatory regime since the last FSAP. The Australian Prudential Regulation Authority (APRA) has undertaken a comprehensive reform of prudential regulation while improving the consistency of the framework between life and general insurers. APRA has also implemented group and conglomerate regulation and supervision, though not capital requirements at life insurance group level (so called "level 2"). The Australian Securities and Investments Commission (ASIC) has recently shifted from a government funding model to an industry funding model, which could help provide some additional flexibility in addressing resourcing pressures. ASIC has also conducted several important thematic reviews (covering life insurance advice, claim handling, vertically integrated institutions and conflicts of interest, add-on car insurance, etc.) and has enhanced their coordination with APRA. Additional reforms are underway, such as projects to expand and improve data and information systems, which will underpin further strengthening of regulation and supervision.

This focused review confirms that prudential regulation and supervision by APRA is reasonably conservative. The risk-based capital framework is reasonably conservative, which facilitates supervisory risk assessments. APRA has high technical capacity to conduct effective supervision. While there are some gaps in the regulatory regime, APRA seeks to address these through its supervisory process.

However, a recent increase in risk taking by some large, complex life insurers warrants enhancement of regulation and supervision, and further cooperation with foreign supervisors. While the bulk of the industry employs a relatively conservative business model, there are signs of

[1] The assets of superannuation funds are large and accounts for more than 20 percent of the total financial system assets, partly due to its compulsory nature in Australia. Most superannuation funds offer group life insurance cover for their members.

increasing risk-taking by some large and complex insurers, which include: (i) the creation of potentially risky offshore vehicles, such as captive reinsurance and investment vehicles; (ii) an increase in the holdings of foreign bonds due to a shortage of domestic fixed income instruments to hedge duration exposure; (iii) offerings of new investment products, some of which use derivatives, securities lending, etc., without clear regulation (for example, in relation to embedded leverage, risk concentration and disclosure) by either APRA or ASIC; and (iv) introduction and increasing sales of annuities with minimum investment guarantees and specified maturities. While APRA is cooperating actively with the relevant foreign supervisors through useful contributions at supervisory colleges, etc. and monitoring international expansion, there is scope for further deepening supervisory cooperation.

APRA should expand and deepen its scrutiny of group activities, especially those entailing risky investments and material intragroup transactions. Robust prudential regulation at the solo level provides a strong incentive for insurers (especially life insurers which are not subject to capital requirements at the group level) to shift riskier activities and products outside the regulated entity as well as offshore. In particular, the lack of group capital requirements for life insurance entities generates a potential regulatory arbitrage opportunity which may lead to nascent systemic risks. Enhanced monitoring and prudential supervision of group risks is strongly recommended.

Further improvements to the independence and funding capacity of the regulatory agencies would facilitate continued high-quality supervision. While both APRA and ASIC have clear responsibilities, they are subject to powers of government direction that may impact their independence. APRA and ASIC are also subject to a number of constraints and uncertainty in their budget (particularly over the medium term), which may prevent them from attracting and retaining sufficient staff with requisite specialized skills. Areas of increasing risks, such as cyber, group, conduct, and cross-border, warrant an expansion of resources in certain key functions at ASIC and APRA, such as in enforcement, and the supervision of IT and operational risks, as well as to support strengthened monitoring of foreign activities and cooperation with international regulators.

ASIC is encouraged to continue strengthening the effectiveness of conduct supervision, by taking a more forward-looking approach, and further strengthening enforcement powers and technical capacity. ASIC has improved the effectiveness of supervision by shifting to risk-based supervision from a compliance and event driven approach. Resources devoted to insurance supervision have been significantly increased since the last FSAP. However, supervisory activity still focuses heavily on remediation of materialized incidents. Further attention to actions to mitigate future misconduct risk is warranted, such as imposing a robust risk management framework in product design, sales materials, etc. Boosting ASIC’s enforcement powers (including product intervention powers) would provide a stronger incentive to improve compliance, such as imposition of significantly higher penalties. In addition, ASIC is encouraged to expand the use of existing powers, including the application of license suspension orders. Further strengthening of APRA-ASIC coordination would also help to raise the effectiveness of supervision of governance and conduct issues, by expanding enterprise risk management (ERM) to capture conduct risks, ideally by joint work between the agencies, such as joint rule making, reporting, and onsite inspections.

Table 1. Australia: Recommendations on Insurance Regulation and Supervision		
Recommendations and Responsible Authorities	**Timing[1]**	**Priority[2]**
Take steps to further enhance the independence of APRA and ASIC. Such actions include; (i) elimination of the direction that Minister can impose, and (ii) enhancement of funding and flexibility to retain and attract experts with specialized skills. (Treasury, APRA, and ASIC)	ST	H
Impose group level capital requirements on large and complex life insurance groups if high risk, capital creation, or capital relief transactions are identified in the intra-group transactions. (APRA)	ST	H
Improve supervisory data systems further to facilitate supervisory risk analysis of increasing complex activities of the insurers. (APRA and ASIC) Continue to improve the methods and data availability for robust validation for stress testing. (APRA)	MT	M
Enhance coordination between APRA and ASIC to analyze and mitigate misconduct risks (such as suitability, disclosure, conflict of interest) and prudential risks (such as concentration, leverage, liquidity) stemming from the wholesale unit trusts used by life insurers for their investment linked products. (APRA and ASIC)	MT	M
Provide additional safeguards to the recognition of derivative hedging, linked to adequate counterparty risk charges and liquidity risk management. (APRA)	ST	M
Expand enterprise risk management (ERM) requirement to cover conduct risks and enhance coordination ideally by joint work such as joint rule making, reporting, and inspections. (APRA and ASIC)	MT	M
Strengthen ASIC's enforcement powers and expand the use of existing enforcement powers to mitigate future misconduct. (Government and ASIC)	MT	H
Further strengthen coordination with foreign supervisors (especially those that are home supervisors of large insurers) to enhance the governance and risk management of internationally active insurance groups. (ASIC and APRA)	I	M
Resume periodical monitoring of the size and development of Discretionary Mutual Funds (DMFs). (APRA and Treasury)	ST	L
[1]C = Continuous; I = Immediate (within one year); ST = Short Term (within 1- 2 years); MT = Medium Term (within 3-5 years)		
[2]H= High; M= Medium; L=Low.		

INTRODUCTION

A. Scope and Approach

1. **This technical note provides an update on the Australian insurance sector and an analysis of certain key aspects of the regulatory and supervisory regime.** The note is part of the 2018 Financial Sector Assessment Program (FSAP) and has been prepared by Nobuyasu Sugimoto (IMF), drawing on discussions in Australia from June 6 to June 26, 2018. The technical note references the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS) in October 2011, as revised in November 2017.

2. **The note analyzes the practice in relation to selected ICPs in the context of a wider discussion of key issues in regulation and supervision.** The note does not provide a detailed assessment of observance of the ICPs.[2] The most recent assessment, conducted on the basis of the 2011 version of the ICPs, was carried out in 2012. The main focus of this note is on recent developments in the regulation and supervision of the insurance sector, including major reforms of solvency, group and conglomerate requirements as well as reviewing developments in some specific areas highlighted in the previous FSAP, such as market conduct and group supervision.[3]

3. **The note refers to laws, regulations and other supervisory requirements and practices in place at the time of the discussions in Australia, as well as to ongoing and planned regulatory reforms.** In respect to the 10 ICPs that served as a point of reference for this note, the authorities provided a full self-assessment, supported by anonymized examples of actual supervisory practices and assessments. The institutional arrangements for financial sector regulation and supervision are outlined in the section titled Institutional Setting of this note.

4. **ICPs selected as the focus for the analysis are broadly those with macro financial relevance and those where there have been material regulatory changes.** They include the ICPs on solvency requirements (valuation, investment, and capital adequacy), supervisory approach (including supervisory authority, supervisory review, preventive and corrective measures), market conduct, group supervision, and macroprudential surveillance.[4] In addition, cross-border cooperation has been covered by a supplemental questionnaire. As the exercise did not entail a detailed assessment of observance in line with the IAIS ICP methodology, no grading of the level of observance of the selected ICPs is given in this note.

5. **The author is grateful to the authorities and private sector participants for their excellent cooperation**. The author benefitted greatly from the inputs and views expressed in

---

[2] The IAIS ICPs apply to all insurers, whether private or government-controlled. Specific principles apply to the supervision of intermediaries.

[3] Private Health Insurers are not included in the scope of this Technical Note.

[4] 10 selected ICPs are 2 (Supervisor), 9 (Supervisory Review and Reporting), 10 (Preventive and Corrective Measures), 14 (Valuation), 15 (Investment), 16 (ERM for Solvency Purposes), 17 (Capital Adequacy), 19 (Conduct of Business), 23 (Group-wide Supervisor), 24 (Macroprudential Surveillance and Insurance Supervision).

meetings with insurance regulators, supervisors, insurance companies, industry associations, and professional organizations.

B. 2012 FSAP Recommendations and Implementation

6. The 2012 FSAP conducted a full detailed assessment of the ICPs and made recommendations to improve the compliance with the IAIS ICPs. Amongst other points, it identified some areas for strengthening the supervision and regulations that are relevant to the scope of this Technical Note. In particular, the assessment identified:

- The 2012 assessment noted that the relevant Minister was provided with powers ranging from the possibility to give directions to APRA and ASIC to being in charge of certain supervisory decisions. APRA and ASIC are dependent on the approval of the Government for their funding. A significant amount of ASIC's funding is non-core funding earmarked for specific projects, raising a concern regarding ASIC's ability to allocate its resources effectively. The reasons of removal of an APRA member or ASIC commissioner are not required to be publicly disclosed. (ICP2); and

- There is a material gap in regulatory guidance, in particular those relating to minimum training and competencies standards for intermediaries. Sufficient legal powers are also missing, such as to supervise insurer's claim practices and policy servicing. ASIC's supervisory approach is predominantly based on desk-top review and relies heavily on self-reporting of breaches of regulatory requirements or third-party notifications. ASIC is also suffering from resource shortages which results in largely reactive surveillance. There is no market conduct supervision at the group level. (ICP 19);

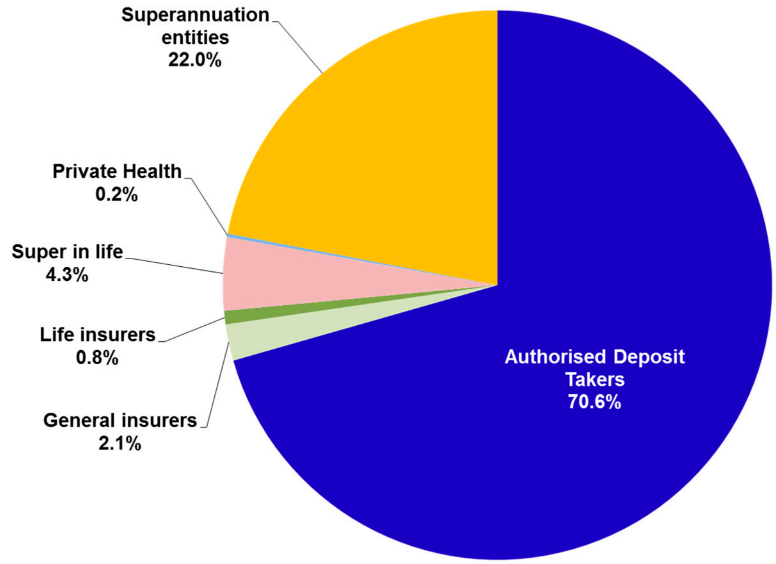
7. Insurance sector regulation and supervision has strengthened further since the previous FSAP. The 2012 assessment recognized a high level of observance with the ICPs supported by robust prudential supervision. Since the assessment, new capital requirements (Life and General Insurance Capital or LAGIC) have been implemented. A level 3 conglomerate framework has been established relating to governance and risk management. ASIC has also conducted several thematic reviews (such as life insurance advice, life insurance claim handling, and auto add-on insurance). Those reviews identified some inappropriate practices in the industry. To address the key findings, several reforms have been implemented or in the process of implementation (such as remuneration reforms, enhanced data collection, legal amendments to improve enforcement powers at ASIC, remediation to the policyholders, introduction of caps to the sales commission on some products, such as life insurance, etc.).

C. Market Structure, Insurance Products, and Industry Performance

8. The insurance industry in Australia is relatively small and suffering from low growth and declining life premiums. Life and general insurance accounted for 7 percent (life 5.1 percent, health 0.2 percent, and general 2.1 percent respectively) of total financial system assets. The largest share of business (4.3 percent) is provided through superannuation funds whose trustee has a group insurance contract and distributes it to the individual members. The insurance penetration ratios for both life and general insurance were less than 3 percent in 2017, which are lower than other advanced countries. Life insurance premiums have decreased about 1 percent since 2013, and general insurance premiums have grown only 2-3 percent annually since 2013, which is slower than general economic growth.

Figure 1. Australia: Size of Insurance Sector

Insurance sector is small. Largest share of business measured by total assets is made through superannuation.



Sources: APRA

9. While large insurers continue to dominate the market, the ownership of some large life insurers has shifted from domestic conglomerate groups to foreign insurance groups. The five largest life and general insurers account for more than 80 percent and 75 percent of the market share in terms of respective total assets. Recently, three out of four largest domestic conglomerate groups have divested their life insurance subsidiaries to foreign insurance groups.[5] The trend appears to reflect several influences including lower returns in the life insurance business compared with other financial services, as well as desire by some of the major banks to simplify their business models. While these transactions could bring new challenges to the authorities and local managements, there are also positive aspects, including improved diversification, capacity to make investments to upgrade capability and access to further specialized insurance and wealth management skills within these acquiring entities.

10. Both life and general insurers have enjoyed relatively favorable profits since 2013, which has helped them to maintain high capital adequacy ratios. The life insurance sector has

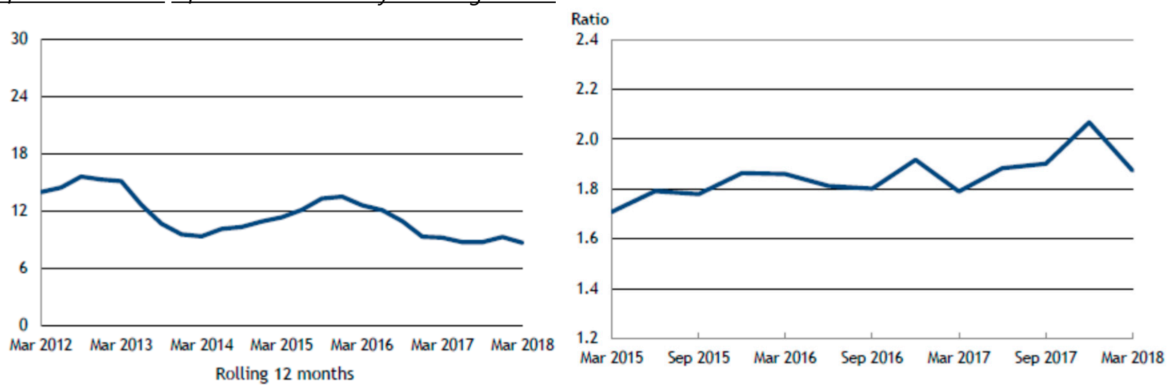
[5] OnePath life (2nd largest life) which belonged to ANZ group has been acquired by Zurich Financial Group (Switzerland). The Colonial Mutual Life (4th largest life) which belonged to CBA group has been acquired by AIA group (Hong Kong). MLC (6th largest life) which belonged to NAB has been acquired by Nippon Life (Japan), with 80 percent of MLC shares held by Nippon Life and 20 percent retained by NAB.

recorded relatively stable profit in the last five years, with Return on Equity (ROE) of the sector ranging from 9 percent to 15 percent. It should be noted however that the profitability of life insurers shows a clear declining trend in the recent few years. Profitability of general insurers is more volatile but typically higher than life insurers, with ROE of the sector ranging from 9 percent to 19 percent over this period. Thanks to broadly favorable profitability, the industry average solvency coverage ratio[6] has reached 200 percent for life insurers and 182 percent for general insurers as of the end of 2017. Recent figures as of March 2018 have declined for both life and general insurers to about 190 percent. As described in section B, the prudential capital requirement standard at the entity level is set relatively conservatively, and thus this high-level capital adequacy ratio indicates that the overall insurance sector is relatively resilient against a plausible adverse scenario.

Figure 2. Australia: Profitability and Solvency of Life Insurers

Insurance sector has high profitability and solvency coverage ratio with some negative pressure recently.

Life Insurers ROE *Life Insurers Solvency Coverage Ratio*



Sources: APRA

11. Life insurers in Australia are experiencing relatively limited impact from the low interest rate environment, although some life insurers still have legacy policies with guarantees sold more than 20 years ago. Most life insurers stopped offering long term insurance policies with guarantees in 1980–90.[7] The duration of assets and liabilities is broadly matched through some firms' use of derivatives for hedging. Most of the saving products are investment linked products without guarantee. The other main product provides protection (term), where insurers can adjust their premiums every year, depending on the performance of expenses and mortality. Risk sensitive capital requirements provide a strong incentive for insurers to match the duration between assets and liabilities. Some insurers use interest rate swaps actively to reduce their duration gaps.

12. There are signs of increasing shares of assets invested in illiquid and foreign instruments with reliance on short term hedging instruments at an individual company level. The industry wide statistics of investments do not provide striking evidence of searching for yield

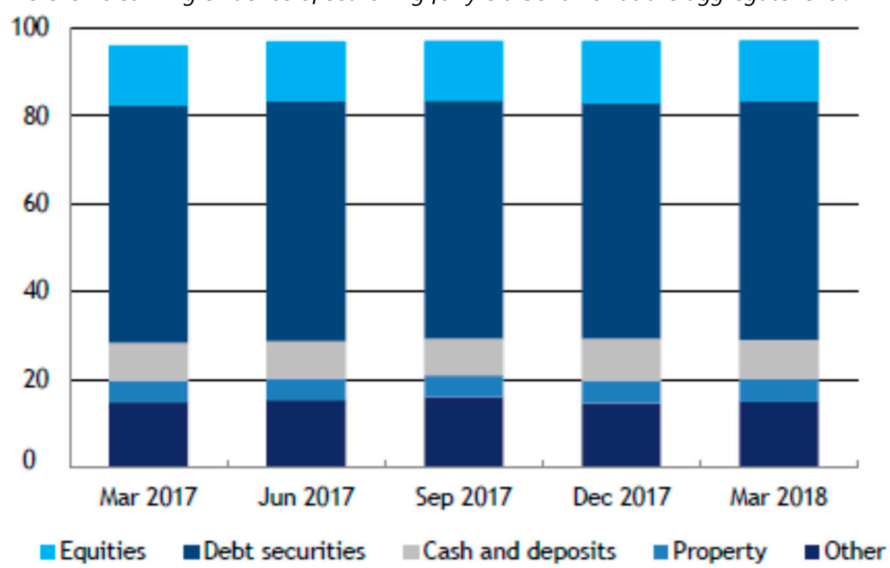
[6] The regulatory minimum ratio is 100 percent for both life and general insurers.

[7] As those policies have long duration, some insurers still have to manage this legacy portfolio. For example, the largest insurer by asset has about 30 percent of its insurance liabilities from the legacy portfolio.

behavior. For example, the majority of investments are held in high-quality government and corporate bonds and bank deposits. There is no clear trend of credit risk taking in the debt securities portfolio at the industry wide level. The majority of the equity investments have been made by investment-linked products and thus investment risks to insurers are limited. However, life insurers are suffering from the shortage of domestic fixed income instruments with a high yield and extended duration. Thus, some are expanding their illiquid and foreign asset investments with reliance on short term hedging. As the hedging instruments (typically IR/FX swaps and forward) need to roll over regularly, there is a roll over risk where insurers might have to pay a much higher cost in the future or suffer from FX loss in case of AUD appreciation.

Figure 3. Australia: Trend of Asset Allocation of Life Insurers

There is no striking evidence of searching for yield behavior at the aggregate level.



Sources: APRA

13. Financial institutions, including those within the insurance industry, are under social pressure. After considerable public pressure, a Royal Commission (RC) was established in December 2017 to review misconduct in the Australian financial sector. The hearings are making public a number of serious misconduct issues, including the fact that the largest life insurance group admitted to misleading ASIC about charging customers for advice they never received. Public and social trust in large financial institutions has been eroded. A high degree of media, public, and political attention and pressure will be likely to continue until the RC has reported in February 2019 and the government has announced its response to the Commission's recommendations.

14. Discretionary Mutual Funds (DMFs) offer insurance-like "discretionary cover," but are not subject to APRA prudential regulation. DMFs do not have a legal obligation to pay claims, and thus do not meet the insurance definition under the Insurance Act and Life Insurance Act. Therefore, they are not subject to APRA prudential regulation or supervision. While they cannot offer insurance products, there is no binding restriction about the type of products that DMFs can offer and DMFs seem to offer a wide range of insurance-like products, including liability "insurance" and car "insurance" to taxi drivers. As society may not distinguish between insurers and DMFs, there could be reputational risk to the regulated sector if DMFs failed to pay claims. APRA used to collect information regularly from DMFs under Financial Sector Collection Data Act (FSCODA) but ceased the collection of data in late 2016. Therefore, APRA does not have recent information about the size, types of products offered, and activities of DMFs. In 2016, APRA ceased its data collection from DMFs and thus the current size and product features of DMFs are unclear. APRA is recommended to conduct periodical monitoring of the size and development of DMFs.

INSTITUTIONAL SETTING

A. Supervisory Responsibilities, Objectives, and Powers

15. **Australia adopts a functional regulatory structure.** APRA is responsible for the prudential regulation of ADIs, life, general and private health insurers (including reinsurers) and most of the superannuation industry. ASIC is responsible for market conduct regulation and supervision, promoting market integrity and consumer protection across the financial services sector (excluding private health insurers). The Reserve Bank of Australia (RBA) is responsible for monetary policy as well as overseeing financial system stability and the payments system.

16. **All three financial sector authorities are statutory authorities and share responsibility with the Commonwealth Treasury for the stability, efficiency, and integrity of the financial system.** The Treasury advises the Australian Government on: (i) the framework for financial sector regulation, as well as on policy and possible reforms to promote the stability and efficiency of the financial system; (ii) matters relating to the exercise of the Treasurer's powers; and (iii) the broader economic and fiscal implications of developments that pose a threat to the stability of the financial system.

17. **The Council of Financial Regulators (CFR) serves as a coordination forum for the three regulatory agencies and the Commonwealth Treasury.** The objectives of the Council are to contribute to the efficiency and effectiveness of regulation and the stability of the Australian financial system. The CFR is a non-statutory body chaired by the Governor of the RBA and plays an active role in reviewing global market conditions, coordinating advice to the Government, and enhancing Australia's crisis management arrangements. It regularly forms working groups with agreed terms of reference to undertake more detailed policy development. During the financial crisis, the CFR was the focal point for agency cooperation.

18. **The CFR agencies have a long history of effective inter-agency cooperation and coordination on financial sector policy issues** through: (i) overlapping representation on the agencies' boards: one APRA member sits on the RBA Payments System Board and the Secretary to the Treasury sits on the RBA Board; (ii) bilateral Memoranda of Understanding (MoU) between CFR members and an MoU on Financial Distress Management shared among the four CFR member agencies; (iii) regular bilateral coordination arrangements, e.g.,,,, the RBA-APRA Coordination Committee comprising senior executive staff from both agencies, which meets approximately every

six weeks; and (iv) legislation that allows APRA and the RBA to share institution-level data to carry out their respective duties. Underlying all these formal structures is a culture of cooperation and collegiality.

19. APRA has implemented a major enhancement of the solvency regimes for insurers as well as formalizing conglomerate supervision. In January 2013, APRA implemented a comprehensive reform of capital requirements for general and life insurers, including increasing the risk-sensitivity of the capital framework and the harmonization among banks, life and general insurers. APRA has also implemented comprehensive group supervision for general insurance groups, referred to as Level 2 supervision, as well as a noncapital prudential framework for conglomerate groups, referred to as Level 3 Supervision.

20. The prudential regulation and supervision of private health insurance in Australia has been transferred from the Private Health Insurance Administration Council (PHIAC) to APRA. Private Health Insurance had been prudentially regulated by PHIAC but reflecting government initiatives to reduce the number of public agencies, PHIAC was closed and its prudential regulatory and supervisory function were transferred to APRA in 2015.

MAIN FINDINGS

A. Independence and Resources

APRA

21. APRA is governed by an Executive Group, headed by an executive chairperson. The APRA Act requires the appointment of between three and five APRA members, and currently (as of June 2018) there are three members.[8] The Executive Group is responsible and accountable for the operation and performance of APRA. APRA also has four internal governance committees (Supervision and Resolution, Prudential Policy, People and Culture, and Organisational Effectiveness and Infrastructure). In addition, APRA has a separate Risk Management Committee and Audit Committee comprising a majority of external members, including an external chair, appointed by the APRA chair person.

22. APRA members are appointed by the Governor-General on the advice of the Minister[9] with a specified term. The term cannot exceed five years but can be renewed without any limitation of reappointment. The limited circumstances under which the appointment of an APRA member may be terminated by the Governor-General are set out in the APRA Act. As a matter of constitutional convention, the Governor-General would exercise such power only upon the advice of Government Ministers. The APRA Act does not provide for the public disclosure of the specific reasons for

[8] A bill enabling the appointment of a second Deputy Chairperson was introduced into Parliament on May 24, 2018. Subject to Parliamentary agreement and Royal Assent, a second Deputy will be appointed taking the number of members to four.

[9] Treasurer is responsible for APRA issues.

terminating the appointment of an APRA member.

23. APRA is subject to a formal power of direction by the Minister under the APRA Act. The Minister is permitted to give APRA a written direction[10] about the policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. The direction would be published in the Gazette within 21 days after the direction is given. APRA must comply with this direction, although the direction cannot be made on a particular case. The APRA Act also states that APRA must advise the Minister respecting a wide range of matters, including competition, contestability or competitive neutrality. The government also periodically issues a Statement of Expectations (SOEs) to APRA that elaborates on the Government's expectations of APRA and its role, responsibilities and priorities.[11] APRA responds with a Statement of Intent (SOI). Both the SOE and SOI are published on APRA's website. Furthermore, the Australian Parliament can disallow prudential standards, although in practice no standard has been disallowed to date.

24. Most decisions made by APRA are subject to judicial review, with certain decisions subject to administrative review. Crisis resolution-type decisions are generally not subject to administrative review, but only judicial review. The Insurance Act and Life Insurance Act provides a similar review procedure to certain decisions ("reviewable decisions"), where an independent APRA delegate (who was not involved in the previous decision and at the same level or higher than the initial APRA delegate) will reconsider the decision and confirm, revoke or vary it. Where a review decision is made, the dissatisfied party may apply to the Administrative Appeal Tribunal (AAT).

25. APRA's budget is set by the Australian Government after consideration of a funding request proposed by the APRA members. APRA is funded primarily by levies imposed on all regulated institutions. Following consultation with the industry, the Minister determines the rates for each regulated industry in each financial year. Industry levies are based on the costs incurred in APRA discharging its duties. In the 2017–18 Federal Budget, APRA obtained an additional A$40 million over four years (total expenses in 2016–17 were A$129 million) to cover a number of new initiatives such as stress testing, IT security, review of industry remuneration practices, etc. The new budget will allow APRA to increase headcount by around 20 to some 640 staff in 2018–2019. APRA can submit a New Policy Proposal (NPP) to request additional funding, if it is asked to undertake new activities or is inadequately resourced to meet future demands. APRA has also received Special Appropriations from the Government and indeed significant funding has been provided to enhance APRA's ability to deal with the last global financial crisis.

26. While APRA is committed to the recruitment and retention of highly skilled staff, the evolving environment is posing additional challenges. The APRA Act enables APRA to hire risk

[10] However, this power has not been used in the past.

[11] The SOE issued in 2014 described that "all information, briefing, press releases, and correspondence being provided to Ministers by APRA should be provided to the Secretary to the Treasury."

specialists, industry experts or other professional staff where necessary.[12] Turnover rate of staff in charge of insurance regulation and supervision is generally relatively modest, especially among those with more than 10 years' experience. However, there are some constraints through the APS Workplace Bargaining Policy and vetting by the Australian Public Service Commission (APSC). APRA is also subject to an "efficiency dividend," which requires a certain percentage of annual reduction in future budgetary resources as a part of Australian Government policy. These constraints create challenges for APRA to attract and retain the highly specialized skills that it currently needs to better oversee the new technology and risks in Australia's evolving insurance sector.

27. The government recently announced the appointment of a deputy secretary of the Treasury to become an additional deputy chairperson at APRA, subject to the amendment of the APRA Act. In May 2018, the Government introduced legislation into Parliament to provide greater flexibility and strengthen APRA capability by creating a second Deputy Chairperson. It has also announced the appointment of a Deputy Secretary from the Treasury to this post, subject to the legislation being passed. The role and function of the second deputy Chairperson is yet to be decided.

ASIC

28. ASIC is governed by a commission with five full-time Commissioners, headed by a Chairperson. The commission has a Chairperson and two Deputy Chairpersons. The Commission is responsible for setting and overseeing ASIC's strategic direction and priorities. The Commission appoints and evaluates the performance of ASIC's senior executive leaders and approves budgets and business plans. It also makes decisions on matters within its regulatory functions and powers that have strategic significance.

29. ASIC Commissioners are also appointed by the Governor-General on the advice of the Minister[13] with a specified term. The term cannot exceed five years although they are eligible for reappointment. The limited circumstances under which the appointment of an ASIC member may be terminated by the Governor-General are set out in the ASIC Act. As a matter of constitutional convention, the Governor-General would exercise such power only upon the advice of Government Ministers. The ASIC Act does not provide for the public disclosure of the specific reasons for terminating the appointment of an ASIC Commissioner.

30. ASIC is subject to a formal power of direction by the Minister under the ASIC Act. The Minister is permitted to give ASIC a written direction about the policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. The direction would be published in the Gazette within 21 days after the direction is given. ASIC must comply with this

[12] APRA also invests heavily in training and development, such as for leadership program and secondments to other regulators. In addition, APRA's travel budget incorporates provisions for on-site visits to insurers, including visits to offshore operations and attendance at supervisory colleges, as well as participation in international standard setting activities.

[13] The Minister for Revenue and Financial Services is in charge of ASIC issues.

direction. Although the direction cannot be made on a particular case, the Minister can direct ASIC to investigate a particular matter when the Minister consider it in the public interest. The Minister cannot direct a particular outcome from the investigation. The government also periodically issues SOEs to ASIC that elaborates on the Government's expectations of ASIC and its role, responsibilities, and priorities. For example, an SOE was issued in April 2014 and April 2018. ASIC responds with an SOI. Both the SOE and SOI are published on ASIC's website.[14] Decisions of ASIC to issue legislative instruments, such as class orders are subject to parliamentary review. Either House of the Australian Parliament may disallow such an instrument, although there have not been any such cases in the past.

Box 1. Enhancement of ASIC Capability

In July 2015, the then Assistant Treasurer announced a review to consider the capabilities of the ASIC. The Government established an expert Panel to conduct the review. The Capability review forms part of the Government's response to the Financial System Inquiry (FSI) which recommended periodic reviews of the capabilities of financial and prudential regulators, commencing with a review of ASIC in 2015 to ensure it has the skills and culture to carry out its role effectively.

The Panel found there were some aspects for improvement. The Panel found that many of ASIC's regulatory capabilities are in line with global best practices. However, it also found number of areas for improvement such as strategy, governance, IT, data infrastructure, information system, and engagement with stakeholders. To enhance ASIC capabilities, the Government has made the following improvements.

Data analysis need to be enhanced to identify and mitigate conduct risk. The review highlighted the critical role that sophisticated analytics and risk management processes can play in identifying and mitigating conduct risk. In response, the government has committed A$61 million to enhance ASIC's data analytics and surveillance capabilities as well as to modernize ASIC's data management systems.

Additional powers are being granted to ASIC. A product intervention power would enable ASIC to respond to market problems in a flexible, timely, effective, and targeted way. Industry would be subject to product design and distribution obligations for financial products to ensure that products are targeted at the consumers for whose needs the product is designed for. The Government has also agreed to strengthen ASIC's enforcement regime, including penalties, to ensure ASIC has tools for effective deterrence of misconduct. The government has conducted a consultation on Treasury Laws Amendment Bill 2017, which is in the parliamentary process.

The Government also introduced an industry funding model for ASIC. As recommended in the 2012 FSAP and FSI, an industry funding model was introduced to ASIC in July 2017. Industry funding ensures that the costs of regulation are borne by those entities that have created the need for it.

31. Some decisions made by ASIC are able to be reviewed as to their legality Many decisions of a regulatory nature are subject to review by the Administrative Appeals Tribunal (AAT) which allows review on the merits of the decision. There are a few other decisions that are not reviewable for merits, such as decisions relating to a process where the rights of the affected party are otherwise protected. It is also possible for legal challenges to ASIC's decisions in the Federal, Supreme, and the High Court. ASIC's actions are also subject to review by the Commonwealth Ombudsman. The

[14] https://asic.gov.au/about-asic/what-we-do/our-role/statements-of-expectations-and-intent/ .

Ombudsman may make recommendations to ASIC about what action should be taken. However, unlike the AAT, the Ombudsman does not have the power to change ASIC's decisions.

32. ASIC has moved to an industry funding model in July 2017, with more resources allocated to insurance supervision. The shift to an industry funding model was in response to a recommendation of the FSI. The FSI noted that the absence of industry funding exposed ASIC to an increased risk of funding cuts. In 2017–18, approximately 65 percent of ASIC's total budget will be funded by industry levies. ASIC is now allocating more resources into insurance work through specialist insurance practitioners who dedicate a greater proportion of time to insurance work. The total number of FTE in the Deposit Takers, Credit and Insurers team has increased from 28 to 83 from June 2012 to June 2017. However, the Government continues to determine ASIC's actual budget on a yearly cycle with a four-yearly forward estimate. ASIC can allocate general resources at its own discretion, while restrictions are applied to other resources funded by special arrangement. The Commission approves budgets and business plans for each team.

33. The Government is trying to address constraints of ASIC regarding remuneration. ASIC employees are remunerated according to the Australia Public Service pay classification. In March 2018, the Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018 was introduced into the Commonwealth Parliament so that ASIC will be able to employ staff more flexibly. However, as is the case of APRA, some constraints on remuneration apply through the APS Workplace Bargaining Policy and vetting by the Australian Public Service Commission (APSC). ASIC is also subject to an "efficiency dividend," which requires a certain percentage of annual reduction in baseline budgetary recourse as a part of Australian Government policy.

34. ASIC is experiencing resource constraints and higher employee turnover, which could worsen further due to heightened public awareness of misconduct. As of February 2018, the staff annual turnover ratio has been increased to around 9 percent among overall staff, but higher among staff with long experience. The staff turnover ratio is higher than that of APRA, particularly among those with long experience. The budget for training has been reduced since 2010–11, although efficiencies of the training might have been improved. A number of industry participants shared their views that ASIC resources need enhancement. Due to recent heightened public interest in compliance and misconduct, there is likely to be pressure from industry to hire additional market conduct experts, such as lawyers and supervisors with relevant experience, which would pose additional pressure for ASIC to attract and retain conduct experts.

35. Similar to APRA, the government recently announced an additional Deputy Chairperson at ASIC. In March 2018, the government introduced legislation into Parliament to enhance ASIC capability by creating a second Deputy Chairperson position—taking the number of Commissioners to five. This was recently approved by Parliament, and the new Deputy Chairperson took up office on 16 July 2018. This meets the Government's standing commitment to appoint an additional ASIC Commissioner with experience in enforcement.

Recommendations

36. In line with international best practice, the independence of APRA and ASIC to undertake their duties should be strengthened. The ability of Ministers to give directions to APRA and ASIC on matters of supervisory policy and priorities limits independence and accountability of the supervisory authorities should be removed. Independent decision making by the management (APRA members and ASIC commissioners) of APRA and ASIC in relation to their statutory duties should also be supported by the introduction of a requirement for disclosure, in case of dismissal of an APRA member or ASIC Commissioner. The possibility of the Minister to give ASIC a written direction should also be removed.

37. APRA and ASIC should be equipped with sufficient budget and flexibility to ensure adequate supervisory resources. While ASIC has increased resources allocated to insurance supervision substantially, the workload of both APRA and ASIC has increased significantly due to increasing complexity of the industry and emerging cases that need active monitoring and enforcement actions. To enable APRA and ASIC to continue to perform effective supervision, a sufficient budget with additional flexibility and predictability of funding is needed to support the recruitment and retention of staff with specialized expertise (such as in the areas of IT, cybersecurity, and advanced risk modeling). The Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018 should be enacted as early as possible to provide more flexibility of remuneration for ASIC staff. Further upgrading of APRA and ASIC information systems is also strongly recommended to support high quality supervision and address the risks from increasingly complex activities of insurers. In particular, APRA and ASIC IT infrastructure (such as data and IT systems) should be further improved to facilitate effective risk-based supervision and enforcement, particularly of insurers' conduct of business and complex activities (such as derivative transactions).

B. Solvency Requirements

Valuation of Assets and Liabilities

38. Insurers are required to adopt a fair-value approach to the valuation of their assets and liabilities under the Australian Accounting Standards. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the assets or to transfer the liability would take place between market participants at the measurement date under current market conditions. For the valuation of assets backing insurance liabilities, the fair value methodology is adopted to reflect all relevant information about the market assessment of value and risk. For the valuation of other assets, which account for a very small share of total assets, accounting standards do not prohibit the use of amortized cost.

39. Liabilities are generally valued using a discounted cash flow calculation with a risk-free discount rate and other assumptions. Under GPS 320, general insurers must use a risk-free discount rate that is based on current observable, objective rates for government bonds. For life insurers, for profit reporting purposes under LPS 340, the discount rate must be a risk-free discount rate (other than where the benefits under the policy are contractually linked to the assets backing the benefit, in which case a discount rate reflecting the expected investment earnings on the assets backing the benefit is used). However, for solvency purposes, the discount rate should be adjusted to be the sum of the risk-free rate plus a liquidity adjustment[15] even for such policies. In addition, if the total termination value exceeds the value derived from the application of risk free discount rate with, where relevant, a liquidity adjustment, the excess would be deducted from the capital resources. As a result, future profits and recovery from Deferred Acquisition Cost (DAC) would be excluded from the capital resources.

40. The current estimates are mainly made according to insurers' own experience, incorporating actuarial review. For general insurers, the Appointed Actuary is required to review the assumptions used for determining the best estimate of insurance liabilities at least annually and to disclose any information regarding changes made to these assumptions from those of the previous period. Liability valuation methods and assumptions are required to be appropriate to the experience of the insurer and the class of business being valued. For life insurers, the Appointed Actuary is required to make best estimate assumptions using professional judgment having regard to available statistics. Most life insurers are large enough to generate sufficient business volumes to support the assessment of their own lapse and expense experience for the purpose of setting assumptions. Assumptions for mortality are based on the insurer's own experience but should also be informed by broad based industry studies. Life insurers must at a minimum separate acquisition expenses from non-acquisition expenses, as the standards allow acquisition expenses to be deferred and expensed over the life of the policy. The valuation of technical provisions is required to make appropriate allowance for embedded options and guarantees. Such features are generally not found in general insurance contracts. For life insurance, embedded options may either be valued in accordance with a suitable option pricing method, or the best estimate assumptions may be appropriately adjusted to capture the value of the options.

41. Technical provisions include Margin Over the Current Estimate (MOCE) explicitly in general insurance and only implicitly in life insurance. For general insurers, GPS 320 requires MOCE at a minimum 75 percent level of sufficiency. Although there is no methodology specified by APRA, the Institute of Actuaries of Australia (IAAust) has issued a guidance as the best practice in the calibration. MOCE is primarily applied to the net insurance liabilities and must be determined according to the uncertainty in each of the gross insurance liabilities, the reinsurance recoveries and the non-reinsurance recoveries. MOCE needs to be determined for each class of business with a proper adjustment of diversification benefits. For life insurers, policy liabilities include composite margins, which effectively eliminate day one profit. In addition, there is an adjustment for conservatism by deducting the difference[16] between the best estimate liability and total termination values for all policies, with this acting as an implicit MOCE.

[15] Liquidity premium is calibrated as 30 percent of A rated bond spread at a three-year maturity as published by the RBA and is only applicable to illiquid liabilities.

[16] As of the end 2017, the difference reached A$11 billion at the industry wide level.

Investment Requirements

42. **General and life insurers are required to address investment risk in the Risk Management Strategy (RMS).** At the solo level, general insurance groups must address investment risk at insurance group level and groups designated by APRA as Level 3 groups must address it at conglomerate level. RMS is to address all facets of investment risk through the establishment of Board approved investment risk and return objectives. RMS should cover security, liquidity, diversification, concentration, and currency risks as well as asset liability management. The Board Risk Committee for insurers must have full oversight of investment activities. Similar requirements are applied at the group level for general insurers but not for life insurers.

43. **The Asset Concentration Risk Charge (ACRC) provides some incentives to diversify investments, albeit with some exemptions and relaxed requirements for life insurers.** Life insurers, general insurers, and general insurance groups must hold 100 percent of capital charge against a counterparty exposure[17] that exceeds prescribed thresholds. There are some exceptions, for example, general insurers do not have a limit against reinsurers with high credit ratings. For life insurers, the limits on deposits held with and bills issued by a single bank (including its parent or related bank) are much higher than the capital resource (50 percent and 25 percent of value of the corresponding statutory fund[18] respectively). Other limits are also set, for example the limit to an individual traded security is set at 5 percent of the corresponding statutory fund. Moreover, the capital charge is exempted for assets[19] linked to investment products without guarantee.

44. **Additional requirements are in place to protect policyholders of both general and life insurers.** The Insurance Act (IA) requires a general insurer to maintain assets in Australia of a value that equals or exceeds the total amount of its liabilities in Australia in addition to the requirement that the capital held exceeds the prudential capital requirement. For a branch insurer, the assets in Australia must exceed liabilities in Australia by at least the amount of its minimum capital requirement. For life insurers, the LIA requires a life insurer to establish statutory funds relating solely to the life insurance business of the company or to a particular part of that business. The LIA also prohibits the mortgage or charging of any assets of a statutory fund, controls the movement of assets in and out of a statutory fund, provides a definition of restricted investments (which relates to related-party dealings) and requires the reporting of such restricted investments.

45. **The risk-based capital regime combined with the assessment by appointed actuaries could help to disincentivize complex investments.** A general insurer is required to apply to APRA prior to entering into an investment through a Special Purpose Vehicle (SPV) or other related entity where it wishes to look through the vehicle to the underlying assets for large exposures and capital calculation purposes. For life insurers, there are some disincentives in the capital calculation towards

[17] This include the exposures to the related parties.

[18] Statutory fund is set at the insurance liabilities plus the corresponding capital to support the insurance liabilities, less any exposures to the counterparty in respect of asset classes with lower limits.

[19] This capital relief applies only for policies where the policyholder bears the investment risk (i.e., investment linked policies) when there has been full disclosure to policyholders of the risks to which they are exposed.

investment into illiquid and complex assets. For example, treating complex assets as equity assets for the purposes of calculating the asset risk charge. Lower ACRC limits also apply for less-liquid assets, such as certain non-traded securities.

46. High related-party balances of the life insurance industry seem to be mainly due to investments in unit trusts that are managed by a corporate trustee related to the life insurer. Life insurers have material related party exposures totaling A$138 billion in 2015, A$144 billion in 2016, and A$70 billion in 2017.[20] As the underlying assets of these unit trusts (e.g., shares, bonds, property, etc.) are not directly related to the life insurers, APRA considered these balances to be no more risky than if the portfolio was outsourced to an investment management firm or managed internally by an in-house investment department. During its onsite reviews, APRA also develops an understanding of the structure of the relevant group, the intra-group relationships and the insurers' involvements with related parties. Any balances that exceed concentration limits would attract capital charges. Further, a deduction from capital resources is made in respect of regulatory capital requirements of subsidiaries, joint ventures, and associates. Intangible assets of subsidiaries, joint ventures, and associates are also deducted from capital resources unless they are operationally independent, represent a genuine arm's length investment, are not subject to prudential capital requirements and do not undertake life insurance business or business related to insurance business. The value of investments in subsidiaries, joint ventures and associates, less deductions made from capital resources, are subject to asset stresses in the Asset Risk Charge.

47. While APRA does not routinely collect information on the underlying assets of insurers' unit trust investment, various process checks are in place including data requests. Insurers can and have a strong incentive to[21] look through unit trust investment and calculate the capital requirements as if they directly hold those assets. Insurers are supposed to consider and analyze such risk appropriately and APRA check those through onsite inspections. If an insurer has outsourced some or all of its investment activities to a third party, APRA assesses the investment manager selection process, the process for manager reviews, the selection of appropriate benchmarks for assessing manager performance, and the circumstances under which continued investment through a manager will be reconsidered or terminated. APRA makes similar assessments where an insurer is investing in unlisted assets through a fund-of-funds structure. Where an insurer chooses to invest in securities directly (rather than through a collective investment vehicle), APRA reviews the insurer's methodology for selecting securities within various asset classes. The assessments are supported by internal guidance material and a specialist market risk unit. APRA issues requirements to any insurer or general insurance group investing in assets where the risks are not being adequately assessed or managed. However, APRA does not have ready access to information on the underlying assets of outsourced investment activities.

[20]The total assets of the life insurers were A$230 billion in the end of 2017. According to APRA, the majority of the assets are related to Unit trusts managed by the group asset manager.

[21] Insurers have two options either (i) to look through their unit trust investment, or (ii) to treat the investment as an equity asset. However, if the unit trust is leveraged and unlisted, insurers have to look through the unit trust and calculate capital requirements as if they hold the underlying assets directly.

Capital Requirements

48. Capital adequacy requirements are in place at both entity and group levels (with the exception of life insurance groups), with a 99.5 percent confidence level over one year. Capital adequacy requirements for general and life insurers are outlined in separate prudential standards. The minimum requirement is the Prescribed Capital Amount (PCA) plus any supervisory adjustment determined by APRA referred to in sum as the Prescribed Capital Requirement (PCR). The level of required capital corresponds to a 99.5 percent confidence level over a one-year time horizon. A regulated entity that breaches the PCR needs to take immediate actions to address this breach.

49. Capital requirements cover a wide range of risks, including those of insurance, assets, concentration, and operational. For example, asset risks cover interest rate inflation, currency, equity, property, credit spread, and default. Those risk charges are aggregated utilizing an APRA specified correlation matrix to recognize some diversification effects. Tax benefits can be recognized only up to the same amount of deferred tax liabilities with additional condition of legal enforceability. Life liabilities whose value depends on the illiquidity premium must be revalued using a stressed illiquidity premium. The stress adjustment to the illiquidity premium is an increase of 30 basis points to the forward rates for the first 10 years after the reporting date and zero thereafter. The stressed illiquidity premium is subject to a maximum of 150 basis points.

50. Risk sensitive capital requirements allow a wide range of management actions and risk mitigating instruments. Management actions, such as reduction of termination values, discretionary benefits, adjustment of future premiums for existing policies, and change of asset allocations, can be recognized to reduce the capital charges. Insurers seem to be actively using hedging instruments, such as interest rate, currencies and credit default swaps to mitigate market risks, which provide capital relief benefits that are allowed under both standardized and internal model capital requirements. However, the capital requirements do not require any preconditions on such risk mitigating instruments, such as duration of the instruments, credit quality of the counterparties,[22] and trigger events of the instruments. There are, therefore some incentives for insurers to reduce hedging costs by relying on cheaper instruments, particularly those with shorter duration. In fact, according to a sample check of some insurance companies, most of the hedging instruments that those insurers relied on as of the end 2017 expire within a year. Thus, insurers are exposed to roll over risk, which is not incorporated into the capital calculation. Potential management actions, such as change of asset allocation, are allowed. Reliance on such actions needs to be monitored carefully, as they might not be feasible under stress, or could cause market instability if a majority of insurers simultaneously assume they can achieve a material reduction of their exposures to illiquid assets. Such monitoring would become particularly important if the industry asset allocation is shifting to more illiquid assets, as appears to be the case.

51. APRA has approved one general insurance group to use internal models to support its solvency setting. APRA has one centralized and dedicated unit (RDA Market Risk and Models team) for internal model validation which is responsible for model validation of all sectors (banks and

[22] There is a capital charge associated with the credit risk of the counterparty default.

insurers). The unit has imposed rigid requirements (including statistical quality test, calibrating test and use test) by leveraging on their experience in model validation for the major banks. APRA has imposed a floor of 90 percent of the prescribed method for the first two years after approval. The insurer which uses internal models is required to conduct an independent review at least once every three years, to be undertaken by consulting firms with expertise or by other experts within the insurer who have not been directly involved in the development. Internal models must be calibrated conservatively and the standardized approach is also established on an economic capital basis. Thus, there is no strong incentive to adopt internal models across the industry at this stage.

Capital Resources

52. Prudential standards require high quality instruments for the capital resources. Prudential standards provide for the classification of the capital resources of an insurer into two tiers (Tier 1 and Tier 2, net of all specified deductions and amortization). Tier 1 compromises the highest quality components of capital that fully meet all the essential characteristics (permanent, available, without servicing charge, subordination). Common Equity Tier 1 needs to exceed 60 percent of the prescribed level. While the degree of reliance on lower quality capital varies among entities, the average share of Tier 2 in total available capital is less than 5 percent on average among life, general and reinsurers respectively. Intangible assets, good will and net deferred tax assets must be deducted from Common Equity Tier 1.

53. However, the lack of a group capital requirement for life insurers may create undue pressure on the life entity within a large insurance group or conglomerate. For example, the prudential standard for a general insurer allows the capital instruments issued by the insurer and held by the group life insurer as eligible, if the instruments are held under investment link products. This could create a conflict of interest between the group interest and policyholders' best interest. In particular, under conditions of severe stress, life insurance companies could be under group pressure[23] to provide capital (or liquidity) to the group entities (such as by investing in securitization products issued and arranged by the group bank). The lack of group capital requirement may create a conflict of interest where life insurers may provide capital to the group entities.[24] APRA is aware of this potential conflict of interest and imposes requirements that such investments take place at arm's length.

[23] The board of the life insurer is required (s48 LIA) to give priority to the interests of policyholders over shareholders. This example would seem to involve a clear breach of that provision.

[24] The life insurers and statutory funds must continue to meet their prudential requirements. There are level 1 requirements imposed on the life company. In addition, the level three framework requires groups to monitor intra-group exposures and set exposure limits. APRA can also impose license conditions to supplement these where necessary.

Box 2. Interlinkage Between Life Insurers and Other Financial Sectors

The contribution of the insurance sector to systemic risk has increased since the global financial crisis. The extensive analysis of the insurance sector in the IMF April 2016 Global Financial Stability Report identified increased commonalities in the exposure to aggregate risk within the insurance sector and other financial sectors. The changing nature of insurance activities (shifting to more asset management type business models) may contribute to higher commonalities with other financial sectors. The Australian insurance sector used to be highly connected with the banking sector through the conglomerate structure and high intra-group transactions. Recent divestments by the majority of the largest banking groups of their life entities have reduced the intra-group transactions significantly, although the level of intra-group transactions is still quite high compared to other advanced jurisdictions.

Life insurance companies have high investments into investment products managed by the group. According to a survey conducted by ASIC, investment linked products issued by life insurers on average invest 65 percent of the fund into in-house products, which is a higher proportion than for other investment services. While external products are available to the policyholders, they tend to choose in-house products, mainly due to the advice received through the sales channel.

The investments held under investment linked products are largely exempted from both APRA prudential requirements and ASIC conduct requirements. The majority of investment is made into unit trusts, mainly equity funds. Those tend to be structured as wholesale unit trusts and thus may not be subject to ASIC regulatory requirements for retail funds, and would thus not be subject to investment, leverage, liquidity, concentration, use of derivatives and other requirements. Instead, insurers need to provide clear investment mandates and limits to protect policyholders of those products. APRA capital charges are exempted for such products (except operational risk) unless the insurer provides an investment guarantee. Therefore, there is no incentive for insurers to diversify their investment portfolio. Some products seem to be using derivatives for leverage and security lending to enhance the investment return. If such products have an excessive concentration within the group (such as through holding of capital instruments issued by the group entities, or derivative or securities lending transactions with concentrated counterparties (typically the group bank)), it could result in contagion or an increased level of step in risk for other group entities, which is important prudential risk that APRA should be monitoring.

APRA and ASIC are encouraged to work jointly to analyze the risk arising from such investment products provided by insurers. APRA and ASIC have regular conversations on topics of mutual interest. At this stage, however, the cooperation on insurance mainly focuses on conduct issues related to insurance products, such as the claim data projects. Given the market development in investment linked products, there is merit in further exploiting potential synergies between APRA and ASIC to analyze the interlinkages, potential conflict of interests and potential systemic risk implications stemming from the interactions between insurers and asset management activities. Some of the findings support a case for potentially further strengthening of both prudential and conduct regulation and measures to address conflicts of interest, such as enhancement of disclosure, concentration/leverage limits for the investments and robust investment policies on the instruments issued by the group entities.

54. APRA should impose group capital requirements on large and complex life insurance groups, if high risk, capital creation, or capital relief transactions are identified in the intra-group transactions. Some life insurers are using complex vehicles within the group structure. Life insurance companies are subject to capital requirements both at an entity level and statutory fund level. Therefore, the implementation of group level capital requirement would become the third layer of policyholder protection. Nonetheless, a failure of large and complex life insurance group could have material externalities and affect the reputation of the authorities. APRA has monitored intra-group transactions and imposed a group capital requirement on one life insurance group. APRA is recommended to apply this approach universally by continuing to monitor intra-group transactions of other large and complex life insurance groups and imposing group capital requirements if high risk, capital creation, or capital relief transactions are identified in the intra-group transactions.

55. APRA and ASIC should strengthen coordination and monitoring of the investments made through unit trusts linked to insurance products and consider applying regulatory requirements similar to those of retail unit trusts. While the scale is declining, life insurers rely heavily on wholesale unit trusts, typically managed by the asset manager within the same group. As there is no regulation imposed to such wholesale unit trusts, there is a possibility that policyholders are exposed to unduly high risk, such as high leverage, high concentration, and illiquid investments. In addition, there is a potential conflict of interest between policyholders and the group. APRA should analyze potential systemic risk implications if monitoring reveals high concentration, leverage or liquidity risk. Australian authorities should also consider applying requirements similar to those of retail unit trusts, such as disclosure, leverage, concentration, liquidity, if necessary.

56. Additional safeguards should be provided to the recognition of derivative hedging, linked to adequate counterparty risk charges and liquidity risk management. Some insurers are actively using derivatives. While it is appropriate to recognize the benefits from robust hedging, this should be safeguarded by application of prudential treatments or similar considerations to address the additional risks from derivative transactions. For example, reliance on short-term hedging instruments could lead to additional exposure to roll-over risk. APRA is thus recommended to monitor closely and impose restrictions in case of excessive reliance on short term instruments. Similarly, counter party credit risk should be recognized for both current exposure and potential future exposure. A large volume of derivative transactions may cause liquidity stress due to the need to hold high quality collateral for initial and variation margin, and thus liquidity risk management would be important to the insurers and groups which have substantial derivative positions. While APRA is monitoring the liquidity situation, it would be useful for APRA to conduct thematic reviews among large insurers on the use of derivatives, particularly if the use of derivatives continues to grow.

C. Macroprudential Regulation and Surveillance

57. APRA Risk and Data Analytics (RDA) division provides comprehensive support to the frontline supervisors. RDA division monitors the macroeconomic environment, cross sectoral developments, and systemic risk by analyzing the data submitted by regulated institutions together with other sources of information. RDA produces a range of internal tools and reports, such as quarterly industry outlooks, analytical tool kits and annual industry reports.

58. The industry risk management framework has been established to identify and act on significant emerging industry-wide risks. APRA aims to be forward looking and identify thematic or macro-prudential risks and the industry's response to these risks. A key feature of the framework is the preparation of industry risk registers which outline heightened industry risks. Industry risk registers are included in an industry risk report, which includes cross-industry risks. The Supervision and Resolution Committee (SRC) has been established as the primary forum for senior level discussion and coordination. Its purpose is to oversee the risk profile of industries, contribute to material supervisory and resolution decisions, and to oversee core supervisory and resolution functions.

59. APRA is conducting supervisory stress tests for both life and general insurers. Enhancing the stress testing capabilities of insurers is an area of continued focus. APRA has conducted two supervisory stress tests, for life insurers in 2015 and for general insurers in 2016. The RDA team coordinates regular industry stress tests on a rolling three-year basis. The results of the APRA stress tests are reflected in supervisory activities such as dedicated discussions with the entity, on-site reviews, etc. APRA expects the stress test results to inform the insurer's approach to capital management, including maintenance of appropriate buffers. Supervisors will also challenge institutions where the results are not consistent with Internal Capital Adequacy Assessment Process (ICAAP) management actions. For more detail of the stress tests, refer to Box 3.

60. The determination of the capital requirement allows for management actions including a change of asset allocation, which need careful analysis from a macro-prudential perspective. As noted above, while a change of asset allocation could work under certain scenarios, it might cause herding behavior of insurers under conditions of market stress and insurers may not be able to reduce capital charges without substantial realized loss. Therefore, it is important to analyze the feasibility of such management actions by aggregating individual management actions and forming a judgement on the overall consistency.

Box 3. APRA Stress Tests

APRA conducted its first supervisory stress test on life insurers in 2015. The 2015 life insurance stress test was undertaken on a large, diverse representative sample of the industry. Eight firms, including two large reinsurers, participated in the exercise. 70 percent of the industry by insurance liabilities was covered. It covered all Australian entities within the participating groups including local subsidiaries of foreign owned groups, however the foreign entities and activities were exempted from this exercise.

The stress scenario assumed a severe downturn scenario in the Chinese economy that imposed a series of asset and liability shocks. The scenario assumes a 5 percent GDP fall, and a house price decline by 43 percent. The scenario for life insurers intentionally had a particularly severe impact on income protection insurance, both on incidence and termination rates. The scenario also prescribed certain additional details of the shock, such as equity prices drop by 44 percent, credit spread increases by 2.7 percent, etc. Other details of the scenario were left for decisions by each company, APRA collecting the scenario assumptions from each company with the results.

While the scenario had a severe impact on most participants, life insurers recovered after taking various management actions. The aggregate capital base dropped by 46 percent. However, participating life insurers

Box 3. APRA Stress Tests (concluded)

reported that capital positions could be recovered by taking various management actions. Some life insurers noted that they could change premiums and policyholders' dividends in an adverse scenario. Insurers also assumed other risk mitigation, such as an adjustment of their asset allocations and capital raising from the group entities or public. After taking the benefits from those management actions, the aggregate capital level returned to near pre-stress levels.

In 2016, APRA conducted a second stress test on general insurers. It covered the four largest direct insurers and two largest reinsurers, which represent about 70 percent of the market in terms of gross premium. The participants cover all Australian entities within the group but foreign activities were exempted. The scenario assumed a 3.8 percent GDP fall and a house price decline by 26 percent, which are generally milder than those of the life insurance scenario.

The two stress scenarios contained two different liability stresses as well as an economic stress common to both scenarios. The liability stresses were not tailored to insurers, with the same underlying stress (earthquake or Compulsory Third Party (CTP) claims) affecting all. The scenarios assumed that the stress took place over a three-year time horizon. Insurers assumed no adverse impact of the stress on reinsurance counterparty credit ratings/quality, under the view that the assumed scenario, such as the Australian earthquake event in isolation, would be unlikely to impact their counterparty, which hold large and internationally diversified portfolios. The impact on an insurer varied depending on its exposure profile.

In both scenario, while insurers suffered from some losses in year 1, risk mitigation recovered most of the loss in year 2 and 3. The most common mitigants were dividend restrictions, capital injections from the parent group, and premium rate increases. Mitigating actions reported by participants were consistent with those documented in their ICCAPs. Insurers assume an increase of capital, albeit with re-pricing. An Increase of premium warrants careful consideration how other competitors and policyholders behave.

Stress testing on Lenders' Mortgage Insurers (LMIs) has been conducted twice as part of ADIs stress testing. Given the similarity of risk and exposure between LMIs and ADIs, LMIs stress tests were conducted as part of ADIs stress test in 2014 and 2017. The same macro-economic scenarios provided to ADIs have been applied, with a focus on a severe housing market downturn.

APRA is preparing for an upcoming stress test for life insurers, which is planned to take place later in this year. Industry stress tests have been conducted on a three-year cycle (life insurers in 2015, general insurers in 2016 and ADIs in 2017). APRA has been increasingly centralizing stress testing resources and coordination through the dedicated Stress Testing Committee. Based on the lessons from the three stress tests, APRA is improving the approaches to make the exercises more consistent while taking into account the heterogenous nature of the insurance industry.

APRA is encouraged to continue to improve the methods and data availability for robust validation. Stress test results have been validated with available data. However, APRA staff seem to have faced challenges to validate the submitted results due to the lack of robust internal data. To avoid continuous ad-hoc data requests to the industry, especially in case of market turmoil, it would be useful for APRA to develop regular reporting tools that would strengthen the monitoring and analysis of potential stress, drawing on the lessons from the stress testing exercises.

61. APRA has conducted a number of horizontal reviews and ad hoc industry wide surveys. Horizontal reviews have been conducted within the broader activities of stress testing, benchmarking exercises and other industry/thematic reviews. In addition, APRA collects information from the industry when risks are identified or more information is needed to inform risk assessments. The analysis has identified outliers which are excessively exposed to those risks. Recent examples are summarized in Box 4.

Box 4. Horizontal Reviews and Ad-hoc Industry-wide Surveys

ICP 24 (Macroprudential Surveillance and Insurance Supervision) encourages insurance supervisors to perform horizontal reviews. A horizontal review is performed across many insurers around a common subject to reveal sector level vulnerabilities. It is also used to analyze whether industry practices are robust enough to address certain risks.

APRA's horizontal reviews include ad hoc reporting requirements, FSIs, and intensive supervisory reviews of outliers. APRA has actively conducted reviews of emerging issues, such as cyber security, remuneration policy. The reviews identify industry wide practices and/or outliers, which are subject to supervisory reviews and inspections to improve firms' practices and risk profiles. The following are some examples of reviews that APRA has conducted recently.

In 2015, cybersecurity preparation has been reviewed across the financial sector. The purpose of the activity was to inform APRA of any industry-wide issues, challenges or concerns. The results of the survey and analysis was released in an information paper in September 2017. It revealed that financial entities experienced a range of incidents, and that the frequency of incidents correlates with entity size, where the group of the largest entities experienced almost twice as many significant cyberattacks as the next largest group. Most participants have plans to implement security incident and event monitoring systems by engaging specialist security services providers. Based on the exercise, APRA has introduced a new cross-sectoral prudential standard, titled as "Information Security Management" in March 2018.

APRA has undertaken a stocktake of current remuneration practices in large financial institutions, including the insurance sector. The primary aim of the review was to allow APRA to better gauge how existing remuneration related requirements contained within the relevant standard and guidance were applied in practice. The review primarily focused on whether performance-based components of an entity's remuneration framework have been designed to encourage behavior that supports the long term financial soundness and risk management framework of the entity. Outcomes from the review were conveyed to institutions in April 2018. The review has been supplemented by the forthcoming Banking Executive Accountability Regime (BEAR), although an insurance entity is not subject to the regime.

A review of target surplus was undertaken in 2016 and 2017, focusing specifically on the approach and methodologies applied by life insurers. The objective of this review was to assess different target surplus approaches used by insurers to determine APRA's position on minimum standards of adequacy and identify better target surplus practices and areas for improvement.

Recommendation

62. APRA should enhance their data and information collection further both at solo and group level, so as to enable supervisors to deepen their analysis of individual firms and sectoral risks. The current IT system storing insurers' data has been in use for over 10 years. While the introduction of LAGIC in 2013 had given a significant opportunity for APRA to improve the reporting system, APRA has not made a major upgrade of the reporting requirements regarding the detail of capital requirement calculations and the supporting system, and the system is clearly behind international best practice. In particular, the regular reporting requirements and data is not granular enough to decompose management actions and effects from risk mitigation instruments. There is also not sufficient data to validate either gross or net exposures. A systematic review of data and information requirements would be helpful to support and enhance prudential supervision of both firm and system-wide risks and reduce the current reliance on ad hoc surveys.

D. Market Conduct

63. Despite limited powers and resources, ASIC has put considerable effort into strengthening conduct in the insurance sector in recent years. Drawing on and contributing to best practice internationally through the IAIS,[25] ASIC has adopted and improved a risk-based approach based on multiple sources of information. Those include lapse and churn rates as mis-selling indicators and complaints obtained through the Financial Ombudsman Service and other sources (consumer groups, whistleblowers, and breach reports). ASIC is also actively monitoring sales materials, listening to sales phone calls, conducting shadow shopping and consumer research. While ASIC has seen a gradual improvement in the management of conduct risk in the insurance sector, ASIC still sees room for additional improvements and the insurance sector remains a key ASIC focus.

64. ASIC has identified several key areas of poor conduct which have prompted subsequent thematic reviews. In particular, product designs need to improve the value for the policyholders. Remuneration structures should promote policyholders' interests. There is still some misleading advertising. Quality of advice by intermediaries is weak in some areas, particularly advice pertaining to life insurance. Some disclosure is inadequate, misleading, lengthy and difficult to understand, and ASIC is also observing some inappropriate sales practices, such as targeting vulnerable customers. Claim handling and dispute resolutions also warrant additional enhancement by firms.

65. The Corporations Act has been amended to raise education, training and ethical standards of financial advisers (FAs) of life insurance products. The reforms would apply to an individual who is an Australian Financial Services (AFS) licensee, as well as an authorized

[25] ASIC has been playing a leading role in the market conduct policy developments in the IAIS. Mr. Michael Saadat (Senior Executive Leader of Deposit-takers, Credit, and Insurers) is the chairman of the IAIS Market Conduct Working Group which has been producing a number of important studies, for example an issues paper on conduct of business and its management which was released in November 2015. The working group has also contributed to upcoming revision of ICP 18 (intermediaries) and 19 (conduct of business) standards and is currently working on an issues paper on the increasing use of digital technology in insurance business and its impact on fair consumer outcomes and conduct of business supervision.

representative, employee or director of an AFS licensee, etc. It would cover a wide range of financial products except basic banking products, general insurance products, etc. All relevant individuals must meet requirements, including holding a relevant bachelor or equivalent qualification, passing an exam, continuing professional development, completion of a year's training, and compliance with a code of ethics. Those conditions are to be introduced in a phased manner, ranging from January 2019 to January 2024.

66. ASIC is encouraging the insurance industry to improve their practices through the establishment and enhancement of codes of practice. ASIC is coordinating with industry associations to establish and improve their codes. For example, the development of the Insurance in Superannuation Code of Practice introduced tighter timeframes for claim and complaints handling. It will also help to improve more consumer-focused disclosure. However, there are some shortcomings. For example, the codes have a long transitional period and are purely voluntary. ASIC is working with the life and general insurance industry associations to address those shortcomings, such as minimum standards for insurance investigators and introducing standard medical and condition definitions. These points have also been made by ASIC in the process of revision of the General Insurance Code of Practice.

67. The Government issued a consultation paper in June 2017 to provide ASIC with a power to mandate approval of industry codes in the financial sector. According to the proposal, ASIC could mandate which codes require ASIC's approval, and financial entities would be required to subscribe to the relevant code. The approved codes should be enforceable by contractual arrangements under a code monitoring body. In addition, a customer should be able to seek appropriate redress through individual and external dispute resolution for non-compliance with an applicable approved code. According to several industry representatives, while they support the Government and ASIC initiatives on this front, a dilemma exists as to how to motivate the industry to improve the code itself, while ensuring policyholders' protection in case of a breach of the code.

68. Insurers and intermediaries are required to provide timely, clear and adequate information to the customers. The Corporations Act 2001-financial services disclosure requirements include an obligation to provide the following three documents to retail clients.

- Product Disclosure Statement (PDS) needs to be given to retail clients at or before the contract. There are certain contents which need to be described in the PDS which must be worded and presented in a clear, concise and effective manner.

- Statement of Advice (SOA) sets out or records personal advice which a FA gives to a retail client, which is required for life insurance products and certain general insurance products when personal advice is provided.

- Financial Services Guide (FSG) describes the key features of the financial services provided. It must include details of the licensee, information about remuneration arrangements and potential conflicts of interest of the licensee and others, as well as dispute resolution arrangements.

ASIC Regulatory Guide 168 Disclosure gives policy guidance on preparing a PDS and explains how ASIC will monitor the use of PDS and enforce PDS requirements.

69. AFS licensees must notify ASIC in writing of any "significant" breach of their obligations under licensing conditions, compensation arrangement, or financial services laws. Licensees need to give appropriate consideration to whether the breach is significant and if so provide timely notification to ASIC, as soon as practicable and in any event within ten business days of becoming aware of the breach or likely breach. While failure to report is subject to penalties, a recent Royal Commission hearing revealed that ASIC is experiencing undue reporting delay from financial firms. According to a review of ASIC's of breach reporting practices, the average time frame from an event occurring to it being identified internally within the firm for investigation takes more than four years. In addition, the average time frame from the start of an internal investigation to lodging a breach report was 123 days.

Risk Based Supervision

70. ASIC has shifted the supervisory approach from compliance based to risk based. To allow maximum flexibility of limited resources, supervisors are not allocated to individual firms. Rather, surveillance is undertaken at various levels, including individual firm, multi-firm, and thematic reviews by utilizing a range of tools, including data requests, review of business processes and strategies, file or call reviews, and discussions with management. Onsite visits are also conducted to complement off-site exercises. To adjust the focus in line with emerging risks, ASIC is conducting regular assessments, including a weekly assessment and semiannual business planning, in addition to multi-year cycle corporate planning for strategic priorities.

71. ASIC has information gathering powers and actively uses these powers to enhance its surveillance capabilities. The Corporations Act, ASIC Act and Insurance Contracts Act allow ASIC to issue directions and notices to provide information. Surveillance has focused on ensuring understanding of an identified issue and assessing the adequacy of remedial action. Tools are also used to test for poor outcomes and understand the root cause and adequacy of systems, processes, controls and resources. According to industry representatives, ASIC monitoring exercises have been strengthened over the years, and while they do not welcome the costs of information provision to ASIC, they understand the rationale and priorities of those exercises.

Corrective Measures and Enforcement

72. ASIC deploys a range of tools for corrective measures and enforcement. Negotiated outcomes and enforceable undertakings are permitted to remediate policyholder losses under agreement of the financial entity. If an entity breaches such an undertaking, ASIC can obtain a court order compelling the entity to comply with the undertaking and/or remedy the breach. In some cases, the insurer taking corrective measures agreed to provide a payment to benefit the community as well as to conduct an independent compliance review. ASIC also can issue infringement notices to penalize lesser compliance breaches. For more serious breaches, ASIC can issue stop orders or injunctions to prevent further sales of financial products or to compel compliance. ASIC can also penalize more serious misconduct that may not be criminal in certain conditions. In addition, ASIC can ban and cancel a financial services license and make criminal prosecutions.

73. However, ASIC enforcement powers remain relatively limited in some areas and further strengthening is warranted to raise their effectiveness. In October 2016, the Government established a Taskforce to review the enforcement regime which found several limitations. The resulting Taskforce recommendations include, (i) enhancement of licensing and banning powers, (ii) increase of penalties, (iii) enhancement of search warrant powers, and (iv) new directions powers. The Government has agreed or agreed-in-principle with all of the recommendations, although some reforms are currently pending due to possible interactions with the recommendations from the ongoing RC.

74. ASIC does not currently have any product intervention power, such as approval, change or prohibition of a new product. In response to the FSI in 2015, the Government committed to introduce product design and distribution obligations. These would impose requirements related to product design, product distribution, review of product performance, distribution strategies, conduct at point of sale, and would allow ASIC to take regulatory actions to remedy deficiencies. It would also grant ASIC new product intervention powers, which would enable ASIC to intervene in relation to the product feature, the types of consumers that can access the product, or the circumstances in which consumers access the product. Draft legislation was released for public consultation in December 2017.

Dispute Resolution Schemes

75. There are three external dispute resolution schemes, which are planned to be merged in November 2018. The Financial Ombudsman Service (FOS) handles the complaints about general and life insurance policies. The Superannuation Complaints Tribunal (SCT) covers complaints relating to insurance products sold through superannuation. These two schemes along with one other credit scheme, the Credit and Investments Ombudsman (CIO) will be merged into the "Australian Financial Complaints Authority".

76. FOS reported that general insurance disputes increased by 28 percent, but those of life insurers declined by 7 percent in 2017 compared with in 2016. 33 percent of the claims of general insurers are related to Auto insurance. 69 percent of general insurers' disputes concerned claim handling (such as denial of claim or the amount of payment). Similarly, the most common disputes for life insurers is denial of claims. In income protection disputes, disputes are heavily related to communication from insurers to policyholders regarding the ceasing of benefits. Most of the disputes have been resolved by the mutual agreements. Of those that go to decision by FOS, slightly more are found in favor of the financial providers than the applicant policyholders.

77. According to industry representatives, the increasing number of disputes are mainly due to increasing awareness of policyholders' rights. The claim handling process, which is the reason for many disputes, has been improved over the years, by increasing resources, and strengthening process and governance in claim handling at most insurers, although there are some mixed views on the current status of the improvement among industry representatives. Whenever FOS identifies systematic issues, FOS is required under its Constitution to inform ASIC and the two bodies will coordinate to address the problem.

Quality of Advice and Commission Structure

78. ASIC has conducted an intensive review of life insurance advice in 2014 and found material problems, such as high lapse rates, failures to meet legal standards and material conflicts of interest. The review focused on the advice that policyholders received about life insurance products. ASIC conducted roundtables, a survey of twelve life insurers and targeted surveillance of advisers who provided advice on life insurance products. It found that life insurers are suffering from a high lapse rate (more than 14 percent) for major life insurance policies with step up premium adjustments. It also found significant variation on the quality of advice and that 37 percent of the policyholders received advice that failed to meet the relevant legal standard. It also found that advice given on products where there is an upfront commission have a significantly higher fail rate. ASIC concluded that the impact of adviser conflicts of interest on the quality of life insurance advice is an industry-wide problem.

79. ASIC has implemented remuneration reforms and is enhancing data collection for further review. In November 2015, Parliament passed the Corporations Amendment (Financial Advice Measures) Bill to introduce remuneration reform covering life insurance products. The reform was specifically targeted at reducing adviser's incentives to engage in unnecessary product replacement. By reducing the incentive to churn clients through products, the reforms are intended to provide a better basis for the provision of advice. The reform has become effective from January 2018, although exemptions are granted to certain life insurance products such as existing policies.

80. Key components of remuneration reform include a cap on upfront commissions and claw back requirements. Given the high ratio of lapses and failures on products with upfront commission, a cap was introduced equal to 60 percent of the initial premium and 20 percent on ongoing premiums. It also introduced a claw back requirement, under which a portion of the upfront commission is repaid to the insurer if the life insurance product lapses in the first two years. However, because of the number of exemptions and permanent grandfathering arrangements, the ASIC submission to the RC revealed that grandfathered commissions continue to form a significant portion of adviser remuneration.[26] In addition, grandfathered commissions incentivize advisers to keep clients in legacy products, even where there may be better alternatives available to meet the client's needs.

81. ASIC is also taking supervisory action, including enhancing data collection for further review. ASIC is engaging with AFS licensees, advisers and their professional associations about the issues they need to consider. ASIC is also updating the consumer information requirements to provide better guidance for policyholders about their life insurance. ASIC is also expanding its data

[26] For instance, it appears that the majority of revenue that is being paid to financial planners within the AMP network is derived from grandfathered commissions – Regan; T1150.32. See also Kotsopolous; Exhibit 2.11 at [13]-[14].

collection and will continue to review and assess whether the reforms have addressed the material problems. ASIC is committed to conduct a post-implementation review in 2021 to assess the impact of the reforms.

Life Insurance Claim Handling

82. ASIC has examined claim handling practices in the life insurance industry given concerns about some products. ASIC has conducted this review to identify whether data or industry indicators suggest the need for additional focus on this issue. The review covered death, disability, trauma, and income protection. This review did not find evidence of cross-industry misconduct across life insurers. However, there were issues of concern in relation to declined claim rates and claims handling procedures associated with particular type of policies (disability), particular insurers, direct sales channels as well as particular causes of consumer disputes. Although a large majority of claims are paid, the review highlighted that some claims have been declined on technical grounds that are not in accordance with the spirit or intent of the policy.

83. Thematic reviews have been conducted to follow up, focusing on higher decline rates. Decline rates were higher for policies sold without personal advice and for disability insurance. Of the claim-related disputes, most disputes related to the evidence that the policyholder was required to submit to the insurer to assess their claim and the timeframes taken by an insurer to assess a claim. The review also identified limitations of the current claim data, which makes it quite difficult to compare declined claim rates across insurers, for insurers to assess the performance of their claim handling, and for policyholders and other stakeholders to assess the claims outcome and performance. ASIC and APRA are working together on ongoing data collection and publication at the industry and insurer level to address this issue.

Add-on Insurance

84. ASIC identified systemic problems with the sale of add-on insurance products in car dealerships. A range of add-on insurance products are sold through car dealerships (e.g., tire and rim insurance, Consumer Credit Insurance (CCI) and GAP cover[27]). The review identified significant low claim ratios due to restrictions in cover and overlapping cover, which suggest extremely poor value for policyholders. Policies have been sold in a high-pressure environment and reflect reverse competition, where insurers compete for access to car dealer distribution networks by paying extremely high commission (up to 80 percent). Car dealers earned four times more in commission than consumers received in claims.

85. ASIC has taken action to secure refunds and negotiated commission reductions. These negotiations resulted in refunds totaling over A$120 million paid to over 210 thousand policyholders. The industry is also reducing their commissions to car dealerships. ASIC also issued a consultation paper to propose a deferred sales model for add-on insurance products sold with cars that would

[27] Gap cover insurance is to help the policyholder (auto loan borrower) to pay back the outstanding auto loan balance in case of an accident or theft.

require a pause in the sales process, introduce tools to improve consumer decision making, require enhanced supervision obligation for insurers, and use technology to create opportunities to drive a better sales process.

Consumer Credit Insurance Sold by Banks

86. ASIC identified poor selling practices and claim outcomes in Consumer Credit Insurance (CCI) sold by Authorized Deposit-taking Institutions (ADIs). CCI is usually sold to policyholders either when the policyholder applies for credit or after the policyholder has taken out a credit product. Complaints reviewed by ASIC highlighted multiple conduct issues, including consumers being sold CCI without their consent, pressure tactics being used to induce consumers to purchase, misleading representations being made during the sale of CCI products, and serious deficiencies in the scripts used for the sale of CCI products. In addition, a large proportion of CCI claims are denied.

87. The majority of CCIs were sold together with credit cards, while others are linked to personal and mortgage loans. About 20 percent of consumers with mortgage, personal loans or credit cards also purchased CCI. Especially noteworthy, the majority of consumers of personal loans also purchased CCIs. The overall rate of denied claims was 16 percent, with one ADI having a denial rate of 47 percent for CCI sold with credit cards. 14 percent of CCIs were cancelled during the period (1 year) that this review has been conducted for reasons other than the closure of the loan.

88. ASIC review of CCI sales practices identified serious issues. Serious issues have been observed in a number of ADIs. Seven ADIs had scripts that did not point out that the purchase of CCI was optional. Four ADIs had used potentially ambiguous words (such as activate, enroll, and process) to confirm that a consumer was buying CCI. Nine ADIs had scripts that did not include a clear question about whether consumers consented to the purchase. Ten ADIs had scripts that did not point out the main applicable exclusion.

89. ASIC has taken actions to improve practices. One ADI refunded over AUD 10 million to policyholders. A working group was established to develop a deferred sales model and better sales practices, which was incorporated into the Banking Code of Practice. The Australian Banking Association has established a new Code of Banking Practice lodged with ASIC for approval in December 2017, which include a new deferred sales model, where to avoid customer's misunderstanding that CCI is part of the credit card approval, CCI is now offered after the issuance of a credit card. It also includes other requirements, such as enhanced disclosure and customer's consent processes.

Conflict of Interest from Group Entities and Group Supervision

90. ASIC is mindful of a possible conflict of interest arising from group entities. While the degree of vertical integration has lessened as the life insurance arms of several large Australian financial conglomerates have been sold to foreign insurers, several large financial entities still have a vertically integrated business model covering a range of financial products and services, from banking, insurance, superannuation, asset management, and financial advice services. While advisers are required to act in the best interest of policyholders, there are potential risks of inappropriate advice due to conflicts of interest from such business models.

91. ASIC has conducted a project to review how the largest banks and financial services institutions manage the conflicts of interest. All financial institutions provide both inhouse and external products. However, the review demonstrated that investments are skewed to inhouse products. In case of insurance products, the share of in-house products was 65 percent.

92. The review found that most advice does not comply with the regulatory requirements. A common theme was the unnecessary replacement of financial products, especially related with insurance products already in place through superannuation. Moreover, in 10 percent of the files reviewed, ASIC found significant concerns about the potential impact of the noncompliant advice on the customer's financial situation.

93. ASIC is undertaking a range of regulatory actions to remedy the situation. To improve the quality of advice provided by largest banking and financial services institutions, ASIC has taken several actions, including enhanced monitoring and applying enforcement actions on some advisers with serious compliance failings, such as revocation of licenses and criminal prosecution. ASIC is also conducting a project that focuses on the remediation process where advice-related failures have led to poor customer outcomes.

Recommendations

94. ASIC is encouraged to continue to build its supervisory effectiveness of insurance conduct issues, by taking a more forward-looking approach and by strengthening further the close cooperation with APRA. ASIC has transitioned to risk-based supervision and improved the effectiveness of conduct supervision significantly. However, supervisory activities still focus heavily on remediation of materialized incidents with a particular focus on the products which face high lapse rates and low claims ratios. Further attention is warranted on preventative actions to mitigate future misconduct risks. In particular, ASIC could enhance cooperation with APRA to expand the ERM framework to cover conduct risks. Future conduct risk could be mitigated by imposing a robust governance and risk management framework in key processes, such as product design, level, and design of commissions, development of marketing and advertisement tools, training of sales channels, etc. ASIC and APRA should coordinate closely, ideally through joint reporting requirement and inspection to follow up the implementation of the ERM requirements.

95. The authorities should continue efforts to strengthen ASIC powers for intervention, correction, and enforcement. While ASIC has a wide range of tools for corrective measures and enforcements, there are a number of limitations as highlighted by recent inquiries including a government-led ASIC enforcement review taskforce in 2017. For example, ASIC does not yet have a power to intervene to ban or prohibit conduct in relation to products and require changes be made to better align product design with customer needs (legislation to provide ASIC with these powers is in draft form). The maximum civil penalties that ASIC can currently apply to misconduct within the financial sector is low and often less than the value of benefits obtained from the contravening conduct. A civil penalty cannot currently be imposed for failure to report material misconduct incidents. The Government agreed or agreed-in-principle to all of the findings and recommendations made by the ASIC enforcement review taskforce, however the implementations of many recommendations are pending as the RC may make recommendations on the same matters. Early and clear commitment by the government to implement the enhancement of ASIC powers would also give stronger negotiation power to remediate policyholders' loss and improve internal governance of the insurers. Product intervention powers would also provide useful tools for ASIC to encourage the industry to accelerate work on further standardization, simplification, improvement of sales materials and practices, quality of advice, etc.

96. ASIC should make the best use of existing enforcement powers to generate a stronger incentive for insurers to improve conduct risk management. While further strengthening is needed, ASIC has already a wide range of powers, including some strong powers such as suspension and revocation of licenses. While these actions can only be taken after certain incidents, more active use of those strong powers could support ASIC in creating additional incentives among insurers for the prevention of misconduct and improvement of their governance. Active use of these powers accompanied by disclosure of the actions would also help to improve the social trust in the sector.

Box 5. ASIC Initiatives on Fintech

ASIC is actively promoting innovation in the financial sector through Fintech. ASIC is one of the most active regulators in the world on Fintech space. The Government and ASIC have implemented a number of initiatives including (i) Innovation Hub, (ii) Regulatory Sandbox and (iii) the Enhanced Sandbox proposal. The ASIC approach is guided by the objective of finding the right balance between innovation and consumer protection. Fintech has significant potential to improve efficiency and competition but may also have adverse effects on consumer protection absent appropriate regulation. ASIC is considering both aspects, ensuring that markets operate in a fair, orderly, and transparent manner. The government is also supporting the Fintech sector so as to remain at the forefront of international developments, such as through the establishment of a FinTech Advisory Group, releasing a Backing Australian Fintech statement, and introduction of a new bill to expand the ASIC Regulatory Sandbox.

The ASIC Innovation Hub is assisting about 300 fintech startups developing innovative financial products and services to navigate regulatory requirements. Through the Innovation Hub, ASIC engages with the fintech community by hosting and attending events, provides eligible businesses with a designated contact to help understand the regulatory framework, offers one-stop information through the dedicated website, and addresses innovation issues through a coordinated approach. In particular, the hub has been established to facilitate close coordination across ASIC departments on fintech issues and also to help fintech firms understand ASIC's views on good consumer outcomes. The Innovation Hub includes a Digital Finance Advisory Committee, composed of nine external experts, which helps ASIC to make informed decisions on which areas to focus.

The ASIC regulatory sandbox provides more support, including licensing exemptions to the firms which meet the conditions. To mitigate the risks to consumers, the regulatory sandbox imposes various caps on the entities which succeed in applications for 12-month licensing exemptions. These conditions include, (i) maximum of 100 retail clients, (ii) total client exposure up to A$5 million, (iii) investments up to A$10,000 per retail client, and (iv) in case of general insurance up to A$50,000 coverage per policyholder (life insurers are not allowed to use the

Box 5. ASIC Initiatives on Fintech (concluded)

regulatory sandbox). Other regulations, such as core conduct disclosure requirements, remain applicable to the services provided by entities operating in the sandbox.

ASIC is observing limited developments in the Insurtech space. However, ASIC is aware that many Insurtech firms are actively collaborating with incumbents, especially in general insurance. For example, a start-up is collaborating with one large insurance group to launch micro-insurance products on a blockchain to insure consumers' peer-to-peer transactions. Other applications include easier, more accurate, and prompter claim handling, as well as more tailored and effective marketing and pricing. In the near future, ASIC is not expecting major disruption in the insurance sector.

The Government made a proposal to enhance the ASIC Sandbox in October 2017, including to expand the scope to cover life insurance and superannuation. The Treasury released draft regulations proposing to expand ASIC's Regulatory Sandbox in terms of (i) testing period length (up to 24 months) and instances of entry, and (ii) expanding the scope to allow additional services and products. The proposal expands the eligible services to life risk products up to A$300,000 coverage per retail policyholder and superannuation products up to A$40,000 investment per retail client.

ASIC is expecting that a sizable number of entities could apply for the proposed enhanced regulatory sandbox. ASIC approves over 700 AFS license applications on a yearly basis and has provided informal assistance to over 200 fintech businesses over the last two years. The ASIC comment letter to the consultation paper suggests that potentially "a material portion of these businesses could decide to rely on the proposed enhanced regulatory sandbox. This could be in the hundreds per year." This would impose another challenge on ASIC to ensure consumer protection of clients given the likely diversity of products and approaches.

ASIC is also exploring possible applications of Artificial Intelligence (AI) and Machine Learning (ML) to enhance conduct supervision. Currently, ASIC is devoting significant staff resources to monitor sales calls, and to review advertising materials to detect inappropriate sales practices to support conduct supervision. While such activities are identifying many incidents, resource limitations prevent ASIC from expanding the scope of the surveillance. Recently, ASIC initiated a project to develop pilot models to assess the feasibility of using natural language processing to support conduct supervision. ASIC is currently testing the pilot models and is finding significant potential. Given current resource limitations and heightened social expectations of policyholder protection, such projects should be prioritized and supported by an appropriate budget allocation to confirm their feasibility.