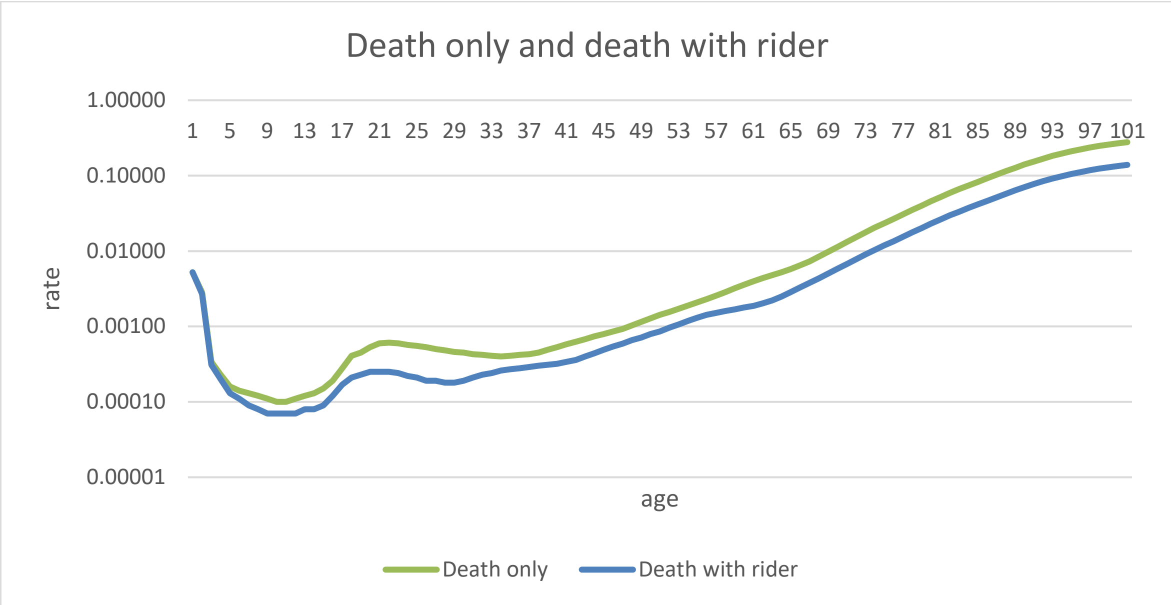
COURSE COVERAGE

Question	Unit	Key performance outcome	Learning objective	Marks
Q1 a	1, 3	1.1, 3.8, 3.9	1.1.1, 3.8.2, 3.9.2	3
Q1 b	1, 3, 4	1.1, 3.9, 4.14	1.1.1, 3.9.2, 4.14.1, 4.14.2	17
Q1 c	1, 2	1.1, 2.5	1.1.1, 2.5.1, 2.5.5	5
Q1 d	3, 4	3.10, 4.12	3.10.3, 4.12.2, 4.12.3, 4.12.4	5
Q2 a	1	1.2, 1.3	1.2.6, 1.3.1, 1.3.2, 1.3.3	4
Q2 b	1	1.1	1.1.2	7
Q2 c	2, 3	2.4, 2.5, 2.7, 3.8, 3.9, 3.10	2.4.1, 2.4.2, 2.4.3, 2.5.1, 2.5.5, 2.5.6, 2.7.4, 3.8.1, 3.8.3, 3.9.2, 3.9.3, 3.10.3	19
Q3 a	1, 2, 3	1.2, 1.3, 2.4, 3.9	1.2.5, 1.3.2, 1.3.3, 2.4.3, 3.9.1, 3.9.3,	15
Q3 b	2, 3	2.4 3.8	2.4.3, 2.5.5, 2.5.6, 3.8.1, 3.8.2, 3.9.2,	15

QUESTION 1 (30 Marks)

a)



- If graphed on a log scale – the typical q_x curve is apparent with the accident hump clearly visible. **(1 mark)**
- The gap between the rates generally increases as age increases. **(1 mark)**

Maximum 1 mark for describing the general nature of the shape of the curves.

- Death with Rider graduated rates are lower than Death Only graduated rates for all ages > 0 particularly at older ages. **(1 mark)**

1 mark for noting that Death with Rider rates are always lower than Death Only after age 0.

- A reason that Death with Rider rates are lower than Death Only is because many of these policies terminate on payment of the TPD and/or trauma claim payment before the life insured dies. **(1 mark)**
- Conversely Death Only graduated rates incorporate all lives, including those who have suffered a total and permanent disablement and/or a critical illness. Given this includes all lives including all those in ill health, then the average risk across the portfolio of a life dying, particularly at older ages is greater than the average risk under the Death with Rider portfolio. **(1 mark)**

1 mark for any other valid point

Max 3 marks for a)

b)

Effective decrement rates
Table of effective i_x (base TPD * selection) **(1 mark)**
Table of effective k_x (based Death with rider * selection) **(1 mark)**
Table of effective q_x (based Death only * selection) **(1 mark)**

Decrement tables
Death with rider decrement table that include mortality, morbidity and lapses **(3 marks)**
Award 1 mark where a student has allowed for removal of lives that TPD in applying k_x.
Mark the remainder of the student's answer using the decrements they have derived and award marks accordingly.
Death only decrement table that include mortality and lapses **(2 marks)**

Claims cost[1]
Add together TPD and Death with rider decrements and applying to TPD SI **(3 marks)**
Apply Death only decrements to remaining SI (1m – 400K) **(3 marks)**
If a student has determined their decrement table a different way, ensure claims cost is consistent with their assumptions. Award a maximum of 3 out of 6 marks.
Allowance for l_x **(1 mark)**

PV
PV with end of year timing **(1 mark)**

Assumptions
Actual experience is in line with the standard tables in respect of shape by age, sex and smoker status and by commencement year. Otherwise experience factors would need to be added as an overlay to the standard basis. **(1 mark)**

1 mark per assumption reasonably explained, to a maximum of 3marks.

Total 17 marks for b)

c)

- We would need to set an assumption regarding the expected proportion of lives that might purchase this option. **(1 mark)**
- In setting mortality and morbidity assumptions we would need to consider whether lives that take up this option would have a different claims profile to those who purchase life with a TPD rider, i.e. could they have knowledge or information about themselves which could put them at greater risk of claiming under both TPD and death cover. **(1 mark)**
- We would need to consider setting an assumption regarding the expected mortality risk for lives who have suffered a total and permanent disabled relative to lives who are healthy. **(1 mark)**
- For the proportion of lives that claim under TPD, we would need to model the cost of waiving their future premiums for the sum insured that is reinstated. **(1 mark)**

[1] Total claims cost = q_x * death SI + (i_x – k_x * q_x) * TPD SI where k_x is the proportion of deaths attributable to TPD (analogous to the definition for trauma in Fabrizio & Gratton). Assuming k_x * q_x is (death only q_x – death with rider q_x) from the FSC table, then total claims cost is given by death only q_x * death SI + (i_x – death only q_x + death with rider q_x) * TPD SI, which can be re-expressed as death only q_x * (death SI – TPD SI) + (i_x + death with rider q_x) * TPD SI

- We would also need to set lapse assumptions for lives who have claimed under TPD and had their sum insured reinstated, for example a nil lapse rate should be applied for lives whereby the full value of their future premiums is waived. This will impact claims and expense cost through the number of lives in force. **(1 mark)**
- Administrative and system changes may be required to allow a policy on which a claim has been paid to stay in force and the additional costs relating to this may need to be considered when setting unit cost assumptions. For example, maintaining contact with policyholders who have claimed on TPD may be problematic where there is no regular premium being paid due to the premium wavier. **(1 mark)**
- We could compare the cost of the option against the expected cost of claims and expenses for standalone TPD and death only business offered by competitors (given Life Co does not currently write standalone TPD) to ensure it is reasonable. **(1 mark)**

1 mark for any other reasonable point, well explained

Max 5 marks for c)

d)

- Marginal pricing involves the use of different expense assumptions than those that were determined as part of the annual expense analysis. Typically, it involves disregarding overheads and costs that would normally be shared amongst policyholders and is most commonly used when considering a development that does not materially impact the expenses of the business and so can be considered a marginal activity. **(1 mark)**
- If the TPD benefit was sold on a standalone basis it would have to cover all the costs of policy issue etc., but where the TPD cover is written in conjunction with a death benefit (even if it doesn't reduce the death benefit when paid) then it can be argued that the Double TPD should be priced differently from a standalone cover as the death cover premiums will already have an allowance in them for policy issue etc. **(1 mark)**
- An objective of marginal pricing is that the initiative generates revenue and volumes that would result in a downwards reduction in expense assumptions once this is taken into account and so it is effectively bringing forward benefits. **(1 mark)**
- Only allocating marginal expense when pricing the Double TPD option means that the option could meet profitability targets that do not reflect the full allocation of all expenses. **(1 mark)**
- Ultimately Life Co would need to be able to cover overheads from revenue in order to be profitable therefore sales volumes for products where expenses are fully allocated would need to be sufficient in order to justify using marginal pricing for a new benefit. **(1 mark)**
- The level at which premiums are set under a marginal pricing approach should be sufficient to cover costs, however, low enough to encourage take up of the option and/or to increase sales of the primary benefit being Death with TPD rider. **(1 mark)**
- If sales volumes of the primary benefit increase then fixed overheads could be spread across more policies which would improve overall profitability of the line of business. **(1 mark)**
- The fact that this option includes a premium waiver feature means for policies with equal death and rider sums insured, no income would be being received while Life Co is on risk for paying the full value of the death sum insured. This premium waver would need to be considered when pricing the option. **(1 mark)**

- Life Co could benchmark its pricing for Double TPD with its competitors to ensure it is aligned with the market. In the event its competitors are also marginally pricing, using a fully allocated basis may make Life Co's double TPD option unattractive meaning it may not achieve its sales targets if lives can get cheaper cover elsewhere. **(1 mark)**

1 mark for any other reasonable point that is well explained.

Max 5 marks for d)

Total 3 + 17 + 5 + 5 = 30 Marks for question 1

END OF QUESTION 1

QUESTION 2 (30 Marks)

a)

Appointed Actuaries

- Under the Life Act, a Life Company needs to appoint an Appointed Actuary who meets the criteria set out in Prudential Standard LPS 320. **(1 mark)**
- Under the Life Act, a Life Company must always have an Appointed Actuary and the Appointed Actuary position must be filled within six weeks of registering the Life Company and written notice must be provided to APRA within 14 days of the appointment. **(1 mark)**
- The Appointed Actuary must at all times comply with APRA's prudential standards. **(1 mark)**
- Under LPS 320, the Life Company must ensure the Appointed Actuary satisfies the eligibility criteria in CPS 520 Fit and Proper and is at all times a fit and proper person. **(1 mark).**
- Under LPS 320, the Life Company must ensure the Appointed Actuary has access to all relevant data, information, reports and staff of the life company that the Appointed Actuary reasonably believes are necessary to fulfil the role. **(1 mark)**
- Under LPS 320, a Life Company must ensure that its Appointed Actuary is fully informed of all prudential requirements applicable to the life company. In addition, the life company must ensure that the Appointed Actuary is provided with any other information APRA has provided to the life company that may assist the Appointed Actuary in fulfilling the role and responsibilities under this Prudential Standard. **(1 mark)**
- Under LPS 320, a life company must arrange for its Appointed Actuary to investigate and report on the financial condition of the company at least annually. **(1 mark)**
- Under LPS 320, a life company must not issue or modify a policy without first receiving and considering written advice from the Appointed Actuary in accordance with paragraph 24. **(1 mark)**
- Under LPS 320, a life company must not enter into, modify or terminate a reinsurance arrangement without first receiving and considering written advice from the Appointed Actuary. **(1 mark)**
- A life insurance company must have a policy, approved by the Board that identifies when advice from the Appointed Actuary is required, to whom the advice should be given and under what circumstances the advice should be addressed to the Board. **(1 mark)**
- A life insurance company must seek advice from the Appointed Actuary in relation to distributions and dividends. **(1mark)**

1 mark for any other reasonable point.

Max 4 marks (students must state that the Life Act requires an AA to be appointed to get full marks).

b)

Strategy

- In the last few years NAB, CBA and ANZ have agreed to sell their life insurance businesses to Nippon Life, AIA and Zurich, respectively. **(1 mark)**
- Life insurance profitability is highly dependent on a number of "natural" and "market" forces and as such is fundamentally different to the steady and predictable fee revenue that can be earned from a bank's core business (i.e. borrowing and lending). **(1 mark)**
- The volatility and uncertainty of the profit stream for life insurance has led to many investors reconsidering their involvement in the business. **(1 mark)**
- Historically it was considered attractive to be able to offer your customers a full range of financial services to avoid the risk of another service provider poaching them – however, this approach has not been very successful in the Australian market. **(1 mark)**
- In an increasingly competitive market there is a push to find sufficient size to achieve economic viability – this has frequently been achieved via acquisition though the benefits have not always been realised. **(1 mark)**
- The industry has suffered from a lack of investment and renewal with most companies still running policy-based administration systems with limited functionality that are expensive to maintain. At the same time there has been a gradual move away from traditional business and tax effective savings vehicles to pure risk business generating lower expense revenues. **(1 mark)**
- Other factors such as increased capital requirements and reputational risk may also have influenced these decisions. **(1 mark)**

Capital and profitability

In Jan 2013 APRA's new prudential standards for determining regulatory capital (LAGIC framework) were introduced. LAGIC took a significant step towards aligning the standards for life insurance and general insurance and is consistent with the global move towards a risk based capital model.

- If the long-term outlook indicates that an adequate return on capital that meets shareholders' requirements cannot be achieved then selling the business may be an option. **(1 mark).**
- If availability of capital is an issue, particularly where the amount of required capital has increased, then a life insurer may need to sell their business or close to new business and go into run off. **(1 mark).**

Below are some observations about profits for risk products from APRA's quarterly statistics.[2]

- *Losses have been reported for Individual disability income since 2012 (excluding 2013)*
- *Profits for group disability have been low and volatile with losses experienced in 2012, 2015 and 2016.*
- *Losses were experienced for group lump sum in 2013 and 2014.*
- *While individual lump sum has consistently been profitable, the level of profit is has lowered since 2013 compared to the past. Profits for individual lump sum have been used to offset losses on these other product lines.*

[2] http://apra.gov.au/lifs/Publications/Documents/1709-QLIPS_20170930.pdf

- In recent years profitability of the life insurance industry has been variable with individual disability income consistently incurring losses. Insurers have relied on individual lump sum business to offset losses on other lines. Concern about this long-term outlook could prompt insurers to consider selling their business. **(1 mark)**
- Income protection is typically a life insurance company's leading product (as it is typically the main product a financial planner sells). The impact of rating houses and companies competing to have a top quartile ranking and to achieve certain market share has led to overly generous design and removal of many key controls which risk making the current product unsustainable. **(1 mark)**

Regulation and reputation

- The Life Insurance Industry has come under pressure around claims handling due to bad publicity from the Four Corners Program in early 2016. This prompted a review into claims handling by ASIC.[3] Concerns about the reputational risk associated with this has, for some insurers, meant that they have elected to pay more claims, particularly for lump sum benefits such a trauma or TPD. It has become evident that there is sometimes a very big difference between what a customer thought they had bought and the product they were sold. An increase in claims cost that has not been priced for will reduce profitability. **(1 mark)**
- The Life Insurance Code of Practice came into effect from 1 July 2016. This Code requires life insurers to provide services to their customers of a high standard and in a timely, honest, fair and transparent way.[4] Overall, this may have the impact of increasing claims cost as companies comply with these new standards. Higher costs will reduce profitability. **(1 mark)**

Competition

- Competitive pressure continues to put downwards pressure on premium rates, more generous benefit design and fewer underwriting requirements, which when considered alongside increased claims cost and increased regulatory oversight, has put further strain on profits. **(1 mark)**

Other factors

- Life insurance is a product that is sold rather than bought therefore, there are ongoing issues associated with incentivising advisers and addressing the issue of underinsurance. Advisers are constantly seeking product improvements and increased complexity making products difficult to understand (hence the need for advice) **(1 mark)**
- Most life insurance companies have established distribution channels and will not seek to innovate and compete with their current channels. **(1 mark)**
- There is increased reliance by individuals on insurance linked to superannuation rather than purchasing individual risk products. **(1 mark)**
- For many life insurers, reinsurance forms an important component of their financial results. At the same time the relatively small size of the Australian market and significant number of reinsurers has meant that the market is highly competitive.

[3] http://www.asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-347mr-asic-issues-industry-review-of-life-insurance-claims/

[4] https://www.fos.org.au/about-us/codes-of-practice/life-insurance-code-of-practice/

Reinsurers have experienced losses in recent times which may mean that the cost to a life company to transfer insurance risk has increased, therefore increasing the cost of doing business and hence reducing profitability. **(1 mark)**

- A prolonged low interest rate environment has reduced returns and means that liabilities are discounted at a lower rate, meaning higher liabilities on the balance sheet. **(1 mark)**

1 mark for any other reasonable point which is well explained.

Max 7 marks – candidates need to cover more than one factor to earn full marks (not just make 7 valid comments about one factor)

c)

(i) Operational risks

i) Risk	ii) Mitigation
Pricing of the deal will be based heavily on data provided by the seller and other relevant disclosures. As such the buyer will need to rely on the accuracy and completeness of the data, such as past experience. There is a risk that the data may include errors, be incomplete or be misinterpreted. **(1 mark)**	If following the evaluation, it is decided to progress the bid, New Life could make their offer subject to adequate due diligence to enable time for a more detailed analysis of the books. New Life could also seek confirmation of the information and its completeness from Direct Insurer's Auditor. **(1 mark)** New Life's tender submission could include a warranty in the event data errors are identified within a specified period after completion of the deal then specified remedies could be implemented. **(1 mark)**
Even with correct and complete data there is a risk of errors in the analysis and calculations performed by New Life. **(1 mark)**	The evaluation team should ensure that and models / calculations are peer reviewed and signed off for accuracy. **(1 mark)**
There is a risk that New Life may not have the technical expertise or systems knowledge to administer the business, which increases the risk of errors and / or lapses. **(1 mark)**	New Life should ensure it has a clear understanding of the business held by the seller and perform a comparison against its own product lines and familiarise themselves with the Australian Prudential Standards. **(1 mark)** New Life should ensure that it has the appropriate expertise in house or that it recruits people with the necessary skills. **(1 mark)**
There is a risk that key or core personnel currently employed by Direct Life will seek new employment meaning that New Life will suffer a loss of expert knowledge and sales potential. **(1 mark)**	New Life should engage with key personnel early to ensure they are appropriately incentivised or encouraged to remain with Direct Insurer in the event of a change in ownership. **(1 mark)**
There is a risk that core personnel employed by New Life will be distracted	This risk could be managed by ensuring KPIs relating to the current business are

from the day to day running of their core business during the period of the tender. If their attention is diverted this may impact the growth and profitability of New Life's current product lines. **(1 mark)**	maintained to ensure attention is not diverted to the detriment of the existing business. **(1 mark)**
There is a risk that New Life does not have the expertise in responding to tenders under this circumstance and so may be unsuccessful in its bid. **(1 mark)**	New Life could engage an external consultancy firm experienced with insurance M&A to assist with preparing its response to tender. **(1 mark)**
New Life is entering a new market / new product / new country **(1 mark)**	

1 mark for any other risk well explained to a max of 3 marks

1 mark for any other mitigant well explained to a max of 3 marks

Max 6 marks

(ii) Lapse risk

i) Risk	**ii) Mitigation**
There is a risk that policy holders will lapse their policy if they have reservations about the reputation or are uncertain about the continuity of cover provided by New Life. **(1 mark)**	New Life could write to policyholders and provide a company overview to reinforce credentials as well as reassuring policyholders that existing T&C's will continue. **(1 mark)**
There is a risk that the "healthy lives" may be more likely to lapse their policies if they are able to obtain cover from another insurer. This would mean that a greater proportion of "ill health lives" may remain leading to adverse claims experience in the future. **(1 mark)**	New Life should ensure that pricing remains competitive for its target market to help to ensure that "healthy lives" could not get better terms elsewhere. **(1 mark)**
Direct business may have higher lapse rates than insurance sold as a result of a policyholder obtaining financial advice from an adviser, as such, there is a risk that lapses may be higher than expected. **(1 mark)**	New Life should ensure they benchmark expected lapse rates against the appropriate industry segments to ensure assumptions are consistent with and recognise any differences from standard industry practice in Australia. **(1 mark)**
As the business is purchased online there is no ongoing adviser / customer relationship so Direct Insurer may be more susceptible to the impact of the economic climate and experience increased lapses during economic downturns. **(1 mark)**	Careful investigation of past experience will indicate the extent to which the business is subject to economic conditions. **(1 mark)** New Life could seek to build more innovation and interactive customer interfaces that can help reinforce the value that the products provide and present ideas on how to manage affordability now and in the future. **(1 mark)**

1 mark for any other risk well explained to a max of 2 marks

1 mark for any other mitigant well explained to a max of 2 marks
Max 4 marks
(iii) Best estimate assumptions

a) Expenses

- New Life may have a different view of the level of its ongoing operational and administrative costs. **(1 mark)**
  For example:
  - If it moved functions such as customer service and IT to locations where labour costs are cheaper.
  - It may be able to leverage off New Life's existing systems and processes
  - It may be able to change the capital and expense management approach.

  (1 mark for example)
- New Life may believe that it can realise economies of scale by achieving efficiencies by merging functions with its current operations. This may mean that it as lower longer-term expense assumptions. As Direct Insurer only entered the market 3 years ago there may still be residual set up costs impacting the expenses. **(1 mark)**
- Direct Life would have based its assumptions on its running costs allowing for various assumptions. There is a risk that these assumptions may not materialise as assumed meaning that expenses in Direct Life's tender documents might be understated or key items may be excluded. **(1 mark)**

1 mark for any other reasonable point

Max 3 marks for a)

b) New business growth

- Direct Life's projected new business volumes will be based on a set of assumptions about the outlook for the future in respect of overall market growth and growth of market share. New Life may have a different view of the outlook for growth if it has a different distribution or sales strategy for the business. **(1 mark)**
- Direct Life's growth projections are likely to be a best-case scenario and so are unlikely to consider any negative impact of a change in ownership on take up of new business. **(1 mark)**
- If New Life expects to change pricing or introduce new products then this is likely to impact sales volumes. **(1 mark)**
- Either Direct Life or New Life may have relationships or agreements with other entities providing them with access to different customers that could result in different new business volumes and profiles. **(1 mark)**
- The decision to purchase Direct Life may be due to awareness of new systems / technologies / tools that will enable New Life to generate sales volumes and persistency materially different from the past. **(1 mark)**
- As New Life is new to the direct to market insurance they may wish to sample test various alternatives ways to approach sales which may lead to New Life having a different view than Direct Life. **(1 mark)**

- Prevailing economic conditions may have changed resulting in material changes to the level of demand for the products on offer and New Life is more agile and able to respond to changes in customer needs etc. **(1 mark)**

1 mark for any other reasonable point

Max 3 marks for b)

c) Claims

- Direct business tends to have higher claim rates relative to advised business given that it is not fully underwritten. Given New Life does not have experience in the direct to market industry, it may not have access to information about historical claims experience for this industry and as such may take a different, perhaps more conservative, view than Direct Life of expected future claims cost. **(1 mark)**
- Direct Life has only been in business for 3 years and as such is unlikely to have built up credible claims experience. There is a risk that future experience could be more adverse than the past as time progresses. New Life may take a more conservative view of future claims assumptions. **(1 mark)**
- Due to adverse publicity around the life insurance industry declining claims, together with principles underlying the Code of Practice, New Life may take a view that future claims could be more onerous than the past. **(1 mark)**

1 mark for any other point well explained

Max 3 marks for c)

Total 9 marks for (iii)

Total: 4 + 7 + 6 + 4 + 9 = 30 marks for Question 2

END OF QUESTION 2

QUESTION 3 (30 Marks)

a)

(i) Lapse

- ASIC's 2014 Review of Retail Life Insurance Advice report highlighted concerns about high lapse rates, misaligned incentives and poor-quality advice. In response to this Mr John Trowbridge produced an industry sponsored report which lead to the Life Insurance Framework. An objective of the reforms set out in the Life Insurance Framework is to reduce high lapse rates. **(1 mark)**
- A cap on new business commission across the industry reduces the incentive for churning, whereby financial advisers move insured lives to another provider in order to receive another new business commission. Therefore, lapses in the first year should reduce. **(1 mark)**
- Moving to a two year 'clawback' period may also help to reduce lapses by reducing churning through the second year. **(1 mark)**
- Also, higher ongoing renewal commission may help to reduce lapses on an ongoing basis. **(1 mark)**
- Overall, the Life Insurance Framework may give advisers a financial incentive to ensure policy holders are satisfied with, and hence renew their policy, over a longer period of time. **(1 mark)**
- ASIC is monitoring the market to assess whether there have been changes in lapse rates and a commensurate reduction in new business. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for (i)

(ii) Claims

- There is a tendency for adviser's to attempt to "churn" healthier lives who are more likely to pass another provider's underwriting process. A reduction in churning may improve claims experience for a life insurer if a greater proportion of "healthy" lives remain on their books. **(1 mark)**
- The effect of reducing churning and hence changing the mix of "healthy" versus "unhealthy" lives on an individual insurer's books is likely to impact long term claims experience rather than short term claims experience. **(1 mark)**
- Unless the Life Insurance Framework increases the number of lives covered by life insurance, a reduction in churning would not change claims experience, in aggregate, across the industry. **(1 mark)**
- The fact that this change applies across the industry means that there is no additional risk of a particular insurer being selected against by independent financial advisers meaning risk of anti-selection is not increased. **(1 mark)**
- One of the main drivers behind advisers encouraging their healthy clients to switch policies was the fact that another company had recently "improved" their product and offered better coverage. While this is a valid reason for a policyholder to move providers, lower lapses resulting from the Life Insurance Framework are expected to lead to more policies at longer durations, meaning greater potential to have more claims on outdated medical definitions unless a life company offers automatic benefit upgrades. This could help to encourage better claims management practices. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for (ii)

(iii) Pricing and profitability

- Whilst initial commission rates are lower, the significant increase in renewal commission means that total commission costs will be higher for any policy remaining in force from more than a few years. With low interest rates the present value of commission can have a negative impact on profitability. **(1 mark)**
- A reduction in lapses may help to improve the overall profitability of the book as it means upfront expenses and commission can be recouped from the receipt of future premiums which would be forgone if the policy lapsed. **(1 mark)**
- New business commission in excess of 100% of the first year's premium (together with expenses such as underwriting) creates new business strain as outflows exceed inflows on day 1. Capital is required from shareholders to fund this strain which is recouped over the lifetime of the policy. Capping initial commission at 60% will reduce new business strain meaning less capital will be needed on day 1 to service the shortfall. **(1 mark)**
- Shareholders require a return on capital and so holding less capital reduces costs which could lead to polices being more profitable. **(1 mark)**
- Alternatively, this reduction in cost could be passed onto policy holders through lower premiums. **(1 mark)**
- As reinsurance arrangements are often designed to fund a share of the new business strain, there may be some changes made to the commission terms offered for reinsurance treaties in the future. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for (iii)

(iv) Adviser remuneration

- Reducing initial commission (120% to 60%) at the same time as increasing renewal commission (10% to 20%) changes the timing of payment of income to financial advisers. Instead of being weighted towards an upfront payment, a component of income is delayed and is contingent on the policy not lapsing. **(1 mark)**
- This incentivises financial advisers to provide ongoing service to their customers to encourage them to maintain their cover, which could help to improve the quality of financial advice. **(1 mark)**
- The Life Insurance Framework is not intended to limit financial advisers from operating on a level commission or fee for service basis, as such these options still remain available to advisers who are concerned their income may reduce under the Life Insurance Framework. **(1 mark)**
- For many advisers, their existing business will not generate a significant income because of the 10% renewal commission, and they will now only receive half of what they did before (120% versus 60%) when selling a policy because of the reduction in initial commission. This will be very challenging for advisers who will need to be assisted through the transition period. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for (vi)

(v) Operational / Other considerations

- Life insurers will need to establish new systems, processes and controls to claw back commission for polices that lapse during the two-year claw back period. **(1 mark)**
- Lapse investigations will need to consider pre and post LIF business separately due to the different remuneration structures potentially driving different persistency. **(1 mark)**
- Life insurers may also need to review procedures for pursuing bad debts where commission cannot be clawed back as the adviser cannot be located, A longer claw back period may increase the level of bad debts. **(1 mark)**
- Transition arrangements whereby initial commission is capped at 80% in 2018 and 70% in 2019 will help to soften the impact of this change on both advisers and premium rates. **(1 mark)**
- Life companies will have to devote considerable time and resources to adviser engagement, training and education on LIF and how to manage the transition to the new remuneration structure. **(1 mark)**
- During the transition period there may be a push by advisers to process applications before 31 December in order to obtain higher initial commission. Life insurers will need to plan their staffing around meeting such demands. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for (v)

Max 15 (3 + 3 + 3 + 3 +3) marks for a)

b)

(i) Experience analysis:

- LifeCo could undertake further analysis and segmentation of its experience analysis to better understand the root cause of this observation. **(1 mark)**
- LifeCo could segment experience by waiting period. The observation of poor adverse experience for durations < 1 year suggests shorter waiting periods e.g. 30 or 90 days may have particularly adverse experience. **(1 mark)**
- LifeCo could analyse experience gross and net of reinsurance to investigate how effective its reinsurance arrangements are at buffering against adverse experience. **(1 mark)**
- LifeCo could try to determine if this is a market-wide occurrence by consulting with its reinsurer. **(1 mark)**
- LifeCo could investigate the termination experience of mental health claims to identify if there are any additional issues or factors that add to or offset the adverse experience. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for i)

(ii) Underwriting:

- Adverse experience for policies with a duration < 1 year may indicate that underwriting processes and procedures may not be identifying mental health related pre-existing conditions. **(1 mark)**

- LifeCo could investigate whether there has been any change to underwriting practices, procedures or personnel in 2017 which could explain the spike in experience. **(1 mark)**
- LifeCo could consult with its reinsurer and review its underwriting practices and/or definitions to ensure these are up to date and reflect the latest medical knowledge and evidence. For example, ensuring there are explicit descriptions about how pre-existing conditions and co-morbid substance abuse should be treated. **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for ii)

(iii) Product design:

- Product design and terms and conditions could attempt to integrate mechanisms to support recovery such as making benefits contingent on participation in reasonable recovery efforts. This could assist in the process of helping claimants to return to work. **(1 mark)**
- If it does not already, LifeCo should include a feature in its product design whereby partial payments could be considered at the same time as partial return to work. (Partial disability payments are a standard feature of the market.) **(1 mark)**
- LifeCo could consider altering its terms and conditions in relation to mental health related claims, such as increasing qualifying periods or by not covering mental health related claims bearing in mind the competitor impacts (discussed below). **(1 mark)**

1 mark for any other point which is well explained

Max 3 marks for iii)

(iv) Claims management:

- LifeCo could develop guidelines specific for managing mental health claims (For example; SuperFriend is an organisation that has developed training for insurance sector staff, including a comprehensive framework for best practice claims management specifically for claims involving mental illness). **(1 mark)**
- LifeCo could invest in training claims assessors on the nature of mental illness to ensure individuals are treated appropriately and fairly, in order to play a role in ensuring no further harm is done. **(1 mark)**
- Given income protection is a regular income stream rather than a lump sum product, LifeCo could investigate ways to better manage its termination rates so as to manage its overall claims cost. **(1 mark)**

1 mark for any other point which is well explained

Max 2 marks for iv)

(v) Pricing:

- In the event LifeCo anticipates higher ongoing claims cost arising from mental health related claims it could increase its premium rates commensurately by strengthening its best estimate assumption basis that is used in pricing. **(1 mark)**
- Where retail income protection premiums are not guaranteed (e.g. yearly renewable) LifeCo could also consider increasing premium rates for existing customers bearing in mind that this may increase the risk of healthy lives lapsing if they can obtain cover cheaper elsewhere. **(1 mark)**

1 mark for any other point which is well explained

Max 2 marks for v)

(vi) Other considerations:

Competitors

- Where possible, LifeCo could attempt to benchmark its offering in respect to mental health against its competitors and/or discuss with its reinsurer to try to assess if it is more generous than the market meaning it could be exposed to higher anti selection risk. **(1 mark)**
- In the event LifeCo attempted to limit cover for mental illness it may risk reducing its sales volumes as policyholders may move to competitors who offer broader cover. This would reduce revenue and the overall profitability of the product line. **(1 mark)**

Legal

- Both the Disability Discrimination Act and the Equal Opportunity Act include an exception for insurance allowing lawful discrimination under certain circumstances. While LifeCo can lawfully exclude or decline cover it still needs to ensure its assessments are fair and evidence based. **(1 mark)**

1 mark for any other point which is well explained

Max 2 marks for vi)

Max 15 (3 + 3 + 3 + 2 + 2 + 2) marks for b) further reading[5]

Total 15 + 15 = 30 marks for Question 3

END OF QUESTION 3

END OF MARKING GUIDE

[5] https://www.actuaries.asn.au/Library/Miscellaneous/2017/GPMENTALHEALTHWEBRCopy.pdf