

**Financial Services Council**  
**Insurance Regulation into the Future**  
**8 September 2014**

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# Executive Summary

The insurance industry plays a pivotal part in the performance of the Australian economy. This is both in terms of ensuring adequate cover of the population for risk events and also in reducing the financial strain on the Commonwealth Government budget. To continue to maximise the insurance industry's contribution to the Australian economy, regulation and legislation must be maintained in a manner to assist this through product innovation.

The regulation of Australian insurers has been a topic of discussion for some time. Discussion within the market suggests that Australia is heavily regulated, especially when compared to other insurance markets. This is both in terms of the direct oversight of the insurance company and its board, and also in terms of the level of capital required. We have compared Australian insurance regulation with that in Canada, Germany, South Africa and the United Kingdom.

The international regulatory landscape is quite varied. Post the Global Financial Crisis we have seen major upheaval in global regulation and legislation, with the G20 countries are driving the reform of prudential regulations globally.

A major goal of the G20 is moving towards the harmonisation of global capital and oversight regulations. This has seen a continued level of changes occurring with the phased introduction of the Solvency II risk and capital standards across the European Union. We have also seen structural changes in the arrangement of prudential regulators, with the UK leading the change. This is the European implementation of the core principles set out by the International Association of Insurance Supervisors (IAIS) for which part of Australia's interpretation is that of the Life and General Insurance Capital standards (LAGIC).

Australia could update regulation and legislation to improve the insurance market and its value to government and the wider population. Changes to the Australian landscape must help the market improve its international competitiveness, improve its ability to assist the government in reducing budgetary strain or enable development of products and markets to better serve the consumer.

With the increase in costs around the National Disability Insurance Scheme (NDIS) and the ongoing strain on the government budget of the Disability Support Pension (DSP), the ability of a private market Permanent Disability Insurance (PDI) product to contribute in this sector is becoming more important. Through updating the existing insurance acts and creating further detail around the NDIS the private sector may be able to assist the government and the consumer.

To create innovative products like a private market PDI product, streamlining of the Australian prudential legislation and regulatory oversight is needed. New legislation to enable insurers to offer products across current business lines, without having to have multiple licences and statutory reserves for an individual product, would minimise compliance, duplication of work and therefore costs, allowing insurers to meet consumer's needs.

Innovation is driven by the demand of consumers. However, the ability of the insurers to create the products demanded is driven by the combination of regulation, legislation capital requirements and risk profile of the companies themselves. Innovation of life insurance products will help keep them relevant in the ever changing financial services market.

# 1 Introduction

How best to regulate and monitor the financial services industry has been a major topic of debate globally since the start of the Global Financial Crisis (GFC) almost 7 years ago. The management of financial institutions and how the regulatory environment permitted the failures experienced have been key issues. Although insurance companies performed relatively well throughout the GFC when compared with banking institutions, with Australia itself well insulated, the regulations surrounding insurance companies have been strengthened globally.

## Australian Regulatory and Legislative Landscape

The Australian prudential regulatory and legislative landscape has built up over many years. The major changes to the regulatory landscape, both in legislation and oversight, have been driven by major events in the Australian financial services industry and more recently issues surrounding the global financial services industry. This has resulted in a reactive regulatory landscape. This has also led to regulations written to overcome specific issues and implemented in silos around the business type, i.e. life, general, health.

The legislation of Australian insurers is covered by a number of acts of parliament and regulated prudentially through the Australian Prudential Regulatory Agency (APRA) and for market conduct by the Australian Securities and Investment Commission (ASIC). There have been many changes in the arrangement of regulation and oversight over the years, driven by commercial events and system reviews.

For Australian insurers, the bulk of legislative and regulatory changes have been driven by insurance company failures. The issues around HIH Insurance failing in 2001 and Occidental Life and Regal life in the 1990's were big drivers of increased regulation and oversight for the Australian market. The financial services inquiries, most recently being the Wallis Review and the current Murray Review, have challenged the regulatory and legislative landscape faced by insurers, amongst others.

The current Australian regulatory landscape for insurers is becoming more aligned, with the regulation of Private Health Insurance now being transferred to APRA. We have also seen the creation of new capital standards (the Life and General Insurance Capital standard (LAGIC)) covering both the life and general insurance companies, and a move to more consistent regulation of insurers and banks.

The international prudential regulatory landscape is quite varied. In the post GFC landscape we are seeing the introduction of Solvency II standards across the European Union, with other countries implementing new capital standards based upon the Solvency II framework. We have also seen changes in how the oversight of prudential regulation is conducted, with the UK leading the change to a twin peak regulatory arrangement which is already in place in Australia.

## Insurance Role in Government Finances

The insurance industry has long been a key contributor to the economy, with its role in reducing government expenditure a key benefit for the government. This has been done through a variety of methods, through legislation that encourages insurance companies to offer a product, as well as legislation that encourages taxpayers to take out private insurance. The Medicare Levy Surcharge and private health insurance rebate are examples of the latter in Australia.

With the introduction of a National Disability Insurance Scheme (NDIS) in Australia, there has been an increase in the pressure on the government's budget. The previous research conducted for the FSC by Deloitte Access Economics (Deloitte Access Economics, 2014) noted that the implementation of private disability insurance products can help to cover budgetary pressure caused by the National

Disability Insurance Scheme as well as the Disability Support Pension (DSP) which is also a significant drain on government finances. The strain of these on the public accounts was seen during the most recent budget (2014-15), with the government's acknowledgement of the costs of the NDIS rollout, as well as with the tightening of regulations around those eligible for DSP due to the cost of the current claimants on the system.

The creation of a private insurance product that will cover individuals for these risks will require an innovative solution with the product possibly being a hybrid of health, life and general insurance. The current legislation covering life, general and health insurance is unable to enable insurers to readily deliver such innovative products.

## Scope and Structure of this Report

This report contains the following areas of investigation and analysis:

1. Benchmarking of Australia's life insurance legislative and regulatory framework against four comparable global markets, including consideration of efficiency, innovation, market and product development.
2. Opportunities for structural reform of Australia's insurance licencing regime including consideration of potential benefits of single, streamlined licensing/prudential regime.
3. Assessment of potential implications (if any) of recommendations made in relation to the operation of the health insurance market in the Commission of Audit.
4. Assessment of the impacts on the insurance sector of adopted recommendations arising out of the collapse of HIH and the HIH Royal Commission.

# 2 Insurance Regulation in Australia

## 2.1 Legislation

The legislation covering Australian insurance has its foundation in British legislation, namely the British Life Insurance Companies Act of 1870. This covered the life insurance industry and much like current trends, was driven by the collapse of two life companies in 1869 (Keneley, 2006). The legislation of insurance in Australia is now covered by a range of acts of parliament. The main acts covering the insurers are as follows:

- A. Life Insurance Act 1995
- B. Insurance Act 1973 (covering general insurance)
- C. Private Health Insurance Act 2007
- D. Australian Securities and Investments Commission Act 2001

The creation of insurance legislation has generally been driven by corporate actions. This in part has led to the siloed nature of legislation globally.

### Life Insurance Act and Insurance Act

The principles in the acts that cover life insurance and general insurance are quite closely aligned, even with a vast difference in their historical makeup.

The Australian Life Insurance Act was first promulgated in 1945, covering all states and territories in Australia. After the collapse of Occidental Life in 1991 the Act was rewritten to minimise the risk of a similar failure happening again. The Australian Insurance Act was first promulgated in 1973, covering all states and territories in Australia. It was significantly updated as a result of the recommendations made by the Wallis Inquiry (Financial Systems Inquiry, 1997) and after the collapse of HIH in 2001 and the subsequent Royal Commission (Owen, 2003).

The objective of the Life Insurance Act 1995 (Commonwealth of Australia, Life Insurance Act 1995, 2012) states:

*The principal object of this Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry.*

The objective of the Insurance Act 1973 (Commonwealth of Australia, Insurance Act 1973, 2014) states:

*The main object of this Act is to protect the interests of policyholders and prospective policyholders under insurance policies (issued by general insurers and Lloyd's underwriters) in ways that are consistent with the continued development of a viable, competitive and innovative insurance industry.*

Both acts set out a variety of ways in which to meet the objectives of the acts. They include the following areas of concentration:

- (a) Restrictions on the conduct of insurance business to a company that is able to meet certain requirements as to suitability of its business and that it is run by “fit and proper” people.
- (b) Imposing on companies’ requirements designed to promote prudent management of the insurance business of such companies, including requirements designed to ensure the solvency and capital adequacy of its funds.
- (c) Providing for the supervision of life companies by APRA and ASIC, by setting out the scope of regulatory power and control.
- (d) Through the combination of prudent management and regulatory supervision, the capital requirements and associated disclosure are formed, assisting in a prudent business.

## Private Health Insurance Act

Health insurance and universal health insurance, in the form of Medicare, came into being following the Health Insurance Bill 1973. Further changes around health insurance and private industry have led to the Private Health Insurance Act 2007 (Commonwealth of Australia, Private Health Insurance Act 2007, 2014). The Act sets out the three main elements of the private health insurance system in Australia. The key objectives of the Act are to:

- Provide incentives to encourage people to have private health insurance;
- Set out rules governing private health insurance products; and
- Impose requirements on how insurers conduct health insurance benefits.

At the core of the Act is the determination of how a health insurer can act in order to be considered a health insurer. It is here for which the following requirements that set health insurance apart from all other insurance types, being:

- Community rating;
- Guaranteed insurability;
- Ministerial approval of premiums; and
- The level of payments allowed under the policy.





















## 2.2 Prudential oversight




Australian general and life insurers and, with the upcoming dissolution of the Private Health Insurance Administration Council (PHIAC), health insurers are prudentially regulated by the Australian Prudential Regulation Authority (APRA). APRA was established in 1998 for the purpose of regulating the financial services sector under Commonwealth laws; this was based upon recommendations that were made in the Wallis Review (Financial Systems Inquiry, 1997). Through its role, APRA sets out the prudential standards that the insurance companies are to follow.

APRA currently regulates insurance products separately, with different prudential regulations applicable for each business. This is in part due to the arrangement of the governing legislation and the differences associated with the lines of business. APRA has harmonised some of the prudential regulation, with the creation of the LAGIC standards. The harmonisation of risk management across life and general insurance through CPS 220, and the introduction of standards across these lines of business are also assisting in the harmonisation of regulations.

The Royal Commission into the HIH Insurance failure led to significant changes to the prudential regulations for general insurers around valuations, disclosure and review. Parts of these changes were to bring the regulations of the general insurance industry up to a standard similar to life insurance.

However, in some areas the new general insurance regulations became more robust and onerous on general insurers (see GPS 310 and LPS 310) than for life insurers. One such area is around the review of assumptions and valuations for general insurers. As a result of the changes, general insurers are now required to have the valuations and the associated Financial Condition Report reviewed by an external actuary prior to approval by the Board and auditor. This external peer review process is not a requirement for life insurers.

|                    | Life  | CTP  | GI (ex CTP)   | Health  |
|--------------------|---|--|---|---|
| Capital            |  |  |  |  |
| Price              |  |  |  |  |
| Terms & Conditions |  |  |  |  |
| Risk Management    |  |  |  |  |
| Fit & Proper       |  |  |  |  |

Not Regulated  Partially Regulated  Regulated 

### 2.2.1 Pricing Oversight

Australia does not regulate pricing for life and most general insurance products. The pricing of compulsory third party personal insurance (or CTP) is regulated through the state based legislation such as the ACT's Road Transport (Third-Party Insurance) Regulation 2008. While APRA does not directly regulate price, pricing decisions have an impact on the profitability of insurers which APRA does take into account when setting capital requirements. The effects of any pricing decision in life insurance will be reviewed by the Appointed Actuary, who will advise the company of the implications of the proposed pricing on profitability and the capital position. However, the Appointed Actuary is not required to advise on the pricing a general insurance product. There is no requirement for pricing approval from a government agency for either life or general insurers.

The arrangements applying for health insurance are significantly different with pricing directly regulated. As part of the Private Health Insurance Act, the federal Health Minister must approve the annual price changes of all private health insurers. This means that all price changes can only occur on the 1<sup>st</sup> of July and that no changes to prices can occur during the year. This can lead to a conservative process of pricing where insurers will price their increase based upon, expected consensus and a conservative expectation of experience, as there is no framework to update pricing if the assumptions are materially wrong.

The changes to the health regulation due to the changes in PHIAC are not expected to change the current pricing approval process.

### 2.2.2 Regulation Basis

Australia has a "Twin Peaks" regulatory system, with the prudential regulation conducted by APRA and the regulation of market conduct around areas such as distribution, remuneration, etc. covered by the Australian Securities and Investment Commission (ASIC).



APRA applies a risk based system of regulation. This has led the capital requirements being based upon assessment of risk factors. However, with the creep of regulation to cover issues arising from company failures, there have been more and more prescriptive in nature for some components.

ASIC has a broad role within financial services in Australia. ASIC regulates Australian financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit. In their role as the regulator of the financial services industry their role is to ensure that businesses operate efficiently, honestly and fairly.

## 2.3 Major Reviews of Australian Insurance Regulation

Life insurance regulation started in the United Kingdom after the failure of two life insurance companies. That has continued to the current day with major changes and recommendations to the industry coming after corporate failures. The most recent of these relating to insurance in Australia was due to the collapse of HIH and the associated Royal Commission.

The Australian government has also instigated periodic reviews of the financial system to help put Australia at the forefront of the global financial system.

### 2.3.1 HIH Royal Commission

The HIH Royal Commission was instituted in August 2001 to investigate the circumstances around the failure of HIH Insurance Group in early 2001. An outcome of the Royal Commission was recommendations on the Australian regulatory market and changes to the legislation. There were a significant amount of recommendations that were made by the Royal Commission. These ranged from recommendations around actions towards executives, the makeup of boards through to specific areas of prudential regulation in Australia.

Some of these recommendations are appropriate to review when looking at the current regulatory position of the Australian industry.

### Recommendation 38

I recommend that, as a matter of high priority, the Australian Prudential Regulation Authority develop and promulgate a standard for the effective regulation of authorised insurers that operate as part of a corporate group. The proposed prudential standard on corporate groups should include a minimum capital requirement at the group level as well as the authorised entity level.

As a result of this recommendation, and further changes since, we have seen a significant amount of regulation placed around conglomerates. The forthcoming Level 3 conglomerate standard emphasises the risks arising from related parties in conglomerates.

### Recommendation 41

I recommend that the Australian Prudential Regulation Authority modify the prudential standards to require the annual production by an authorised general insurer's approved actuary of a report on the overall financial condition of the insurer.

This is now in force through the general insurance prudential standard (GPS) 310. The requirement has also been brought into the life insurance and health insurance standards.

The recommendations also looked at expanding the existing scope of control of APRA.

## Recommendation 42

I recommend that the Commonwealth Government amend the Insurance Act 1973 to extend prudential regulation to all discretionary insurance-like products—to the extent that it is possible to do so within constitutional limits.

This was completed, in part by the requirement for superannuation entities to be regulated, as part of further review of prudential oversight and the subsequent changes to the legislation.

### 2.3.2 Wallis Review

The Financial Systems Inquiry of 1997 was established to review the performance of the industry. Its mission statement was:

The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.

The inquiry did make a significant number of recommendations on the regulation of the financial services industry. Part of the recommendations were to help the industry become a more competitive and efficient financial system, with the changes driven by the regulators. Some of these recommendations were:

- More neutral regulatory treatment of competitors from different institutional sectors encourages those who are most efficient.
- Arrangements for regulation which are more responsive to market changes, facilitates innovation and new entry.
- More cost-effective conduct and disclosure regulation lowers costs and promotes competition.
- In the face of globalising markets, every effort should be made to ensure that Australia's financial system is able to compete without the impediments of outdated, inadequate or costly regulations (whether financial or otherwise) or discriminatory taxes.
- Moves towards more efficient pricing reducing cross-subsidies should be recognised as a necessary outcome of heightened competitive pressures. Government could contribute to efficiency and fairness in this area by expediting examination of alternative low cost means of meeting the transaction needs of social security and other recipients of government transfer payments.
- Choice should be maximised in superannuation and other steps taken to increase competitive pressures, including by simplifying regulatory arrangements.
- Foreign investment policy should be reviewed where it discriminates between foreign owned and domestically owned life companies and managers of collective investments.
- Privacy provisions which restrict the development of data bases for credit scoring purposes should also be reviewed as they may be imposing considerable costs on consumers.

At this stage there are a significant number of recommendations that have not been fully implemented or implemented at all. We did see some changes to the management and regulation of the industry in order to make regulation more efficient. A significant part of this was the creation of APRA and removing the prudential supervision role from the Reserve Bank.

Although APRA was set up to enshrine the role of prudential regulation through an independent body, the Wallis review did not review the regulations themselves. The Wallis review also did not consider in any detail the possibility of streamlining legislation or regulations across the insurance lines. We have only now seen the merging of health insurance regulation into APRA, even though it was recommended to be combined at the time of the review.

Some of the recommendations revolved around optimising the taxation system. At present it does not appear that the existing system is fully conducive to attaining international competitiveness and other financial system goals. It will be important that in any future review of the taxation system its effects on the financial system be extensively and closely considered. For example, taxation provisions, including income tax provisions and stamp duties, inhibit structural reorganisation of corporate entities. Taxation provisions aimed at minimising tax avoidance through foreign portfolio investments also act to discriminate between foreign and domestic providers of collective investments.

Although taxation may be seen as a hindrance to the competitiveness of insurance, it can also be used to create products and assist in competitiveness. As noted in the DAE report on the NDIS (Deloitte Access Economics, 2014), taxation changes can contribute to the creation of a market of products that can also help to reduce the costs of government spending on social security.

### 2.3.3 Commission of Audit

The Commonwealth Government recently established the National Commission of Audit to examine the scope of efficiency of the Commonwealth Government. It was charged with reviewing expenditure and revenue drivers of the government and to make recommendations to assist in achieving a sustainable fiscal position. Although the Commission of Audit reviewed a broad area of the government operations, there are a number of areas which directly or indirectly affect the insurance industry in Australia, specifically government programs that provide public insurance for longevity or disability risks that the population currently faces.

One area which the Commission targeted was the expenditure around the NDIS and the DSP. These are areas for which the current fiscal outlook is not sustainable. The Commission has recommended slowing down the roll out of the NDIS across Australia. Although this will assist in reducing budgetary pressure in the short term, this does not negate the issue that there is an ongoing demand for these services that will need to be funded.

Aged care is another area for which the Commission recommended reforms to the current position. One recommendation was to assist in implementing arrangements for individuals to fund their care, especially when related to the accommodation bond guarantees. The Commission believes that there is scope for the private insurance market to assist in reducing the burden of residential bonds on the Commonwealth Government.

A further recommendation made by the Commission related to broad reform of the private health insurance sector included a review of community rating principles within the health insurance market. The Commission noted that community rating is an important part of the Australian private health insurance landscape, to ensure affordability to all; however, they recommend that health funds be able to vary premiums for a limited number of lifestyle factors. The following recommendation was made by the Commission in its report, *Towards Responsible Government*, in relation to these issues:

*Commission of Audit Recommendation 17 (g) – Short to medium term health care reforms:*

*...reforming the private health insurance market to provide greater incentives for efficient and cost effective health management through deregulation price setting arrangements, allowing health funds to expand their coverage to primary care settings, relaxing community-rating to allow health funds to vary premiums to account for a limited number of lifestyle factors, including smoking; and reforming the arrangements by which equalise risk through the sector.*

One component of the Commission's brief was to look at efficiency improvements to the Australian government and its direct effect on the economy. Through this, the Commission recommended reducing the regulatory bodies covering the health industry. One such area was to merge the regulatory duties of PHIAC into that of APRA. This recommendation was adopted as part of the 2014-15 Federal Budget, as part of measures to streamline government operations.

# 3 International Insurance Regulation

The international regulatory landscape is currently experiencing changes, with global cooperation leading to regulations and standards starting to converge. In order to fully understand the landscape in each of the countries we undertook the following investigation:

- Interviews with insurance regulation experts, working with and for insurers in each of the countries we reviewed.
- Utilising Deloitte experts globally to get an understanding of the depth of regulation and its effects on the business.

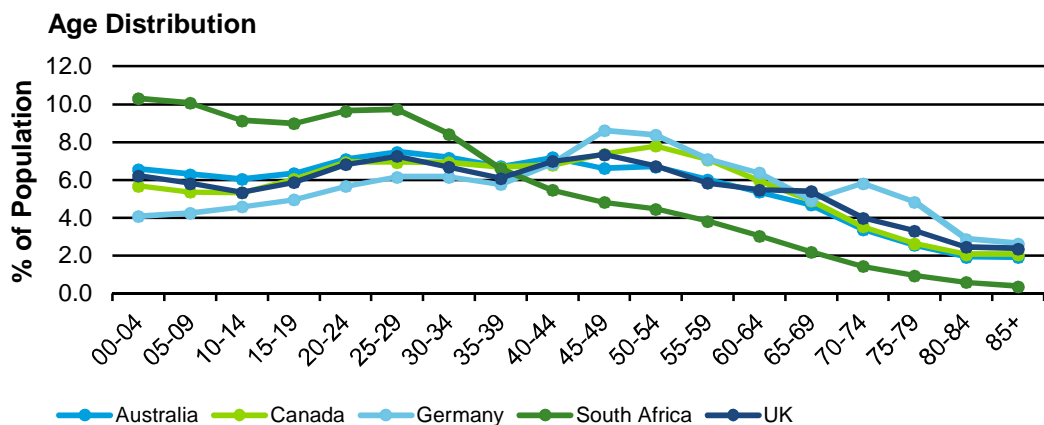
The response of the differing regions to major events such as the GFC has shown how well regulated, be that adequately or under regulated, countries are. As a result of the GFC, and through the priorities of the G20 and the IAIS, we are seeing some countries change their prudential regulation to minimise the risk of failures in the financial services industry. These changes have been both structural, in who regulates whom, and technical, in terms of the level of capital and pricing required.

Although changes to the differing prudential regulations to withstand additional stresses are one part, the ability for different countries to regulate organisations that create innovative products that suit the market and its consumers is another.

## 3.1 Country Selection and Overviews

As agreed with the Financial Services Council, we concentrated on four major markets being Canada, the United Kingdom, Germany and South Africa, and on how the regulatory landscape within those countries helps and/or hinders product innovation. We were also interested in what regulatory changes occurred as a result of the GFC.

The effect of the demographic makeup of each of the countries was also important. The relative age distribution of the selected countries, compared with the Australian demographic, is important for the global comparison. Differences in the age distribution relative to Australia, helps indicate the relative pressures each jurisdiction may have in managing the impacts of the ageing population.



Source: OECD 2013

The distribution of the population across the age bands is quite similar between the UK, Australia, Canada and Germany. South Africa has a much younger population to that of the other countries reviewed and it still has a developed and sophisticated life insurance market.

### 3.1.1 Canada

Canada was one of the earliest adopters of an integrated prudential regulatory framework, covering banks, insurers, friendly societies, credit unions, pension plans and trust and loan companies. The main regulator (the Office of the Superintendent of Financial Institutions (OSFI)) has created a risk based approach to regulation that covers all types of financial services institution that is in many ways simpler than APRA's.

Although prudential regulation is driven by the OSFI, the complexity of the Canadian political system further complicates the regulatory landscape. Canada has a two-tiered approach to its regulation. The main prudential regulation, relating to capital levels, is managed by the OSFI for all provinces other than Quebec, which is managed by the Autorité des Marchés Financiers (AMF). Further regulation is completed at a provincial level, where pricing and terms and conditions are regulated where required. The regulation of market performance is effected at a provincial level, requiring licensing to be completed within each province. This increases the number of regulatory requirements across the industry in Canada, but not necessarily the intensity of the regulation.

Canada currently has a competitive long term care insurance market and the regulation of this market and its competitiveness will be of interest to the Australian market. The effect of Canada's universal health care system, similar to that of Medicare, is also of interest due to its interaction with the life insurance sector.

The Canadian insurance market is quite mature and competitive. It currently has 145 active general insurance companies and 90 active life insurers. There are currently 108 insurers offering health insurance, which is made up of a combination of life and general insurance organisations. This is in comparison to the Australian market, for which there are 121 active general insurance companies and 28 active life insurers.

### 3.1.2 United Kingdom

The United Kingdom could be seen as the birth place of modern insurance. The global general insurance market is still heavily guided, both in product design and regulation, by the Lloyds market. The regulations surrounding the general insurance market in the UK is based around the original legislation of the Lloyds market. The life insurance market within the UK has been driven by traditional life insurance products.

The United Kingdom has undergone a significant amount of regulatory and supervisory change since the start of the Global Financial Crisis. The UK, as with the rest of the European Union, is in the process of updating its capital standards to Solvency II.

The UK has also completely redesigned its prudential regulatory supervisory roles. This was driven by the separation of regulatory responsibilities and the subsequent dissolution of the Financial Services Authority. Much like Australia, the UK has moved to a twin peaks regulatory arrangement where the prudential component of regulation is covered by the new Prudential Regulatory Authority (PRA) (a subsidiary of the Bank of England) and the market conduct regulation (as covered by ASIC in Australia) by the new Financial Conduct Authority (FCA). One of the main objectives of the new regulatory regime is to facilitate competition, but not at the expense of financial stability.

The UK is currently making changes to its policies around retirement products (i.e. lump sum vs annuity streams) in an effort to combat the ageing population. The change to prudential regulation has believed to be driving change in the market.

*...research suggests there is going to be a huge amount of innovation and creativity when it comes to developing new products and services...*

Much like Medicare in Australia, the National Health Service (NHS) in the UK may be a restricting factor in a private market for long term care insurance due to the population's expectation of universal care.

The UK insurance market is very competitive; with significant competition from UK based insurers and a significant presence of European Community insurers. There are currently 976 active general insurers in the market and 285 life insurers operating within the UK, with a significant number of these insurers from based within the EEC.

### 3.1.3 South Africa

The South African regulation environment is undergoing significant change. From 1 January 2016 South Africa will have an entirely new prudential regulatory system called Solvency Assessment & Management (SAM). The main principles and methodologies are materially the same as Solvency II, with only some specific details differing. There will be some interim measures around governance that will be introduced in 2015. Both prudential regulation and market conduct regulation is currently covered by the Financial Services Board. However, health insurance is regulated by Council of Medical Schemes. For insurers other than health, the regulatory arrangement is changing with planned movement to a "Twin Peaks" framework similar to Australia.

In contrast to the other countries, South Africa differentiates its prudential legislation into the Long Term and Short Term insurance acts. The regulation of insurers is driven by the tenure of the policies and not the type of products. As expected, this generally does naturally split the applicable legislation along general and life components. However, it should be noted that the long term insurance legislation explicitly covers health policies; this specifically relates to payment of a fixed sum insured on occurrence of a specific event e.g. TPD/Trauma like benefits. There are also additional regulations around health insurance policies, however it is noted that life insurers in South Africa have been able to offer further rehabilitation benefits to their members when compared with the other countries through greater integration of product offerings with related health insurance entities.

The population distribution of South Africa is quite different to that of the other countries being reviewed. The South African market does not currently have the issues surrounding the ageing population that the other countries are experiencing. Yet even without this aging issue, the regulatory framework is being built to cope with these pressures. A driver for this may be the issues around disability care and health care costs for the government. This is driven by the current life expectancy given by the World Health Organisation of 61. This is more than 20 years below the other countries reviewed.

Although the insurance market within South Africa is mature, it does not have the level of competition seen in the European countries. It currently has 100 active general insurers and 79 active life insurance companies. There is some overlap between life and general insurers with the health insurance market.

### 3.1.4 Germany

Germany has a two tiered regulatory structure that was introduced after the GFC. The macro prudential regulation approach is guided by the Financial Stability Council, which is responsible for the overall prudential oversight. In this role the council is concerned with the overall stability of the market and not organisations within it. The direct prudential supervision is completed by the Financial Supervisory Authority (BaFin), which covers similar regulatory requirements as to that of both APRA and ASIC in Australia.

The German market is also undergoing a significant change in its management of capital, as with the UK, it is moving towards Solvency II as the basis of regulatory capital. This is changing the level of capital required and the complexity of regulatory work required by the insurers.

Germany has a compulsory long term care insurance scheme which is a combination of private and publicly issued insurance that has been successfully operated for 20 years. This will be of particular interest in how a private market PDI scheme could regulated in Australia.

Germany is experiencing an ageing population, with a significant drop off in population below the 40 year age group. With this ageing population, the German government has been adopting a number of insurance and government expenditure programs, with the compulsory long term care insurance program one of these. The approach that has been adopted in the German market to regulation and legislation in insurance to assist with these fiscal pressures, is important for the Australian industry moving forward.

Much like the UK market, there is significant competition in Germany. There are currently 318 general insurers operating in Germany and 109 life insurers. This does not include those insurers who sell into Germany from other parts of the European Community.

### 3.2 Regulation Oversight

The level of oversight and the areas for which regulation applies has a dramatic effect on the cost of compliance with regulation and the potential for hindrance to business flexibility and innovation. The scope of the distribution of regulation is dependent on the line of business. The scope of prudential oversight and regulation is fairly consistent across three of the countries, with South Africa and Canada historically having less intensity in the supervision of their regulation.

#### Life Insurance (including Disability Insurance)

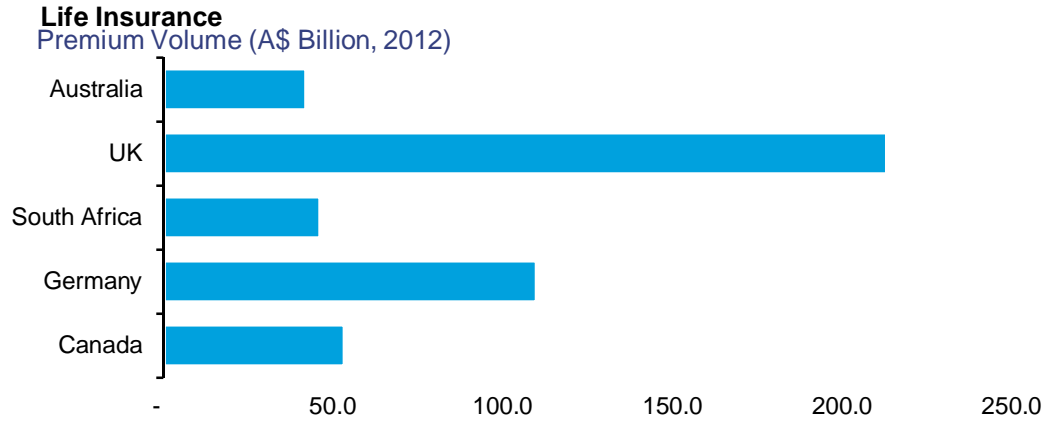
For life insurance the distribution of regulation is fairly consistent, with Capital requirements and the fit and proper person test important across the countries. Although Canada does not explicitly set out a fit and proper test, it is intrinsically required by the governance standards.

|                    | Australia     | Germany             | United Kingdom | South Africa  | Canada              |
|--------------------|---------------|---------------------|----------------|---------------|---------------------|
| Capital            | Regulated     | Regulated           | Regulated      | Regulated     | Regulated           |
| Price              | Not Regulated | Partially Regulated | Not Regulated  | Not Regulated | Not Regulated       |
| Terms & Conditions | Not Regulated | Partially Regulated | Not Regulated  | Not Regulated | Regulated           |
| Risk Management    | Regulated     | Regulated           | Regulated      | Not Regulated | Partially Regulated |
| Fit & Proper       | Regulated     | Regulated           | Regulated      | Regulated     | Partially Regulated |
|                    | Not Regulated | Partially Regulated | Regulated      | Regulated     | Regulated           |

German oversight around pricing and terms and conditions is around the allowable interest rate used in pricing, which reduces the ability to aggressively price certain annuities. Terms and conditions control in the annuity market has restricted the ability of German insurers to sell variable annuities and



other types of insurance products. Instead, the market for these products, although not significant, is being taken up by surrounding countries' insurers selling into Germany to cover this demand.

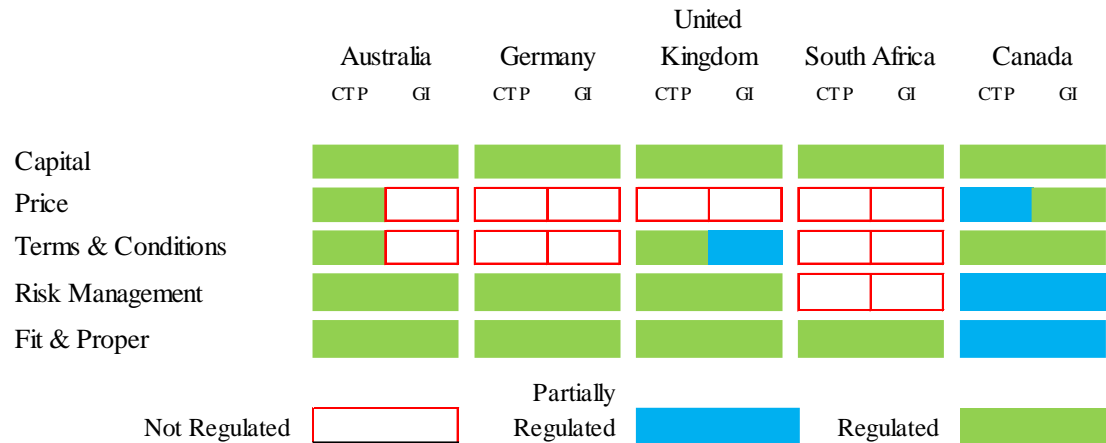


Source: Sigma No3/2013, Swiss Re

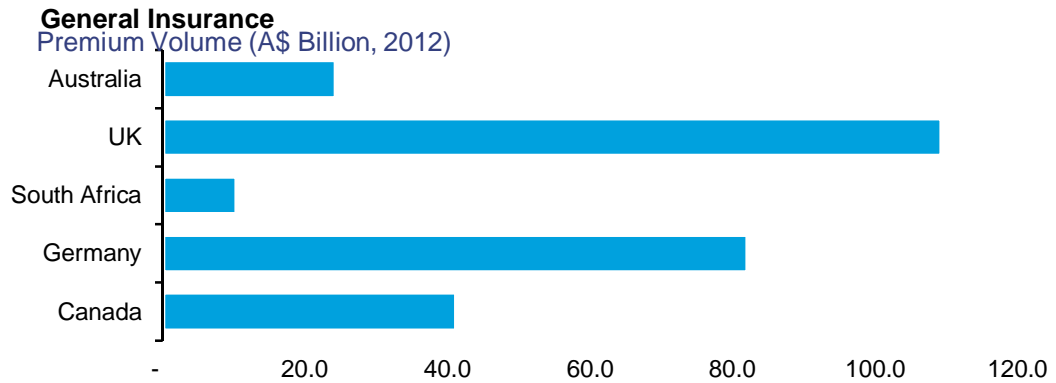
The UK life market is significantly larger than its comparative countries. This is in part due to the maturity of its private retirement income offerings and as a result the size of the pension and annuity market in the UK.

## General Insurance

General insurance regulation is fairly consistent across the industry. Of note are the pricing and terms and conditions around third party auto (CTP in Australia) insurance is where there is significant regulation. For the remainder of the general insurance lines, there is limited regulation around price and terms, with the capital standards and Fit and Proper test important.



The UK market for general insurance is a globally significant market, with the premium volume in part driven by the Lloyds market. General insurance regulation in the UK has been historically driven around ensuring that the Lloyds market remains globally competitive.



Source: Sigma No3/2013, Swiss Re

### Health Insurance

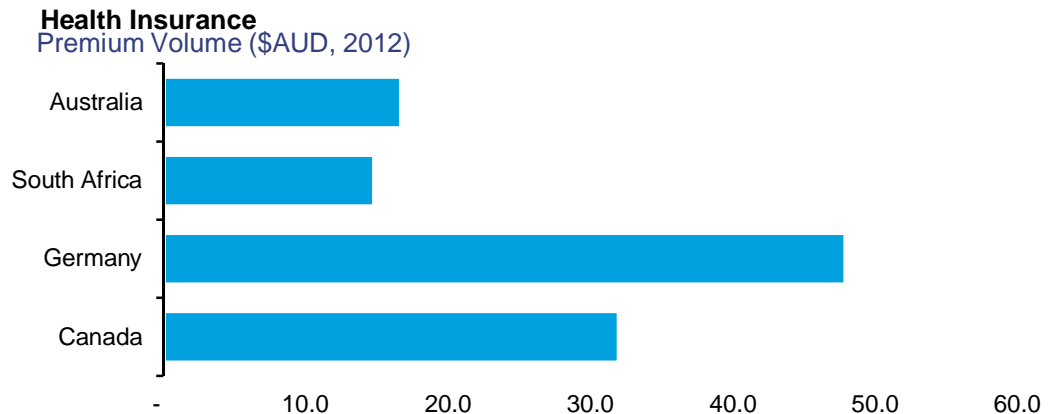
Due to the differing nature of public health benefits around the world there is a large difference in regulation across the countries. Germany, much like Australia, has incentives and disincentives for people to take up private health insurance, which works to minimise the level of government expenditure on health.

|                    | Australia | Germany   | United Kingdom      | South Africa        | Canada              |
|--------------------|-----------|-----------|---------------------|---------------------|---------------------|
| Capital            | Regulated | Regulated | Regulated           | Regulated           | Regulated           |
| Price              | Regulated | Regulated | Not Regulated       | Not Regulated       | Not Regulated       |
| Terms & Conditions | Regulated | Regulated | Partially Regulated | Partially Regulated | Regulated           |
| Risk Management    | Regulated | Regulated | Regulated           | Not Regulated       | Partially Regulated |
| Fit & Proper       | Regulated | Regulated | Regulated           | Regulated           | Partially Regulated |

Not Regulated: Red outline box  
 Partially Regulated: Blue box  
 Regulated: Green box

The level of regulation across pricing and terms and conditions is quite different across all regions and lines of insurance. Health insurance is an area for which insurance coverage and terms are regulated, which is expected due to the way in which it interacts with government payments. The regulations around terms and conditions and pricing of certain life insurance products in Germany are observed to hinder product innovation and design.

While significant limitations exist in most markets to limit payment of medical expenses to payment by health insurers, in South Africa notably a market for strongly integrated life and health products has emerged. These are however products offered under distinct licences and life insurers are not paying for regulated health services.



Source: Sigma No3/2013, Swiss Re, and Deloitte

### Long Term Insurance

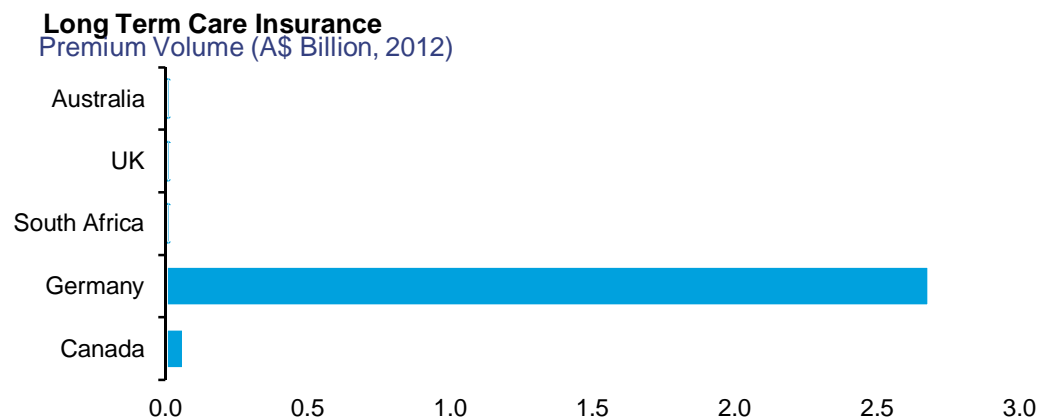
The regulation of long term care insurance across the jurisdictions varies in part due to the nature of the insurance company which is issuing the policy.

|                    | Australia<br>(Life) | Germany<br>(Health) | United Kingdom<br>(Life) | South Africa<br>(Life) | Canada<br>(Life)    |
|--------------------|---------------------|---------------------|--------------------------|------------------------|---------------------|
| Capital            | Regulated           | Regulated           | Regulated                | Regulated              | Regulated           |
| Price              | Not Regulated       | Partially Regulated | Not Regulated            | Not Regulated          | Not Regulated       |
| Terms & Conditions | Not Regulated       | Partially Regulated | Not Regulated            | Not Regulated          | Regulated           |
| Risk Management    | Regulated           | Regulated           | Regulated                | Not Regulated          | Partially Regulated |
| Fit & Proper       | Regulated           | Regulated           | Regulated                | Regulated              | Partially Regulated |
|                    | Not Regulated       | Partially Regulated | Regulated                | Regulated              | Regulated           |

Although the terms and conditions are not significantly directly regulated across the jurisdictions, there is some indirect regulation. A particular example of this is with the payments for medical expenses, as these are generally tightly regulated in the health insurance market. Globally, this restriction is generally avoided by insurers in the LTC market, as payments for LTC policies are predominantly made dependent on the level of disability, measured through the level of help required for Activities of Daily Living (ADLs), rather than an insured amount. This is similar to the way in which the Australian NDIS scheme is working.

The regulation of the German market is quite different due to it being linked to mandatory health insurance products and as such, the product is managed is more in line with a private health insurance product than a traditional life insurance product. As can be seen in the following figure, Canada is the only market of those reviewed, without mandatory insurance, for which there is an active private market.

*There is market demand for long term care insurance in Canada due to the ageing population, but without regulatory or tax incentives there isn't a viable private market.*



Source: OECD statistics

The long term care insurance market is quite limited with few countries where there is a material market operating. The German market is the only market for which there is incentivised LTC insurance. As such, it has a significant higher level of premium volume than the other countries. It should be noted however that the level of premium for LTC is significantly less still than other products, with the German market being around 5% of the associated health insurance premium income.

### 3.3 Depth of Capital Oversight

The depth of oversight of capital is seen as the main area of control that regulators exert. Through the changes in regulation brought on by the GFC, amongst other things, we have seen a change in the way in which capital requirements are calculated.

| Country        | Solvency Assessment – Historical            | Solvency Assessment – New                            |
|----------------|---|--|
| Australia      | A combination of rules and principles based | Principles based                                     |
| Germany        | Rules based                                 | Principles based                                     |
| South Africa   | Rules based                                 | Principles based                                     |
| Canada         | A combination of rules and principles based | An updated combination of rules and principles based |
| United Kingdom | A combination of rules and principles based | Principles based                                     |

The move towards the Solvency II framework has seen regulators change the basis of their assessment of insurers' solvency towards a principles basis, over a rules basis. With the move to the principle based capital standards, we are also seeing a closer alignment in the exposure risk. The level of regulatory capital required may have an effect on the available capital for innovative product designs. The level of regulatory capital required as well as the regulatory expense associated with the capital requirements in Australia versus its global counterparts is an important area of review. These issues may be areas of potential hindrance to innovation in the Australian market. This is discussed in more detail in Appendix C. It should be noted that Australian insurers are currently required to hold a more capital than their international counterparts

## 3.4 Pricing and T&C Regulation

Pricing regulation for life business globally is generally minimal as was seen earlier. The restrictions on pricing are applied more often around general and health insurance. The German market is, of the markets reviewed, the only market with restrictions around pricing and conditions on traditional life insurance business. With the opening up of the European insurance market, any insurer can sell insurance products to other nations within the European Union, whilst only being licensed and regulated by their home country of the insurer. This has led some German consumers to purchase more specialised products, like long term variable annuities, elsewhere in the European market where the available products and competition around them, are more in line with their requirements.

*The German regulatory framework may be viewed as inhibiting innovation within insurance companies through its tight regulation of product terms and conditions and capital requirements.*

With Australia signing additional free trade agreements and the respective opening up of financial markets the ability to sell between countries like the European market may a possibility for the Australian market. This could also lead to Australian insurers selling into other countries and expanding their markets without increasing regulatory issues.

In addition to the pricing requirements specific to life insurance products in Germany, there are also additional regulations enforced by the European Union which impact on pricing. In particular, the European Union has now banned the ability to price insurance based upon gender, as this is considered to be discrimination. As a result insurers must rely on other rating factors than gender.

We have also seen globally the increased restrictions and regulation around commissions and sales payments. The UK, Canada, South Africa and Germany have also recently introduced varying levels of restrictions on commissions, similar to the current Australian Future of Financial Advice changes on regulating commissions.

In South Africa there has been significant concern over the cost to the consumer as a result of the increase in the costs associated with the use of intermediaries in the insurance market. This is especially pertinent with regards to retirement savings products. The South African Treasury recently released a paper (National Treasury, South Africa, 2013) on the charges in retirement products and noted:

*Financial intermediaries, including retail agents and brokers, wholesale brokers, advisors and investment platforms, play a valuable role in bringing buyers and sellers of services together, and in some cases by providing financial advice in order to improve financial decision-making. However, intermediation of all types may have the unintended consequence of raising the complexity of retirement fund designs as well as their cost.*

The South African regulator has addressed these concerns historically by limiting maximum commissions on products where there were concerns about the alignment of interests between policyholders, the insurer and the intermediary, with specific allowance also made to ensure that this did not disadvantage access to products for low income market participants.

Of particular note are the regulations, or the lack thereof, around prices and terms and conditions. Of the markets covered, we note that there are no restrictions on product design and underwriting requirements such as automatic acceptance limits (AAL). These are not considered areas of which regulation is required, as the regulators are concerned with capital stability and customer safety. The regulator may indeed require approval of a products design before it is sold, but this with regards to underwriting requirements. As such, provided that the terms and conditions such as AALs are priced and reserved accordingly there is no concern.

One area where the regulation of insurance contract conditions does vary is the allowance for a statute of limitations on lodging of policy claims. Globally there is a wide disparity on limitations across

jurisdictions as well as insured product and the person/organisation insured. In the United Kingdom, for example, the Limitation Act notes a six year statute of limitation; however there are different rules for minors and brain injuries.

### 3.5 Aged Care / Long term Care

The regulation of long term care is quite varied across those nations that have an active market in long term care insurance. The German market is the most heavily regulated, due long term care insurance being mandatory for all tax payers. The product offerings are regulated in a similar way to which health insurance is regulated in the Australian market. This covers allowable payments, guarantee insurability, community rating and similar requirements.

The German state-subsidised and private supplementary long term care insurance is community rated, with no medical underwriting permitted. In order to encourage additional cover, much like Australia's private health insurance rebate encourages private health insurance take-up; the government will give a co-payment for additional LTC insurance taken out by an individual.

Due to the way that this product is managed and regulated in close association with health insurance, it is usually issued by the health insurer in a product linked to the individual's health insurance policy. For some substitutive health and long term care insurance products, which are additional to the mandatory level of insurance, premiums are limited and there is an obligation to accept all applicants. An additional restriction seen in the market is that once a person moves to a private provider of insurance, they cannot return to be covered by the government.

In the German market, there has been an active private LTC since the introduction of the compulsory LTC scheme in 1995. As of the end of 2009, there were 70 million people insured through the governments' compulsory scheme and 9 million people insured through a private insurer (SCOR Global Life, October 2012). Although there is approximately 12% of the population insured privately, currently there are only about 5% of those on claim that are insured through a private insurer. It should be noted that there was a significant increase in take up of private insurance through the mid 2000's which might account for the difference in claim rates.

The Canadian market does not have any additional regulations of the LTC market over and above traditional insurance products. The market is currently underserved and there are no current moves anticipated by the government to change the existing regulations. In comparison, the U.S has created a number of initiatives to encourage LTC and has approximately 10% of the population with cover, whereas Canada has approximately 1% of the population covered. The product is marketed and managed predominantly as a retirement type of insurance, where the cover is mainly used as an aged care support product. It is provided by life insurers in association with other long term insurance products.

Much like Australia, Canada has a universal healthcare scheme and a perception that support/cover is available to those who need it at no cost. This has resulted in a smaller market for the privately provided product due to the minimal perceived risk. As it is sold like life insurance, it does consist of underwriting and does not have guaranteed insurability. Irrespective, the insurers do experience large claim rates and the premiums are seen as quite high.

The United Kingdom market for LTC is very small, with less than 0.05% of the population over 40 insured with a LTC policy in 2008 (OECD, 2011). Much like Australia and Canada, the UK has a health system for which the population is not aware of the increased costs associated with long term care. The products available are generally known as pre-funded care products and are issued and regulated as per traditional life insurance products; these products are to generally pay the additional costs associated with long term care that is not covered by the non-means tested allowance. The issue of paying for retirement and the associated care is generally accomplished through a variety of income products, like reverse mortgages and enhanced annuities.

## 3.6 Disability Care

Disability care is a growing area of concern around the world. The costs of the long term disability, and not just aged related, are a large strain on the government budget. The Deloitte Access Economics report on expanding the coverage of private disability insurance indicated that private insurance could save the government approximately \$8b over 5 years. Globally this market is fragmented and the insurance cover is currently provided by a combination of life insurers, with income protection and TPD policies, health insurers with rehabilitation, and sometimes general insurers with accident policies.

The German insurance coverage for disability care is the most complete market for countries reviewed. This is due the design of their compulsory long term care cover and its associated private disability products. The coverage in Germany for payment for care and income assistance is similar to which the Australian NDIS and DSP covers. As with LTC, a component of the population is funding this coverage through private insurance, reducing the fiscal burden on the government.

The United Kingdom is currently updating their system of payments for disabled people or those with a long term illness. The new system is still completely government funded and is operated in a similar manner to which the NDIS is being operated. The new system of Personal Independence Payments (PIP) does not means test benefits. There is also still an overlap in payment systems across the National Health Service and the Department of Work and Pensions. Other than traditional disability income and TPD products, there is not a specific disability care market.

The government care for disability in Canada is quite fragmented. The main coverage for care is through the Canadian equivalent to Medicare and a government disability pension (which can also include a temporary income benefit for people who are actively employed and ill). The current system, which also includes very limited care assistance, leaves a significant strain on the individual in the case of disablement. Any private insurance is once again around the traditional disability income (over and above the government scheme) and any TPD insurance.

The disability care coverage in South Africa is the simplest of the four international countries reviewed. Once eligibility requirements related to the level of assistance required with Activities of Daily Living (ADLs) and meeting the assets and income requirements, the disabled may receive an income to cover care and expenses. South Africa is the only country that means tests the disability payments. The innovation in the life insurance market has seen insurers develop products to assist in paying benefits for those in need. These schemes, in conjunction with disability income and TPD policies assist those people who do not pass the means tested government disabilities.

The regulation of the benefits required under disability care, as well as the government's approach, has generally seen a fragmented approach to covering disability benefits. There are two markets for which there is an active market for private disability care benefits. South Africa and Germany have approached the input of private disability insurance. The German model is based around the mandatory nature of long term care insurance, for which disability care is a subset of this. South Africa on the other hand, has means tested the government benefits as well as not hindering innovation of insurance products covering the disability care benefits.

By having an active private disability insurance market, both South Africa and Germany are reducing the fiscal burden on their respective governments to care for the disabled population.

## 3.7 Innovation

The prudential regulations reviewed showed that no country's framework actively hinders or helps innovation. Most jurisdictions have components of assisting innovation and areas of hindrance.

It is noted in the paper Innovation in Insurance (Mills & Tubiana, 2013) that

*Innovation also imposes a compliance cost on innovators. This may be particularly true in financial services, whereas former Harvard Professor Elizabeth Warren noted, the specificity of some regulations worked against their effectiveness, inhibiting beneficial innovations while failing to regulate dangerous innovations. There is a reason that innovation is often preceded by “disruptive”, and disruption is not always welcome in a regulated industry.*

Competition is viewed as a key driver of innovation and this was also observed in the markets studied. The table below highlights the relative concentration of each of the markets for life insurance and general insurance relative to Australia, which stands out as being relatively less served in relation to the number of life insurers and with few new entrants to the market suggesting significant barriers to entry.

| Country        | GDP (US\$b) (2012) | Number of Life Companies | GDP/Life Co (US\$b) | Number of Non-Life Companies | GDP/Non-Life Co (US\$b) |
|----------------|--------------------|--------------------------|---------------------|------------------------------|-------------------------|
| Australia      | 1,532              | 28                       | 54.7                | 121                          | 12.6                    |
| Canada         | 1,821              | 90                       | 20.2                | 145                          | 12.6                    |
| Germany        | 3,426              | 109                      | 31.4                | 318                          | 10.8                    |
| South Africa   | 382                | 79                       | 4.8                 | 100                          | 3.8                     |
| United Kingdom | 2,461              | 112                      | 22.0                | 307                          | 8.0                     |

Source: OECD Statistics, World Bank.

Note: Number of companies for UK and Germany do not include companies registered elsewhere in the EU that issue products within those countries. For the UK this is an additional 173 life insurers and 680 general insurers.

Globally, including in the markets studied, the question of innovation to provide affordable insurance to a wider market and address underinsurance issues is acknowledged and poses an innovation challenge which has been specifically addressed in some markets as noted below.

South Africa has both areas of their prudential oversight which are helpful in innovation and areas for which the regulatory oversight hinders innovation. One area of hindrance to innovation arises from the capital requirements on certain products. Some product areas, such as medical schemes, have capital requirements which are not set based upon the risks of the portfolio. As noted earlier, the arrangement of long and short term insurance legislation has led to increased innovation in the design of products. Discovery, one of the largest health insurers has moved into life and general insurance. It is known within the South African market as an innovative insurer that has been able to gain market share through innovation. Part of this innovation is the Vitality product that it offers to the market. This programme, based on behavioural economic principles, which Discovery is currently partnering with insurers globally on also, encourages its members to get fit and eat healthily. The programme offers discounts on a range of lifestyle products which are varied dependent on the level of engagement and health checks completed.

In addition to fostering innovation within the traditional insurance markets, South Africa is implementing additional regulations to assist innovative companies address the specific challenges of improving access to insurance and consumer protection for lower income families in South Africa. This is an important step towards providing South Africans with better, more affordable insurance. By creating legislation and regulation to assist insurers to meet the population’s need and enabling previously unregulated entities serving the market to fit within that framework, the South African regulators are actively assisting innovation to meet the market in a regulated manner.

The German prudential oversight is generally seen as more onerous than some other jurisdictions. As noted before, the regulations around products like variable annuities have hindered the ability for German insurers to be competitive on these products. This has led those wanting these types of products to innovate and purchase internationally.



In Germany, long term care products are heavily regulated by the government, due to nature of the product being a private offering of a mandatory government product. However, this regulation has not deterred innovation within the products and in addition to the mandatory products. Insurers are selling products that are underwritten riders extending the coverage of the non-underwritten regulated product. The main innovative products are life annuity riders on the LTC product. There has been almost a tripling of riders written in Germany. There were approximately 1.5 million policies and over €400m in premiums written during 2010. (SCOR Global Life, October 2012)

*Although the regulations around private supplementary long term care insurance is quite strict, life insurers within Germany have been able to sell profitable underwritten insurance riders on top of these products.*

Much like in Germany, Singapore's long term care mandated product "ElderShield" has given rise to private innovation and competition for those who opt for private insurers. Although heavily regulated for components of the product, in a similar way to the German LTC product, the insurers have been able to use the basis of the product to create innovative and competitive products for its members. This innovation includes the inclusion of riders on the basic policy to give additional payments to those insured.

## 4 The Australian Insurance Landscape of the Future

The Australian prudential regulatory market has become increasingly streamlined. Combining prudential regulation under one regulator and creating single prudential standards covering life and general insurers are facilitating this process. The regulatory landscape is a major driver of the design of insurance offerings. Insurers are bound by the prudential framework when they are designing new products for markets. In this sense, products have to satisfy the regulator before satisfying the customers' needs. In order to keep the Australian market innovative as well as meeting the needs of the population and the government alike, improvements can be made to how insurance is delivered to the market.

A truly optimal product is one that offers solutions to the market for what they actually need and not defined by what an insurer can offer. By creating a regulatory landscape that fosters sustainable innovation in product design, insurers will be able to better design products to meet the market needs.

One key issue facing the Australian market at the moment, which was noted in the recommendations of the Commission of Audit, is the affordability of the NDIS for the federal government. The financial services sector and the life insurance sector in particular can assist the federal government deliver this important social policy. The Deloitte Access Economics report noted that a private market PDI could save the Commonwealth and State and Territory governments approximately \$8.5 billion. This can be seen in the following table.

| Parameters                                 | Savings / (Expenditure) (billion) |
|--|-----------------------------------|
| <b>Savings to the governments programs</b> |                                   |
| National Disability Insurance Scheme       | \$10.3                            |
| Disability Support Pensions                | \$3.4                             |
| <b>Gross Savings</b>                       | <b>\$13.7</b>                     |
| <b>Commonwealth Rebates</b>                | <b>(\$5.2)</b>                    |
| <b>Net savings to governments</b>          |                                   |
| Commonwealth                               | \$3.7                             |
| States and Territories                     | \$4.8                             |
| <b>Total net savings</b>                   | <b>\$8.5</b>                      |

Source: Deloitte Access Economics, 2014

Internationally, the market for long term care insurance, at both an aged care level and a whole of life market are successful when the products are mandated or incentivised by the government. This government policy creates a viable market for the insurance. Where there is no mandated market and universal health care is similar to Australia, we have seen a less than 1% take up of long term care insurance. In Germany, where LTC is compulsory, there is a competitive market for those offering private insurance.

There are a myriad of ways to design a potential product that meets the current NDIS type delivery. There are two components to the changes required, with or without any innovation in product design, to enable the insurers to complete the changes to be made. These changes are split between regulatory changes and legislative changes.

## 4.1 Innovation

Innovation is driven by the demand of the consumers. However, the ability of the insurers to create the products demanded is driven by the combination of regulation, legislation, risk profile of the companies themselves and their ability to raise the required level of capital. Innovation of life insurance products will help keep them relevant in the ever changing financial services market.

What would a potential innovative product look like in the market moving forward? To be successful, innovation must be seen as a perceived improvement for the consumers and a financial improvement for the insurers. As noted previously, a private disability insurance programme which offers the same or superior benefits as the public programme is one area where innovation may help in improving the Government's fiscal position, by reducing the public cost of the NDIS.

Another area, for which innovation of products can help improve performance for insurers, and also see an improvement in pricing for the insured, is disability based insurance. By linking payments to rehabilitation and/or medical treatment a claimant is likely to benefit from improved health outcomes and the insurer will be able to manage claim durations and costs delivering more sustainable, affordable disability insurance. If the insurer was able to pay for treatments directly, they would be able to have better control over rehabilitation further. This type of innovation is not currently able to occur due to the legislation surrounding payments to medical professionals.

Innovation will not only assist in addressing sustainability issues in insurance, it can also help in creating a better insurance framework. We are not only concerned with sustainability of disability insurance costs, as per the NDIS, the increasing longevity challenge will drive a significant amount of strain on to the future economy.

The regulatory and legislative framework must be able to assist insurers to meet these demands and help manage the strain on the future economy. Increasing longevity is going to cause issues on aged care, long term care, health insurance and traditional life insurance products.

Innovation is not just driven by regulation and legislation. Where there is a culture that rewards innovation, there is a flow on effect for more innovation. As discussed earlier, this can be seen in South Africa, where product innovation across all lines of insurance has been seen for a long time.

## 4.2 Regulatory changes

Australia's prudential regulatory landscape is driven by the way in which APRA, and until the changes put forward in the Commonwealth Budget are implemented PHIAC, controls the insurers and sets the prudential standards. The current prudential framework is divided across product types, i.e. general insurance, life insurance, superannuation and banking.

Through the Wallis Review and more recently the National Commission of Audit Report, there have been recommendations made in relation to the organisation of prudential regulation and oversight. However, there has not been any review or recommendations from these around streamlining the regulations themselves.

We have seen with the introduction of the LAGIC standards a move to uniformity. There is now the possibility that health insurance will now join this standard under common regulatory supervision with APRA.

To minimise regulatory compliance, a continuation of streamlining regulations across insurance products is important. Any streamlining of regulatory oversight will assist in improving Australian market efficiency. Australia has a number of major insurance conglomerates that may see significant gains from any reduction in regulatory overlap.

We have seen the insurance market in the European Economic Community open up through the streamlining of regulatory oversight. This change to regulation has increased efficiency for cross

border companies that has opened up new markets that they were not operating in before and reducing compliance costs where they had an existing operation. For Australia to open up its market to internationally regulated insurance companies, perhaps through the expansion of free trade agreements, there will be increased competition within the market. This increased competition may bring about the introduction of products considered innovative into the Australian market.

As noted in the review of the depth of regulation, Australian insurers are currently required to hold a stronger level of capital their international counterparts. The regulatory hurdles associated with the capital levels are sometimes seen as limiting the entry of new insurers to the market and as such limiting competition and innovation.

## 4.3 Legislative changes

There a number of legislative frameworks that can assist in minimising regulatory compliance, whilst at the same time assist in innovation across the insurance companies. We have seen in South Africa, the arrangement of insurance legislation, across short term and long term products, a legislative framework that has assisted in innovation in customer centric products.

In order to assist the Australian market to increase its innovative potential, and to assist in reducing budgetary stresses on the government, there are a number of changes that could be made to the legislative system.

### A Private Disability Insurance Product

One such area of government budgetary assistance is the care of the disabled through the national disability insurance scheme and the Disability Support Pension (DSP). There is an opportunity for the insurance market to create a product that meets not only the requirements of the NDIS but also covers the associated payments made under the DSP. Those people gaining assistance through the NDIS are generally those who will also be receiving a DSP payment.

The needs of a disabled person span benefits provided by different types of insurers and by Medicare:

- Hospital treatment can result in benefits being provided by Health insurers or Medicare
- Ancillary benefits, such as wheelchairs, home modifications and physiotherapy could be provided by both health or general insurance
- Income benefits such as disability income or a pension could be provided by a life or general insurer
- Medical treatment that is not provided in hospital such as a GP visit will be covered by Medicare

A single insurer could not currently provide a private market Private Disability Insurance (PDI) product with these benefits. To do so would require freeing up the definitions of the products that could be offered by the three types of insurer. The overlap with Medicare would need to be addressed.

An area for further consideration in offering a complete private market PDI is the effect of legislation requiring Health Insurers' premiums to be community rated. A potential solution is to use the methodology put forward by the Commission of Audit and allow the insurers to vary prices based upon a limited number of lifestyle factors.

In order to maximise the reduction of government expenses, as well as incorporating the best benefit for the insured, an optimal product would include the income and benefit payments of the existing NDIS and DSP, plus the ongoing private health insurance cover.

### An Optimal PDI Solution

Any new legislative structure must further align the requirements across life, health, general insurance and aged care. The South African market has reduced their legislation to short and long term insurance, which has enabled their insurers to create more products that blend across insurance lines to better serve the consumers.

As seen in the example for a private market PDI product, new legislation must enable insurers to offer products across current business lines, without having to have multiple licences and statutory reserves for an individual product. This would minimise compliance, duplication of work and therefore costs.

By enabling an insurer to sell a hybrid product, with one licence, the prudential regulations must move closer to alignment as well. With areas such as Appointed Actuary responsibilities, External Peer Review requirements needing to be aligned to ensure that there is no regulatory preference to hybrid product offerings.

A Private Disability, and as a result a Long Term Care insurance market will be able to become viable once some or all of the following changes happen with the Australian insurance market.

- Means testing the NDIS with the DSP, or creating a private disability insurance surcharge as noted in the Deloitte Access Economics report.
  - By incentivising people to move into a private NDIS and DSP product, a viable market is created. This private market will help improve the budget sustainability
- Enabling all insurers to provide payments for benefits currently offered by health insurers
  - This helps in insurers, especially those associated with disability based insurance, to improve recovery rates, which will reduce overall claims costs and may as a result increased market productivity.
- Streamline legislation covering hybrid products, to enable products to be written under one licence.
  - By reducing the regulatory oversight on a hybrid product, there is improved efficiency of regulation as well as enable insurers to provide product to meet the market's needs.
- Align prudential regulations across life, general and health insurance to minimise the risk of prudential arbitrage.
  - With the opening up of the insurance market, any differences in regulation across life, general and health, would enable insurers to offer products that minimise regulatory compliance whilst still covering the same consumer need.

We have seen in the German market that the creation of the mandatory Long Term Care market has helped create an additional insurance product market. German life insurers are now selling life annuity products that payout upon disability. This is in essence a disability support pension, but that is underwritten and profitable.

## Capital

One area for further review is the level of sufficiency of capital that is required by Australian insurers under LAGIC when compared with Solvency II. The intention of Solvency II of ensuring that 85% probability of sufficiency prior to regulatory intervention when compared with the 99.5% of the Australian market is a major difference. A reduction in the capital levels based upon a reduced level of regulatory intervention may enable Australian insurers to free up capital for increased investment and innovation.

## 4.4 Potential Improvements to the Australian Market

There are a range of opportunities within the broader insurance market that will assist in Australian insurers remaining competitive, whilst improving the market efficiency, innovation and product development. These are all areas of difference that have been observed through the international markets reviewed.

The following table highlights the areas identified for potential further consideration:

| Consideration   | Outcome    |            |                     |                    | Commentary   | Reference Country  |
|---|------------|------------|---------------------|--------------------|--|--|
|   | Efficiency | Innovation | Product Development | Market Development |  |  |
| Consistent licencing and prudential framework                                 | X          | X          | X                   |                    | Inconsistencies inhibit offerings and efficiency   | South Africa   |
| Combine certain ASIC and APRA responsibilities                                | X          |            |                     |                    | Improve efficiency of regulated entities   | Germany for market behaviour and prudential stability only |
| Open the Australian insurance market  |            | X          | X                   | X                  | Increased innovation through lower barriers of entry for international insurers, Opportunity for Australian insurers to export their offerings | UK, Germany  |
| Reduce barriers to entry  |            | X          | X                   | X                  | Leading to a more competitive market and more opportunity for innovation   | South Africa   |
| Incentivising the purchase of a PDI product                                   | X          |            |                     | X                  | Improve budget sustainability  | Germany, Canada, UK  |
| Removal of limitations on benefit payments                                    | X          |            | X                   |                    | Improve claims costs, and product options  | South Africa   |
| Scaled approach to regulation, enabling offerings to service the underinsured |            |            | X                   |                    | Improve market coverage and the ability for small companies to create innovative products  | South Africa   |
| Agnostic regulatory framework to technological change                         |            | X          | X                   | X                  | The pace and scale of technological change requires a regulatory approach that monitors developments and responds as necessary                 | N/A  |

| Consideration  | Outcome    |            |                     |                    | Commentary   | Reference Country            |
|--|------------|------------|---------------------|--------------------|--|------------------------------|
|  | Efficiency | Innovation | Product Development | Market Development |  |                              |
| Use of tax incentives to address ageing population         |            |            |                     | x                  |  | Germany, UK, Australia (PHI) |
| Regulate the maximum commissions payable to intermediaries | X          |            |                     |                    | Improving the market price of insurance to consumers and greater alignment of interests to address churn | South Africa                 |
| Statute of limitations on insurance claims                 | X          |            |                     |                    | Improve market certainty and efficiency by having certainty of claim amounts.                            | Canada, UK                   |

# 5 Limitation of our work

## General use restriction

This report is prepared solely for the internal use of The Financial Services Council. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose set out in our engagement letter dated 21 May 2014. You should not refer to or use our name or the advice for any other purpose.



# Appendix A

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# Appendix B

## Relevant International Acts and Regulations

### Canada

Insurance Companies Act 1991

Canada Health Care Act 1985

Canada Disability Savings Act 2007

### Germany

Insurance Contract Act 2008

### South Africa

Long Term Insurance Act 1998

Short Term Insurance Act 1998

### United Kingdom

Financial Services Act 2012

Life Insurance Act 1774

# Appendix C

## Depth of Capital Oversight

The depth of oversight of capital is seen as the main area of control that regulators exert. Through the changes in regulation brought on by the GFC, amongst other things, we have seen a change in the way in which capital requirements are calculated.

| Country        | Solvency Assessment – Historical            | Solvency Assessment – New                            |
|----------------|---|--|
| Australia      | A combination of rules and principles based | Principles based                                     |
| Germany        | Rules based                                 | Principles based                                     |
| South Africa   | Rules based                                 | Principles based                                     |
| Canada         | A combination of rules and principles based | An updated combination of rules and principles based |
| United Kingdom | A combination of rules and principles based | Principles based                                     |

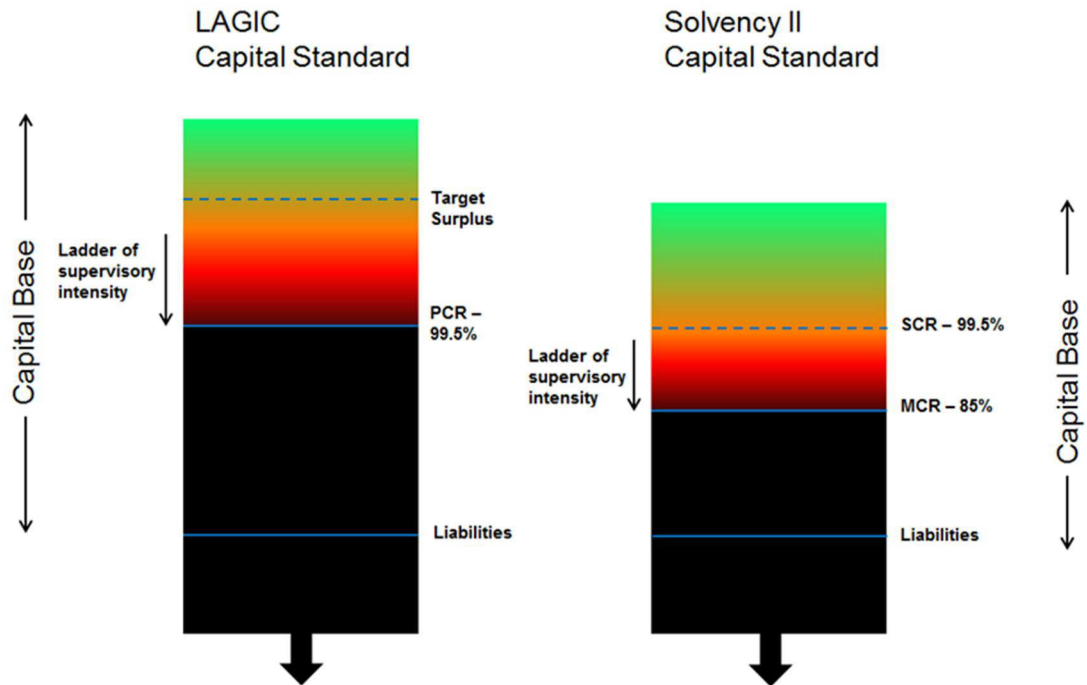
The big change in the method for which capital and solvency levels are calculated has been a move to the Solvency II framework. This is aligning the capital and solvency requirements globally which will help in cross border issues. With the move to the principle based capital standards, we are also seeing a closer alignment in the exposure risk. With the level of capital required to be held based upon a similar Target confidence level, as can be seen below. However, the level of at which regulatory action is taken is markedly different. What is known as the hard floor of prudential capital is the level of capital at which the insurer is deemed to be regulatory insolvent and the regulator will step in. At the soft floor level, the regulator will start to intervene in the management of the insurer to protect ongoing solvency. It is this level to which organisations will generally manage their capital, based upon their risk appetite.

| Country        | Capital Standard                         | Target Confidence Level    |                            |
|----------------|--|----------------------------|----------------------------|
|                |  | Hard Floor                 | Soft Floor                 |
| Australia      | LAGIC                                    | 99.5%                      | 99.5% + Target Surplus     |
| Germany        | Solvency II                              | 80%                        | 99.5%                      |
| South Africa   | Solvency Assessment and Management (SAM) | 80%                        | 99.5%                      |
| Canada         | OSFI Capital Standard                    | N/A (factor based capital) | N/A (factor based capital) |
| United Kingdom | Solvency II                              | 80%                        | 99.5%                      |

Note: Prior to South Africa adopting SAM, the target confidence level hard floor was 95%.

Although both LAGIC and Solvency II have a similar target confidence level for the level of capital required the operations around that level of reserves is markedly different. Under LAGIC, the Australian insurers are required to hold at all times the capital at the 99.5% probability of sufficiency (the Prudential Capital Requirement (PCR)) and below that level APRA can intervene in the operations of the company. As such, the Australian insurers must hold a level of Target Surplus in addition to their capital requirements. However, under Solvency II, insurers are to hold the 99.5% probability of sufficiency level of capital, but the regulator will not take over the company until it breaches its Minimum Capital Requirement (MCR) which is only at 85% probability of sufficiency.

This will lead to a difference in the intent of each standards required capital level, which can be seen in the figure below.



The implementation of the Solvency II capital standards throughout Europe is seen as an expensive imposition to business (Ugwumadu, 2014). The cost of the regulation for what is seen as marginal gain terms of economic safety is viewed as excessive. Australia has recently introduced the LAGIC standard, which has similar capital requirements of Solvency II, albeit a more simplistic version due to the simpler products in the Australian market. The European market especially has required the construction of complex stochastic models which has been at significant cost to the insurer. However, it should be noted, that under Solvency II the companies are allowed/encouraged to use a robust internal capital model, which has seen the level of capital required by the insurers reduce to a level below that of the Solvency Capital Requirement (SCR) noted above. This further reduces the level of capital required to be held by insurers.

It should be noted, that although the EU has yet to implement Solvency II, with the release date being pushed back two years to 1 January 2016, the insurers have already expended a significant amount of time and money to prepare for the launch. Although with the international harmonization of prudential regulation a priority of the G20, the implementation of Solvency II is a matter of when, not if

