Discussion Paper: *Premium Adjustment Mechanisms*

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The Insurance in Superannuation Working Group

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ISWG Foreword

Group insurance in superannuation and particularly its automatic issuance on an opt-out basis has been a successful policy for Australia which has resulted in better risk protection for Australians from all walks of life. It provides a safety net to millions of Australians who would have otherwise not chosen or been able to take out life and disability insurance individually. These benefits contribute significantly to addressing Australia's underinsurance gap and relieving fiscal pressures on our social security system.

The Insurance in Superannuation Working Group (ISWG) was formed in November 2016 to collaboratively enhance future iterations of policy development. While the current policy settings are fundamentally right, there is industry acknowledgment that changes need to be made to improve the experiences of superannuation fund members, including the explanation and disclosure of arrangements that impact them.

Members need to be placed in the middle of a complex stakeholder hierarchy with clarity that superannuation funds are advocating on their behalf. Superannuation funds and insurers must work together in order to achieve the most sustainable benefits for members. Accordingly, the ISWG contains superannuation fund, insurer, industry and consumer representatives.

The ISWG believes that: **The objective of insurance in superannuation is to support the purpose of superannuation by providing a measure of financial support to members and/or their families if the member is prevented from working, either temporarily or permanently, to retirement age by death, terminal illness, injury or ill-health**.

This objective has to be balanced with the broader purpose of superannuation being the provision of retirement benefits for those that do have a full working life, recognising that insurance premiums will erode those sums to some extent. The challenge for superannuation funds is managing these competing objectives and making sure that the balance between meeting needs and affordability is appropriately established and managed into the future.

A key deliverable for the ISWG is a Code of Practice that will apply to superannuation funds. This code will extend on the current Financial Services Council (FSC) Life Insurance Code of Practice by setting standards that ensure a common end-to-end experience for all classes of life insurance consumers.

This discussion paper is one of several focusing on key issues that need to be addressed by the industry. Feedback received from these discussion papers and other stakeholder consultations will inform the development of the Code of Practice and Good Practice Guidance for superannuation funds.

Premium Adjustment Mechanisms were selected for this review because, while they have benefited members, there have been concerns over their transparency and use. Improved transparency and guidance on their appropriate operation will provide greater confidence to both members and the public that they act in the best interest of members.

Unless stated otherwise, the statements in this paper reflect the views of the ISWG as a collective.

EXECUTIVE SUMMARY

Premium Adjustment Mechanisms are arrangements between certain superannuation funds and their insurers to return some group risk premium payments to the fund where the claims experience is less than assumed in the pricing of the insurance contract – and vice versa.

Premium Adjustment Mechanisms benefit members by delivering insurance prices that are lower for superannuation fund members overall and are more closely aligned with underlying claim costs, thus improving equity between insured members.

For life insurers, Premium Adjustment Mechanisms lead to lower capital requirements, so the reduced cost of capital can be passed on to funds and their members through more competitive insurance prices. The lower capital requirements also lead to increased insurance risk capacity in the market, further improving competition.

While these arrangements continue to provide flexibility to deal with the uncertainty of future claims experiences, the ISWG acknowledges that disclosure about Premium Adjustment Mechanisms would benefit from being codified and needs to be addressed on a fund and whole of industry basis.

Other concerns have been expressed about the management of conflicts of interest, and the possibility of inappropriate payments being made to third parties. While the current regulatory regime already means that inappropriate payments to third parties is proscribed, there have been suggestions by some that this may have been occurring. Many of these concerns may have arisen because of poor transparency and lack of articulation by the superannuation and insurance industries that Premium Adjustment Mechanisms must be used for the benefit of insured members.

This discussion paper outlines several proposals to improve Premium Adjustment Mechanisms, and seeks responses to questions about them. These proposals include:

- Use of the term Premium Adjustment Mechanism for consistency across funds and to more clearly explain the arrangements;
- Adoption of the principle that to ensure equity and transparency, Premium Adjustment Mechanism payments should, to the greatest extent possible, be used to benefit the members whose premium payments relate to these payments;
- Trustees using Premium Adjustment Mechanisms must have a detailed documented policy that is publicly available;
- Introduction of an industry-wide requirement that all Premium Adjustment Mechanism payments must be allocated to the fund's Insurance Reserve, and operate in accordance with an Insurance Reserving policy; and
- There should also be disclosure in the fund's annual report and relevant insurance documentation about the existence of Premium Adjustment Mechanisms, the associated policies, and details of payments made.

The discussion paper also explains the different Premium Adjustment Mechanism models, identifies both appropriate and inappropriate uses of Premium Adjustment Mechanism payments, and discusses the regulatory environment within which Premium Adjustment Mechanisms operates.

We want your feedback

We invite you to comment on the key questions that have been raised in Section B of this discussion paper. All submissions on this discussion paper are due by **12 September 2017** and should be sent to the Project Management Office at:

ISWG-PMO@kpmg.com.au

All submissions will be treated as public documents unless you specifically request that we treat the whole or part of your submission as confidential.

SECTION A: DISCUSSION

A.1 What are Premium Adjustment Mechanisms?

Premium Adjustment Mechanisms (variously referred to as Insurance Experience Adjustments, Premium Equalisation, Claims Experience rebates, and Profit Sharing rebates) are provided in group insurance contracts held by superannuation funds for members as mechanisms to return a portion of premiums to members where claims experience emerges more favourably than assumed in the pricing. In some circumstances, the mechanisms can be two-way payments and may allow future premiums to be increased reflecting poor underlying claims experience.

Premium Adjustment Mechanisms have been in existence since the earliest group life contracts (having been used in employer arrangements). They are typically reviewed annually over a number of years as more information becomes known about the claims experience. Premium Adjustment Mechanisms are distinct from volume bonuses (which are unrelated to the claims experience). They are not commissions, but an adjustment mechanism for premiums over time to more closely align with the actual claims experience of the contract.

For insurance within superannuation, any payments arising out of Premium Adjustment Mechanisms are ordinarily payable to the fund (typically into the fund's Insurance Reserves) for the benefit of members, and are not paid to the trustee company, its directors, fund administrators, sponsoring employers or unions.

Members are the beneficiaries of these Premium Adjustment Mechanisms where the cumulative adjustments are used to reduce future member premiums or provide for expanded insurance services to members, such as additional support for claimants, improved insurance administration, online insurance tools and enhancements to insurance benefits.

These adjustment mechanisms can be two way payments. They can be either a payment from the insurer to the fund, or the fund to the insurer.

The different models for Premium Adjustment Mechanisms are detailed in Appendix 1.

A.2 What are the benefit of Premium Adjustment Mechanisms for members?

Premium Adjustment Mechanisms are a way to deal with the uncertainty involved with setting premium rates for group insurance policies. They are designed to create greater alignment between superannuation funds and insurers and help ensure insurers do not make excessive profits at the expense of superannuation fund members.

Where uncertainty exists, both superannuation funds and insurers want the confidence that future claims costs associated with new or uncertain risks can be sustainably priced. Under a group insurance policy which does not make use of Premium Adjustment Mechanisms, the insurer will set premiums based on its expected future level of claims costs and, subject to commercial considerations, will look to include a contingency margin in the premium rates set to reflect uncertain future experience.

By using Premium Adjustment Mechanisms, excess premiums can be returned to the superannuation fund for the benefit of members where the future level of claims cost is less than expected. This allows insurers and funds to smooth premium outcomes for members over time and avoid using conservative contingency margins in setting premium rates. As a result, insurers need to hold less capital against the business, thus reducing premium costs.

These mechanisms have been particularly important over the past few years where there has been increasing levels of claims incidence, including an increase in late notified claims. In this environment, it has been difficult to estimate when the increasing numbers of claims would stabilise.

Premium Adjustment Mechanisms provide a level of protection for the insurer in that, over time, the premiums paid will align with the claims experience cost. This also helps to provide greater competition in the insurance market for superannuation funds where insurers may otherwise not participate in contract tenders. At the same time, prices paid by members in funds with Premium Adjustment Mechanism arrangements are often more stable compared to those without them (particularly when combined with shorter rate guarantees) as the mechanisms allow for more gradual adjustments to reflect the experience rather than significant step changes at the end of a longer guarantee period.

A.3 What concerns are expressed about their use?

Questions have been raised in public debate about whether Premium Adjustment Mechanisms are used appropriately. Concerns are around:

- Whether Premium Adjustment Mechanisms result in higher net premiums than if such arrangements were not in place;
- Whether the existence of Premium Adjustment Mechanism payments may cause the trustee to be in conflict with the requirements of Section 52(7) of the Superannuation Industry (Supervision) Act 1993 (SIS Act) which requires "each trustee to do everything that is reasonable to pursue an insurance claim for the benefit of a beneficiary if the claim has a reasonable prospect of success", since the fund will pay less for insurance if more claims are declined;
- A lack of transparency resulting in perceptions in some quarters that Premium Adjustment Mechanisms are a form of commissions;
- Limited community understanding about the basis and use of Premium Adjustment Mechanisms arising from widespread lack of disclosure about them;
- A perception that Premium Adjustment Mechanisms could be a way to make inappropriate payments to third parties;
- Whether Premium Adjustment Mechanism payments are received by the superannuation fund for the benefit of members, as opposed to being retained by the trustee;
- Whether Premium Adjustment Mechanism payments benefit the specific members who paid the insurance premiums, and whether it is always possible to make payments to members who have left the fund; and
- The arrangements to ensure expenditure of Premium Adjustment payments are related to the member's insurance experience with a fund.

These concerns are addressed in this paper, and show the importance of transparency and explanation to improve the understanding and suitability of any arrangements.

A.4 How widespread are Premium Adjustment Mechanisms?

Premium Adjustment Mechanisms tend to be more commonly used by larger superannuation funds and so cover a large portion of the overall pool of superannuation members with insurance.

They can be found in:

- Many larger industry superannuation funds, where adjustments relate to the fund's own claims experience;
- Corporate plans or employer plans within superannuation funds, where Premium Adjustment Mechanisms relate to the experience of the specific group policy (typically where the employer pays the insurance premiums), or for multinational companies, the experience across all related policies associated with employees of that multinational company participating in the pool;
- Circumstances where the insurer and the trustee cannot agree on the likely prevalence or impact of a future event such as the impact of structural change in an industry and its impact on claims. In such cases, Premium Adjustment Mechanisms are used to ensure that the ultimate cost of insurance aligns more closely to the cost of claims.

Based on a survey conducted of 3 large group insurers (covering 54% of the $6.9bn group market), the prevalence of these arrangements is summarised in the table below:

Size	**% Premium with Premium Adjustment Mechanisms**
Large (premium >$100m)	79%
Medium (premium $10m - $100m)	0%
Small (premium <$10m)	5%
Overall	61%

The key conclusions from this data are:

- There are small number of funds with large premiums (6 out of 11 funds with these 3 insurers) that have Premium Adjustment Mechanisms.
- While they are small in number, they are systemically significant.

A.5 Fiduciary duty and SIS covenants

Trustees entering and operating a Premium Adjustment Mechanism must do so with members' best interests in mind. These obligations are expressed in:

- Fiduciary duty (trust law) – the legal obligation (deriving from trust law) of one party to act in the best interest of another. The obligated party is typically a fiduciary, that is, someone entrusted with the care of money or property on behalf of others; and
- SIS covenants (in section 52(2)) which among other things, require a trustee:

  (c) to perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries;

(d) *where there is a conflict between the duties of the trustee to the beneficiaries, or the interests of the beneficiaries, and the duties of the trustee to any other person or the interests of the trustee or an associate of the trustee:*
  - (i) *to give priority to the duties to and interests of the beneficiaries over the duties to and interests of other persons; and*
  - (ii) *to ensure that the duties to the beneficiaries are met despite the conflict; and*
  - (iii) *to ensure that the interests of the beneficiaries are not adversely affected by the conflict; and*
  - (iv) *to comply with the prudential standards in relation to conflicts;*

(e) *to act fairly in dealing with classes of beneficiaries within the entity;*

(f) *to act fairly in dealing with beneficiaries within a class.*

Questions have been raised in public debate about whether Premium Adjustment Mechanisms are being used inappropriately to benefit third parties. The trustee obligations to members, set out above, are intended to provide sufficient protection to ensure that this does not happen. However, further transparency of Premium Adjustment Mechanisms and Insurance Reserves held by superannuation funds is required to improve public confidence in their use.

Similarly, it has been suggested that Premium Adjustment Mechanisms are the source of conflicts of interest, in that they provide trustees with an incentive to deny claims. Denying a claim to maximise a rebate would not be acting fairly with a beneficiary within a class (section 52(2)(f)) and inconsistent with the trustee's duty to pursue a claim where there are reasonable prospects of success (section 52(7)(d)). Furthermore, the trustee would derive limited benefit from encouraging or acquiescing in claim denials as any benefit would flow to fund members, not the trustee. Whilst this could potentially lead to a fund's premium rates being lower than those of comparable other funds at the expense of those whose claims were denied, any competitive advantage when seeking new business opportunities would only be short-term, given increased transparency of claims ratios. Finally, any accusation that trustees might encourage or acquiesce with the insurer to deny claims applies equally to funds that do not have Premium Adjustment Mechanisms – benefits (if there were any) would flow through in the form of lower premiums at the next policy renewal.

In the absence of Premium Adjustment Mechanisms, the impact of lower (or higher) volumes of claims being accepted is delayed until the premium rates are next reset. However, when a Premium Adjustment Mechanism is in place, lower (or higher) volumes of claims lead to a more immediate change to members' insurance prices – this is not in conflict with the trustee's responsibility to do everything to pursue a reasonable claim.

A.6 APRA Prudential Standards and Practice Guides

There are two fundamental principles that trustees must observe in relation to Premium Adjustment Mechanisms:

- Any monies received from insurers must be applied to the trust funds used to support members' benefits in accordance with the sole purpose test in section 62 of the SIS Act; and
- Except in very limited circumstances, trustees are not permitted to self-insure by reason of Regulation 4.07E of the SIS Regulations.

Current APRA Prudential Standards and Practice Guidance in SPS 250 and SPG 250 – Insurance in Superannuation (which apply to superannuation trustees) and LPG 270 – Group Insurance Arrangements (which applies to life insurers) do not currently give specific guidance in relation to Premium Adjustment Mechanisms for trustees regarding their accounting treatment, their disclosure in member communications, including annual reports, or their appropriate and fair application for the benefit of members.

There are existing requirements in relation to the management of reserves generally and the need for superannuation funds to have policies in relation to reserves, but no specific guidance in relation to the management of Insurance Reserves including the contributions to and distribution from them, their transparency and the way they are communicated to members.

It may therefore be appropriate for the industry to establish guidance or a Code which deals with these matters.

We note that APRA Prudential Standard LPS 600 - Statutory Funds contains a definition of profit share, for the purposes of determining whether these types of payments are participating benefits.

SPG 250 and LPG 270 call out several instances where Premium Adjustment Mechanisms may be considered in addition to others where they could be read as being addressed but only on an implied basis. A brief discussion on SPG 250 and LPG 270 has been included in Appendix 2.

A.7 Timing and equity Issues

Premium Adjustment Mechanisms can lead to equity issues as the proceeds of any adjustment mechanism may be provided to a future group of members that differs from that which directly gave rise to the adjustment payment.

On the other hand, insurance itself is inherently about cross-subsidies - the group of members who claim are benefiting of the expense of members who don't. In fact, the cycle of re-rating insurance premiums for funds that do not have Premium Adjustment Mechanisms based on the fund's own historical claims experience, means that future new members to the fund may pay for the poor claims experience, or benefit from the good claims experience, of previous members (even though they did not contribute to it).

A key benefit of Premium Adjustment Mechanisms is that they enable the trustee to manage Insurance Reserves to ensure the benefits of good (or bad) clams experience are provided to members more quickly and therefore equitably than, for example, under a traditional policy with no Premium Adjustment Mechanism and a two or three year premium rate guarantee.

In superannuation, there are precedents for future cohorts of members being affected by the experience of previous generations. These are often unavoidable outworking of arrangements applying to groups. For example, in unit pricing where deferred tax assets exist, it is possible that previous generations of members had their capital tax benefits (from investment losses) impaired, while future new members benefit from reduced capital gains tax resulting from those unrealised capital losses.

Funds contemplating explicitly sharing the proceeds of Premium Adjustment Mechanisms with members (i.e. refunding members' accounts with a share of the Premium Adjustment Mechanisms payment) need to consider the administrative challenges involved with executing such a strategy. When considering the

appropriate allocation of the proceeds of Premium Adjustment Mechanisms, trustees may rely upon historical experience to distribute benefits in the future to members in a manner consistent with its stated approach to equity between member cohorts.

The time over which the trustee passes the benefits (or otherwise) of Premium Adjustment Mechanisms back to members depends on the nature of the pricing arrangement between the fund and the insurer. A typical rate guarantee period would be over a two or three-year period, which could be suitable as a maximum period under a Premium Adjustment Mechanism. However, time periods for which the Premium Adjustment Mechanism relates need to be considered depending upon the fund's particular insurance arrangements.

In forming its policy on the use of Premium Adjustment Mechanisms, trustees need to consider different cohorts of members such as members who were insured:

1. for the whole period within the fund;
2. for part of the time but remain in the fund;
3. for part of the time and have left the fund; or
4. for part or all the time, but have different levels of cover and may expect different entitlements depending upon their level of cover.

Any Premium Adjustment Mechanism proceeds should be retained within an Insurance Reserve and only used to meet insurance premium costs. They should not be used to provide insurance services or to meet marketing or product development costs. The fund's Insurance Reserve Policy should ensure appropriate and timely use of the Insurance Reserve to adjust member premiums.

A.8 Conflicted Remuneration - FoFA / SIS 29SAC

Most superannuation funds are licensed to provide financial product advice (either general or personal) under the Corporations Act. The provisions in the Act which ban conflicted remuneration therefore apply when advice (including general advice) is being provided to members. Such advice is often provided to members in respect of their insurance in the fund.

Further in the SIS Act (section 29SAC), trustees operating a MySuper product must not charge MySuper members for payment of conflicted remuneration (to a licensee or a representative of a licensee). This is important because in an insurance arrangement with a Premium Adjustment Mechanism, the cost of such an arrangement may be included in the premium.

Conflicted remuneration is defined in ASIC's Regulatory Guide 246. Conflicted remuneration includes "Profit Sharing arrangements" (para 106) and the extent to which such arrangements are conflicted depends on several factors including how direct the linkage is to the value of the product (which is clear for Premium Adjustment Mechanisms) and whether it is paid to an adviser or representative of a licensee.

The significance of these requirements for Premium Adjustment Mechanisms are:

- Payment of profit sharing arrangements to advisers (or representatives of a licensee / trustee) is conflicted remuneration and is banned, unless it falls within one of the relevant exclusions.
- There are obligations on both the product provider (the insurer) and the trustee to not enter into any such arrangements.

The conflicted remuneration arrangements apply to new arrangements after 1 July 2013.

In summary, existing legislation and regulations ensure that Premium Adjustment Mechanisms cannot include conflicted remuneration arrangements.

A.9 Self-insurance

Any Premium Adjustment Mechanisms need to be structured so they do not contravene the restrictions placed on a superannuation fund trustee for self-insurance.

Under SIS Regulation 4.07E, an RSE licensee (superannuation fund trustee) is generally not permitted under its licence to self-insure (noting there are very limited circumstances where this applies; for example, the insurance relates to defined benefit members). It is therefore important for trustees to satisfy themselves that any proposed Premium Adjustment Mechanism does not constitute self-insurance.

There are a series of APRA Prudential Standards and Prudential Practice Guides that apply to RSE licensees and insurers with respect to insurance provision which help determine whether insurance is in fact self-insurance:

- CPS 220 Risk Management – applies to insurers and the pricing and capital adequacy of profit sharing arrangements;
- SPS 250 Insurance in Superannuation – applies to RSE licensees and the relevant group insurance policies held within a superannuation fund as well as any associated agreements, which must include details of the premium structure, including any variable components;
- SPG 250 Insurance in Superannuation – applies to RSE licensees and provides guidance as to how APRA expects them to meet to satisfy the requirements of SPS 250. This includes the appropriate transfer of insurance risk to and between insurers and the risk of self-insurance as well as documented arrangements in place prior to the commencement of the risk that covers profit-sharing arrangements and any experience terms;
- LPG 270 Group Insurance Arrangements – applies to insurers, and whilst it references obligations on RSE licensees under SPS 250, it also covers the requirement to consider the status of any profit-sharing arrangements under Prudential Standard LPS 600 Statutory Funds.

From these Standards, Regulations and requirements, for insurance not to be considered self-insurance:

1) The benefits need to come from an insurance policy issued by an APRA regulated insurer that is registered under the Life Insurance Act 1995;
2) The premium structure, including any variable components, need to be included in the insurance arrangement (i.e. the policy or associated agreements) that are executed prior to the commencement of the risk;
3) Any variable component must have a cap or maximum adjustment – (i.e. it cannot be open-ended or unlimited); and
4) The RSE licensee cannot knowingly permit a gap to exist between a change of insurers or the level of benefit made available to an insured fund member and the supporting insurance policy.

Any failure in the level of coverage of insured benefits under the four abovementioned points could be interpreted by APRA as self-insurance and a breach of SIS Regulation 4.07E, and a breach of Prudential Standard SPS 250 by the RSE licensee or CPS 220 by the insurer.

The types of Premium Adjustment Mechanisms outlined in Appendix 1 of this discussion paper would not ordinarily appear to contravene the self-insurance requirements.

A.10 Disclosure

There are currently no requirements for a superannuation fund to disclose whether it utilises a Premium Adjustment Mechanism. The new accounting standard AASB 1056 – Superannuation Entities which applies from 1 July 2017 at paragraph 8(c) requires the disclosure of reserves (and a statement of change in reserves, including Insurance Reserves) in a fund's financial statements, however this does not extend to Premium Adjustment Mechanisms.

Existing levels of disclosure mean that neither fund members nor those analysing the operation of a superannuation fund are able to fully understand the operation of Premium Adjustment Mechanisms. It is this opaqueness that lends itself to concerns that these adjustment arrangements may be used inappropriately.

It is therefore a high priority of this discussion paper to propose disclosure requirements and best practice guidance to address this issue. Section B provides further details of the proposed solutions.

A.11 Appropriate and inappropriate use of Premium Adjustment Mechanism payments

There should be industry guidelines governing the proper use of Premium Adjustment Mechanism payments and to identify prohibited or inappropriate uses. Premium Adjustment Mechanisms must only be used for purposes consistent with the 'sole purpose test' in the SIS Act.

Furthermore, this paper proposes that payments to the fund under Premium Adjustment Mechanisms should be used exclusively to meet insurance risk costs, typically insurance premiums to the fund's insurer. Therefore, funds received through Premium Adjustment Mechanisms should not be used:

- To help offset insurance administration costs;
- For the development and operational implementation of new or enhanced insurance product offerings;
- To fund improvements in the process efficiency of the insurance offering for members.

The following are specific examples of prohibited payments:

- Material cross-subsidisation of a fund's non-insurance related services and/or products, including subsidisation of other areas of the fund's operations (e.g. retirement income, advice services);
- Use for sales and marketing;
- Payments to shareholders of the trustee;
- Use to cover non-insurance related administration; and
- Payments to third parties for goods or services rendered, other than insurance premiums.

SECTION B: PROPOSALS AND CONSULTATION QUESTIONS

To improve public confidence and transparency of Premium Adjustment Mechanisms, there are a number of solutions that should be implemented. Feedback is sought on these proposed solutions.

Summary of proposed solutions
1. Funds to adopt a Premium Adjustment Mechanism Policy
2. Link to the fund's Insurance Reserve Policy
3. Disclosure
4. Nomenclature

B.1 Premium Adjustment Mechanism Policy

It is proposed that trustees with a Premium Adjustment Mechanism arrangement in place must have a documented Premium Adjustment Mechanism Policy that is publicly available.

This policy should also be a consideration in the fund's Risk Management Framework.

The Premium Adjustment Mechanism Policy should include:

- Details of the Premium Adjustment Mechanism arrangement;
- Guiding principles for use of Premium Adjustment Mechanism payments;
- A requirement to establish an Insurance Reserve to which any Experience Adjustment payment must be allocated (see section B.2 below);
- An annual review process;
- If applicable, investment of Insurance Reserve and treatment of investment income, investment expenses and investment tax;
- Disclosure and reporting requirements;
- Responsibilities to approve the use of any Premium Adjustment Mechanism including any actuarial advice;
- The regular review of the Policy itself.

A guiding principle for use of Premium Adjustment Mechanism payments is that they must be used for the benefit of insured members.

To help ensure equity, and to the greatest extent possible, Premium Adjustment Mechanism payments should be used to benefit the members whose premium payments relate to the Premium Adjustment Mechanisms payments.

This may mean that trustees make payments to the cohorts of members whose experience gave rise to it. To meet this requirement, trustees should consider segregating the Premium Adjustment Mechanism payments by generation and even by product.

These payments should only be used to reduce insurance premiums and should not be used:

- to help offset insurance administration costs;
- to develop and implement new or enhanced insurance product offering;
- to fund improved process efficiency of the insurance offering for members.

B. 1 Feedback questions

PREMIUM ADJUSTMENT MECHANISM POLICY

1. Do you agree that trustees must have a Premium Adjustment Mechanism Policy?
2. Do you agree with the proposed contents of the Premium Adjustment Mechanism Policy?
3. Do you agree that the Premium Adjustment Mechanism Policy should be publicly available?
4. Do you agree with the guiding principles? If not, why?
5. Do you agree that payments received under Premium Adjustment Mechanisms should only be used to meet the cost of insurance premiums?

B.2 Link to the fund's Insurance Reserve Policy

It is proposed that any payment from a Premium Adjustment Mechanism must be allocated to the fund's Insurance Reserve.

This means that there must be a clear link between the Premium Adjustment Mechanism Policy and the Fund's Insurance Reserving Policy and the guiding principles must continue to apply for any payments from the Premium Adjustment Mechanism into the Insurance Reserve.

The trustee must have a Board-approved Insurance Reserving Policy.

To avoid any doubt:

- Neither the trustee, nor fund executives /representatives must benefit directly or indirectly from a payment from the Premium Adjustment Mechanism or from the fund's Insurance Reserve; and
- Payments resulting from the Premium Adjustment Mechanism or the fund's Insurance Reserve must not be paid to third parties, e.g. the trustee company, its directors, fund administrators or unions. It should not be paid to any person giving advice in a way that would constitute conflicted remuneration.

B. 2 Feedback questions

LINK TO THE FUND'S INSURANCE RESERVE POLICY

6. Do you agree that any payments resulting from Premium Adjustment Mechanisms must be allocated to the fund's Insurance Reserve?
7. Do you have any other feedback that could assist in the final decision on adoption of this policy?

B.3 Disclosure

We propose the introduction of standardised disclosure around Premium Adjustment Mechanisms. This should be at both the member level, and a superannuation fund level in the interests of systemic transparency.

In terms of member level disclosure, it is proposed:

- Where there is a Premium Adjustment Mechanism policy, it should be publicly available;
- The fund's Annual Report, PDS and relevant insurance documentation should include a statement that the fund participates in a Premium Adjustment Mechanism and details about which members the arrangement applies to;
- The fund's Annual Report, PDS and relevant insurance documentation should state that trustee has a Board-approved Premium Adjustment Mechanism Policy; and
- The fund's Annual Report should include an attestation from the trustee that it has adhered to its Premium Adjustment Mechanism Policy, with a further disclosure of the details of any non-compliance.

While there is already a requirement for a fund's financial statements to disclose an Insurance Reserve and the movements in that reserve (in accordance with AASB 1056 para 8(c) and AG 21), we suggest additional disclosure of:

- The amount of payments to and from the fund's Insurance Reserve under the Premium Adjustment Mechanism, including details of payees (insurers); and
- The amounts of the payments to and from the fund's Insurance Reserve under the Premium Adjustment Mechanism with investment earnings at the end of the financial year that has not been used.

B. 3 Feedback questions

DISCLOSURE

8. Do you agree with the proposed disclosure proposals? Are there any other items that should be disclosed?

B.4 Nomenclature

The various names given to Premium Adjustment Mechanisms have added to the confusion and lack of understanding about the practice. The most commonly used expression, 'profit sharing', suggests the

use of Premium Adjustment Mechanism payments for purposes other than the benefit of members. This is unhelpful and contributes to ill-informed commentary on the practice.

The term ‘Premium Adjustment Mechanisms’ has been suggested because it reflects the reality that payments under such arrangements are, in essence, adjustments to premiums that have been paid in the past, to allow for information that is now know about the underlying claims experience.

B.5 Consultation

We invite you to comment on the key feedback questions that have been raised in Section B of this discussion paper. All submissions on this discussion paper are due by **12 September 2017** and should be sent to the Project Management Office at:

ISWG-PMO@kpmg.com.au

All submissions will be treated as public documents unless you specifically request that we treat the whole or part of your submission as confidential.

APPENDIX 1 – TYPES OF PREMIUM ADJUSTMENT MECHANISMS

Group Life insurance premiums comprise the following components:

Generally, for Group Life insurance, claims costs are around 80%[1] of the premiums charged.

Different types of Premium Adjustment Mechanisms are applied by superannuation funds. The mechanisms typically follow one of four models:

1. Basic premium rebate model (traditional profit sharing policies)

Under a basic premium rebate model, premium adjustments are calculated using a formula based on the following:

Profit Share % times (Y% of Premiums - Claims)

Where:

- Y% of Premiums is a proxy for expected claims (i.e. premiums after a deduction for expenses, stamp duty and expected insurer profit margin);
- Claims includes not only actual claims reported for the period, but also an allowance for claims that are expected to be notified in the future relating to a given policy year (i.e. Incurred But Not Reported, or IBNR claims); and
- The Profit Share % is the percentage of any favourable experience that is returned to the superannuation fund.

Consider the following simplified example:

- A premium of $100,000;
- Expected claims of $80,000 (i.e. Y= 80% in formula above);

1 Generally, the cost of claims paid represents at least 80% of premiums collected by group insurers. Source: APRA statistics summary- 2011 – 2016

- Profit Share % of 85%;
- If actual Claims were $60,000, the claims experience surplus is determined as $20,000 (=$80,000 - $60,000). The amount paid back to the fund would be $17,000 (=85% x $20,000).
- If actual claims were $90,000 there is a claims experience loss (as the actual claims exceed expected claims) and typically no Premium Adjustment would be made*.

** In some cases, the Premium Adjustment Mechanism agreed between the superannuation fund and the insurer may provide for losses up to a pre-determined limit to be recouped through increased future premiums.*

The initial determination of actual claims incurred (‘Claims’ in the above formula) requires an actuarial estimation of claims that have occurred but not yet reported as claims (particularly TPD claims) can take many years to be notified to the superannuation fund and insurer. In recognition of this, the Premium Adjustment for a given year is typically recalculated in subsequent years to reflect the actual claims as they are received (so the reliance on actuarial estimation diminishes) and any Premium Adjustments already made in respect of that year are adjusted upwards or downwards to reflect actual claims emergence.

Because of the reliance on actuarial estimation of the tail of future reported claims for any given year, such recalculations tend to occur for at least 5 years before a final Premium Adjustment Mechanisms settlement is made for a given year (although interim payments do flow between the insurer and the fund in the intervening years). The nature of the annual recalculations means that there can be situations where a positive amount paid to a superannuation fund in one year may need to be partly repaid to the insurer in a subsequent year should more claims have been reported than expected in the actuarial estimation. After 5 years (in this example) of recalculations, the impact of the actuarial estimation is much smaller and a final settlement of the Premium Adjustment Mechanism for the year concerned can often be achieved.

2. Capped (buffer) models

Under these models, the Premium Adjustments are calculated in the same manner as the basic premium rebate model in 1 above, however they can be either positive or negative, up to pre-agreed limits (usually expressed as a percentage of premiums).

The benefit of such models is that they usually enable member premiums to be lower, as the insurer does not have to include as large a contingency margin as it otherwise might when setting premiums. The disadvantage is that they require the fund to have an Insurance Reserve, or else it will be unable to cater for the impact of a negative Premium Adjustments.

3. “Burning Cost” approaches

“Burning Cost” models originated in general insurance and are arrangements that allow a fund to be charged a premium that is based entirely on their own claims performance, subject to a set minimum and maximum. In these models (sometimes also referred to as “loss sharing models”), the Premium Adjustments are determined in the same manner as the basic premium rebate model in 1 above, however any positive or negative adjustments remaining after a defined period of time (subject to the pre-agreed limits) are automatically factored into the calculation of future premiums.

4. Multinational pooling

Large multinational employers sometimes pool the multiple life insurance policies around the globe covering their employees to minimise risk and better use their global purchasing power and economies of scale. This is termed multinational pooling and is a form of Premium Adjustment Mechanism. It can lead to financial cost savings, and improved underwriting terms and conditions. Inclusion of Australian subsidiaries' policies in the multinational pools is less common than for many other countries, given that life insurance coverage in Australia is more commonly through superannuation funds, rather than through directly owned employer policies. However, several multinational employers have sought to include their primary Australian employer superannuation plan within their multinational pool where this can be accommodated (e.g. for stand-alone corporate plans or employer plans within superannuation funds which allow an employer plan to hold a separate insurance policy for members of an employer plan).

Where multinational pooling covers the Australian employees, the multinational employer will participate in one or more global multinational pools. Each pool will appoint a local Australian insurer as its Australian representative. In an Australian context, the employer's multinational pool may not only include group life and salary continuance policies directly owned by the employer, but also those owned by the trustee(s) of that employer's local Australian superannuation arrangements. If the employer wishes it to cover superannuation policies, the employer as sponsor of its employer plan will request that the plan's trustee effect a group insurance policy with the local insurer participating in the appropriate multinational pool used by the employer.

Before agreeing to the request, the trustee will need to ensure the terms of insurance are in the best interests of members (e.g. after a group life tender had been conducted, or if the employer indicated it would only meet the cost of insurance cover if its preferred insurer were appointed by the trustee). The trustee's group life policy covering that employer plan then operates without regard to the multinational pooling arrangement (i.e. on a with-profits basis or non-profit as per the terms of that policy). However, the overall experience of the policy is then taken into account by the multinational pool when considering if there is to be a Premium Adjustment in the form of an "international dividend".

Appendix 2 - Relevant issues in SPG 250 and LPG 270

SPG 250 – Insurance in Superannuation

Paragraph 7 of SPG 250 states that an Insurance Management Framework supports the identification and monitoring of risks relating to insured benefits, encompassing all aspects relating to the management of those benefits, including (as outlined in paragraph 7(e)), risks relating to the appropriate transfer of insurance risk to and between insurers including the possibility of self-insurance (which with certain minor exceptions are no longer allowed). There is therefore broad guidance in SPG 250 for consideration of such self-insurance matters to occur separately from the actual legislation of 4.07E of SIS Regulations

Paragraph 38 outlines that ordinarily an RSE licensee would have documented arrangements in place which address matters including (at paragraph 38(d)) procedures for deducting premiums from beneficiaries' accounts and paying premiums to insurers.

Again while not specifically referencing Premium Adjustment Mechanisms, it is reasonable to infer that the above guidance implicitly requires documentation to address the insurance reserve management i.e. any re-crediting of premiums to members' accounts in the case where an insurer may return a portion of the premium previously paid or vice versa.

Aside from the awareness of the risks of self-insurance, paragraph 38(i) further highlights the RSE licensee's responsibilities to ensure consistency of any profit sharing arrangements or Premium Adjustment Mechanisms with the requirements to not provide conflicted remuneration under s29SAC of the SIS Act.

The ISWG believes that it would assist clarity if there were to be specific guidance on the considerations to be applied in the application of any experience adjustments and the use of any existing Insurance Reserve, including any timing and equity issues, which may be part of any trustee policy on the management of the Insurance Reserves.

Consideration and documentation of such matters may also assist trustees in making appropriate disclosures to members in relation to such arrangements.

LPG 270 – Group Insurance Arrangements

Paragraph 2 of LPG 270 already details how self-insurance is only permitted by superannuation funds in very limited circumstances as set out in regulation 4.07E of the SIS Regulations and that while not a life insurer's direct decision, paragraph 19 of this prudential practice guide highlights awareness in respect of not making an offering that would result in a superannuation fund providing benefits not fully supported by a life insurance policy.

It is noted the Premium Adjustment Mechanisms prevalent in the market do not reduce the extent to which benefits are supported by life insurance policies. They simply determine the level and timing of premium and any such adjustments. Any such models can be re-expressed as financially neutral in comparison to traditional profit share arrangements where the initial premium is the maximum payable with only potential upside returning to the policy owner. The only difference is an incremental timing/credit risk for the insurer, not an additional self-insurance risk for superannuation funds.

Paragraph 4(c) of LPG 270 further highlights how the insurer typically bears 100% of the losses but retains only a portion of the profits in profit sharing arrangements per the above, demonstrating that above a certain level (total premiums and capped Premium Adjustments) all costs are carried by the insurer fully supporting the benefits of the fund under an insurance policy.

Paragraph 6(b) clearly references the life insurer's consideration of the costs of providing any profit sharing while paragraph 6(c) references the need for consideration in any tender response of the sustainability of the premium rates and terms and conditions. Paragraph 10 further highlights that it is good practice to advise on the factors that could potentially affect policy terms.

The potential for a Premium Adjustment Mechanism's ability to mitigate the impacts of factors that may otherwise cause changes to premium rates and/or terms and conditions needs to be considered by trustees. For example, they potentially allow the offering of more sustainable terms without the insurer unduly gaining should some of the risks allowed for not arise.

Paragraph 12 of the prudential practice guide highlights the need for consideration of the degree of uncertainty around future experience and the consequent degree of capital required (paragraph 12(f)). Premium Adjustment Mechanisms/profit sharing arrangements may mitigate the degree of uncertainty of financial outcomes for the insurer and therefore on a net basis reduce the capital requirements. This may result in improved premium costs net of Premium Adjustments for a superannuation fund for a given set of guarantee terms (paragraph 12(i)) or enable a longer guarantee period for a similar level of net insurance cost.

While this guidance relates to life insurers, LPG 270 does reflect upon the interactions of life insurers with superannuation funds and the connecting insurance arrangements. All such parties are to consider the sustainability of the provision of insured benefits and, as outlined in section A.2 of this discussion paper, such arrangements are to assist in the enhancement of the sustainability of insurer offerings.

Paragraphs 18 and 19 further articulate the insurers' responsibility to

- Consider whether any Premium Adjustment Mechanisms would result in a contract being classified as participating business according to the Life Insurance Act 1995 and Prudential Standard LPS 600 Statutory Funds; and
- Be aware of the legislative requirements applying to the ability of an RSE licensee to self-insure and take reasonable steps to avoid offering an arrangement that might result in an RSE licensee providing insured benefits that are not fully supported by an insurance policy, unless the RSE is permitted to self-insure under 4.07E of the SIS Regulations.

It is noted that SPS 250 does not contain any specific reference to Premium Adjustment Mechanism amounts.