Commonwealth Bank

An Introduction to Life Insurance

April 2001

Disclaimer

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Speaker’s Notes

- Speaker’s notes for this presentation are attached below each slide.
- To access them, you may need to save the slides in PowerPoint and view/print in “notes view.”

Programme

9.00 Welcome

- Michael Ullmer

9.05 Introduction

- Patrick Edwards

9.15 Products & Distribution

- Peter Beck

10.15 Accounting for Life Insurance

- Patrick Edwards

10.30 Transfer to 48 Martin Place

Programme

11.00 Tutorial - Appraisal Values

- Rob Donaghy / Patrick Edwards / Andrew Terzon

12.30 Tutorial - Capital Adequacy

- Patrick Edwards / Michelle Goldstone

13.00 Lunch

Introduction

Patrick Edwards

- Objectives
- Definition of Life Insurance
- A brief History of Life Insurance

Objectives

- What is Life Insurance?
- How is it sold?
- How is it accounted for?
- How is it valued?
- How does it affect the regulatory capital of banks?

What is Life Insurance?

- Risk Insurance
- Investment
- Bundled

What is Life Insurance?

- **Risk Insurance** provides - in exchange for the payment of one or more premiums by the policyholder - for a payment or series of payments by a life insurer to the policyholder on the occurrence of a prescribed event

- In an **Investment** product, the life insurer will invest the proceeds of premiums received for an agreed period or at the discretion of the policyholder

What is Life Insurance?

- A **bundled product** has characteristics of both risk insurance and investment products

- An **Annuity** provides, in exchange for the payment of a premium by the policyholder, for a series of payments by a life insurer to the policyholder

What is Life Insurance?

- **Participating**
- **Non-participating**

What is Life Insurance?

- **Participating business:**

  The policyholder shares in the overall profits of the business but takes on some of the risks

  – 'profits' include investment, mortality, expenses, etc.

- **Non-participating business:**

  The shareholder takes all the profits and losses but bears all the risks

A Brief History of Life Insurance

Australia

- Industry dominated by 'mutuals' until the 1970's
- Unbundling of risk and savings products
- New Life Insurance Act
- Capital requirements are risk-based
- Levelling of 'playing fields'
- New accounting standard
- Investment business now tends to be transacted outside the life company fund structure

A Brief History of Life Insurance

New Zealand

- Industry consolidation following exit of subsidiaries of UK insurers
- Product development trends similar to Australia - unbundled products are the norm
- ‘Superannuation’ business is not tax advantaged, hence market has not developed as in Australia
- Outdated Life Insurance Act
- Regulatory focus is not strong
- Capital requirements are risk-based

A Brief History of Life Insurance

Asia

- Protected industry but changes are occurring
- Heavily regulated, at micro level
- Products are restricted to certain types
- Capital requirements are not risk-based
- Sociological change is driving industry growth

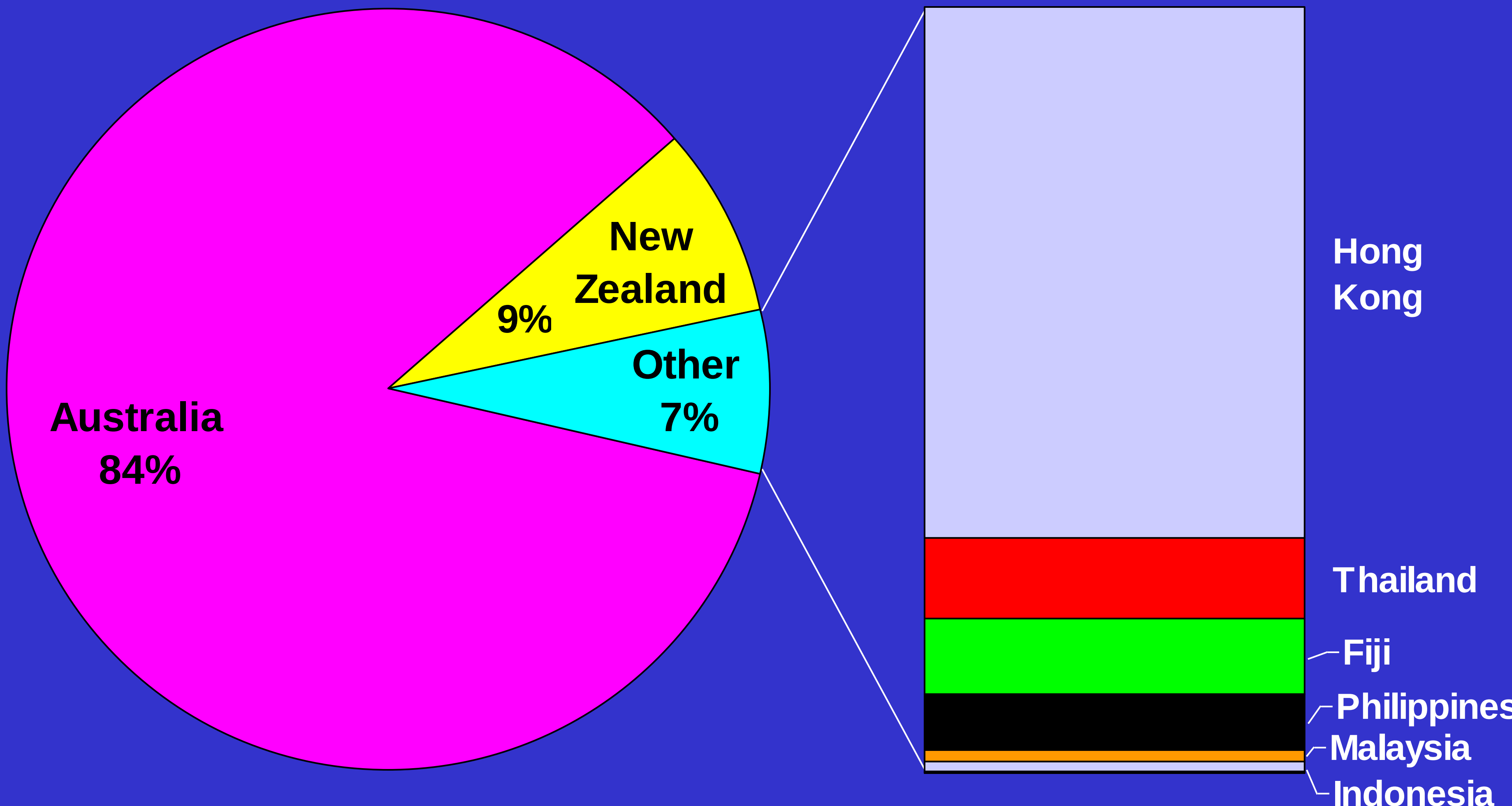
Products & Distribution

Peter Beck

- Scope of the Group's Life Insurance Business
- Life Insurance Products
- Distribution Methods

The Group's Life Insurance Business

Assets Under Management

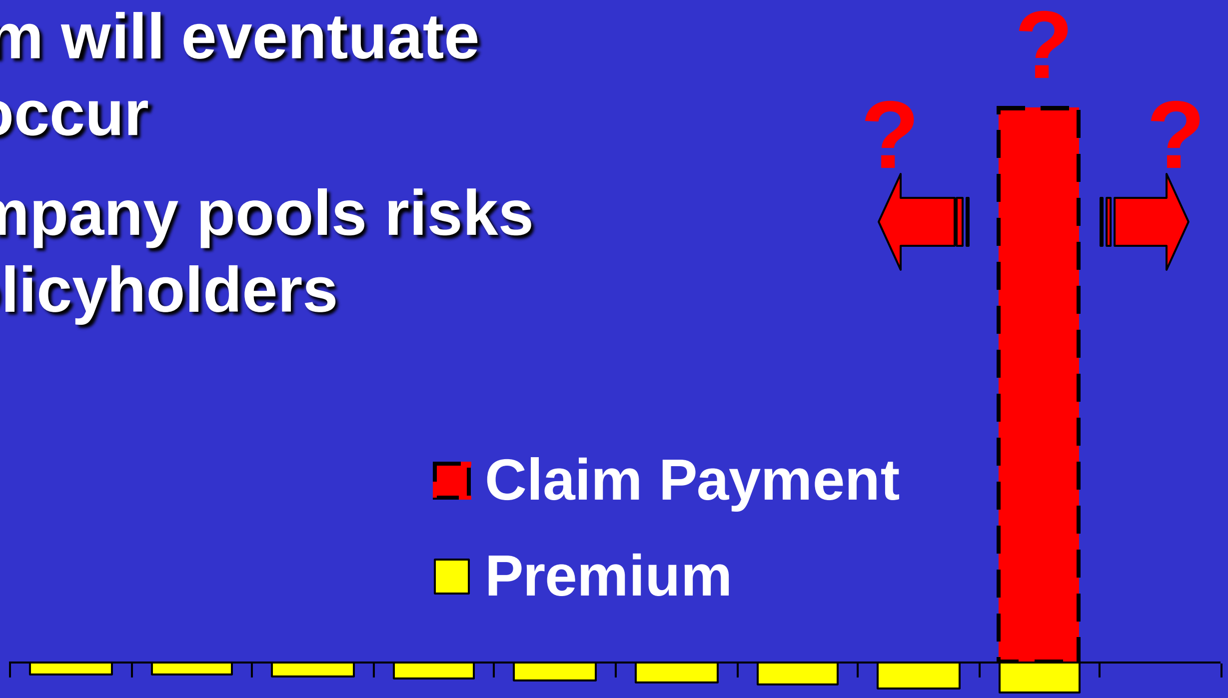


Major Product Groups

Product Group	Key Features
Risk	Provides for contingent payments on death, disability or other traumas during the term of the policy
Investment	Various contracts providing for investment or savings often for long terms
Traditional	Contracts with ‘bundled’ savings and risk elements - eg. whole of life or endowment
Annuities	Provides for payments over period in exchange for lump sum

Risk Policy Features

- Benefit payable on defined event
- Premium very small relative to potential payout
- Uncertainty as to
  - whether claim will eventuate
  - when it will occur
- Insurance company pools risks from many policyholders



Risk Business

Two broad groupings of risk business:

- **Personal**
  - Underwriting involves assessment of risk for each life insured individually
- **Group**
  - Underwriting involves assessment of risk for groups of lives in aggregate

Personal Risk Types

<table>
<tr><th>Product</th><th>Key Features</th><th>Premiums</th></tr>
<tr><td>Term Life
- Level</td><td>Lump sum paid on death during the period of the contract</td><td>Level</td></tr>
<tr><td>- Yearly Renewable</td><td>Yearly renewable term insurance contract (office cannot cancel cover)</td><td>Increase with age</td></tr>
<tr><td>TPD</td><td>Lump sum paid on total and permanent disability (an ‘add-on’ to term cover)</td><td>Level or Increasing</td></tr>
<tr><td>Trauma</td><td>Lump sum paid on health-related event - e.g. heart attack, stroke</td><td rowspan="2">Normally increasing
(yearly renewable cover)</td></tr>
<tr><td>Income Protection</td><td>Periodic income payments while totally disabled (commencing after an agreed waiting period)</td></tr>
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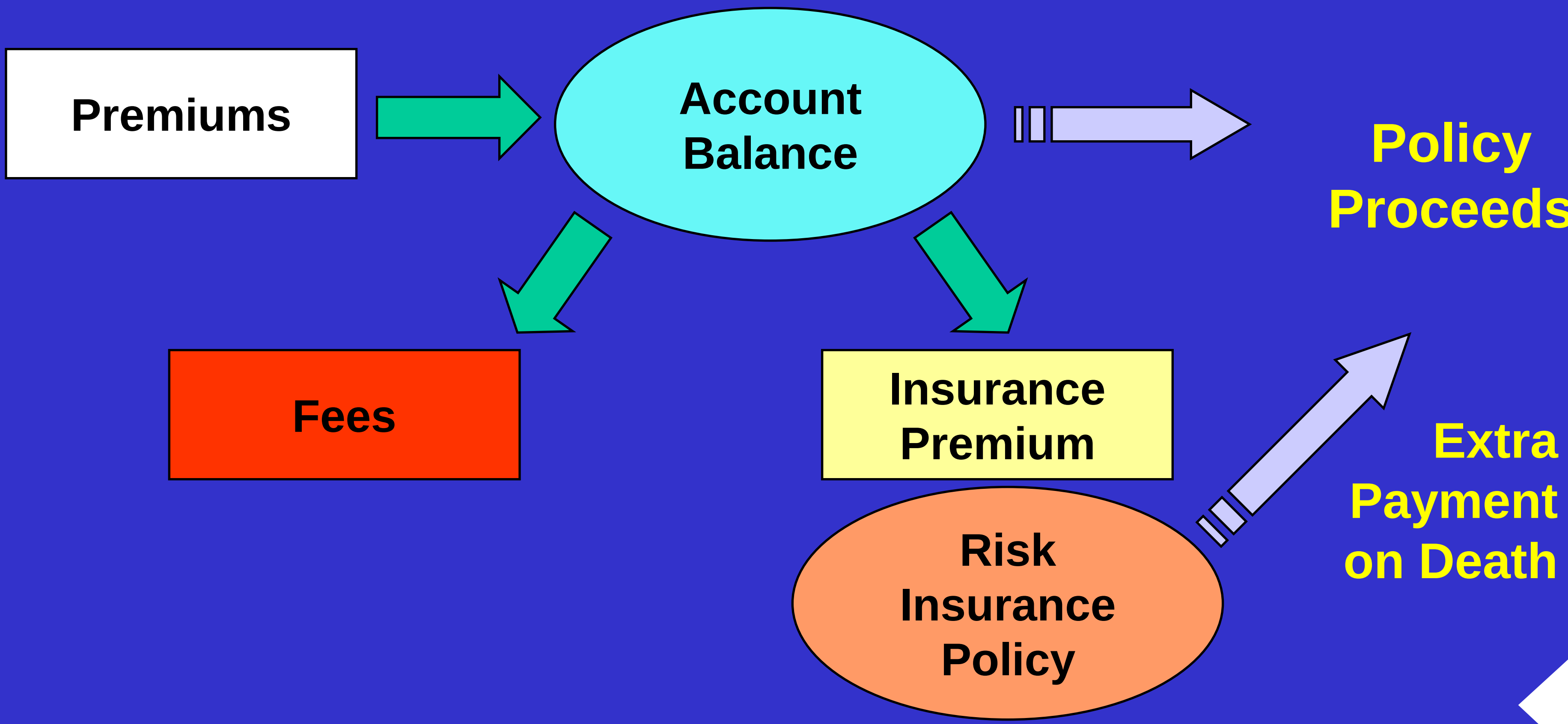
Group Risk Types

Product	Key Features
Death Cover	Lump sum paid on the death of a member of the Group Plan
TPD Cover	Lump sum paid on total and permanent disability of a member of the Group Plan
Trauma	Lump sum paid on health-related event - e.g. heart attack, stroke
Income Protection (Group Salary Continuance)	Periodic income payments (% of salary) during period of sickness or disability (commences after an agreed waiting period)

Premiums are paid in 'bulk' by the Group Plan
- large plans may be 'unit rated'

Investment Policy Features

- ‘Unbundled’ savings policy with explicit fees
- Optional risk cover



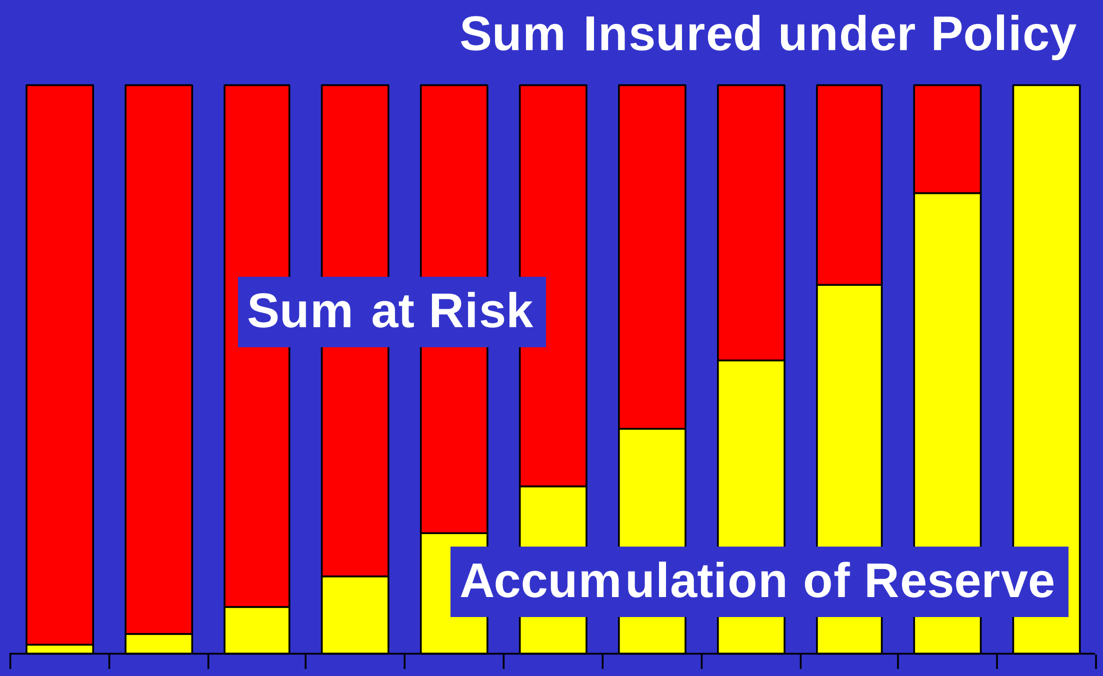
Investment Types

- Investment products are offered on both an ‘individual’ and ‘group’ basis

Product Type	Key Features
Investment Linked	Value of contract is directly linked to underlying investments. Policy is unitised, and value of units may rise or fall. **Unitholder takes investment risk**
Investment Account	Investment returns are smoothed and added to the account balance as a rate of interest. Account balance is guaranteed not to reduce. Some old products may have a minimum crediting rate. **Shareholder takes guarantee risk**

Traditional Policy Features

- Policy 'bundles' savings and risk elements
- Part of premium covers mortality risk and expenses; the remainder is accumulated to provide the end benefit



Full sum Insured
is paid on Death
(or Maturity if Endowment)

If surrendered,
payment approximates
accumulated 'reserve'

Traditional Types

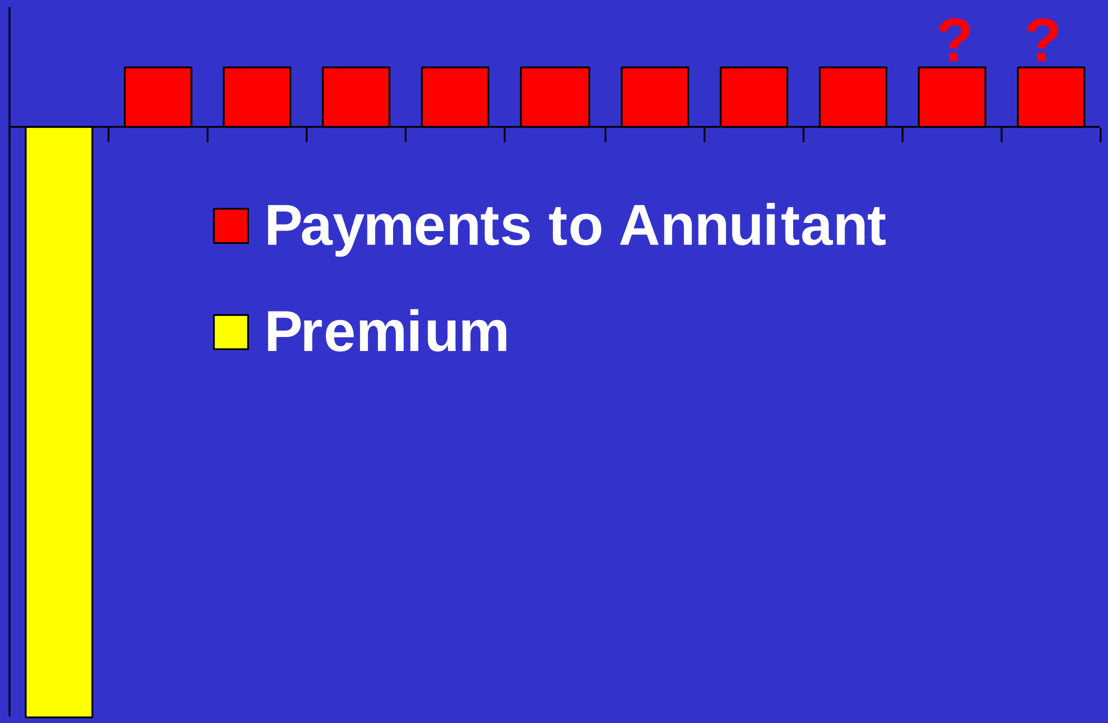
- These are also known as ‘bundled’ contracts, as the policies combine both risk and savings elements for the one premium. There are no explicit charges.

Product Type	Key Features
Whole of Life	Sum Insured payable on death. May be surrendered for reduced value.
Endowment	Sum Insured payable on selected maturity date, or earlier death. May be surrendered for reduced value.

- Benefits are guaranteed
- These products are no longer sold in Aust & NZ

Annuity Features

- Policyholder exchanges a lump sum for an income stream
- Typically wants to insure against ‘living too long’
- Income may or may not be guaranteed



Annuities Types

Fully Guaranteed

Immediate Annuity

Income commences immediately contract is established

Deferred Annuity

Income commences from an agreed age

Life Office bears mortality and investment risk

Non-Guaranteed

Allocated Annuity

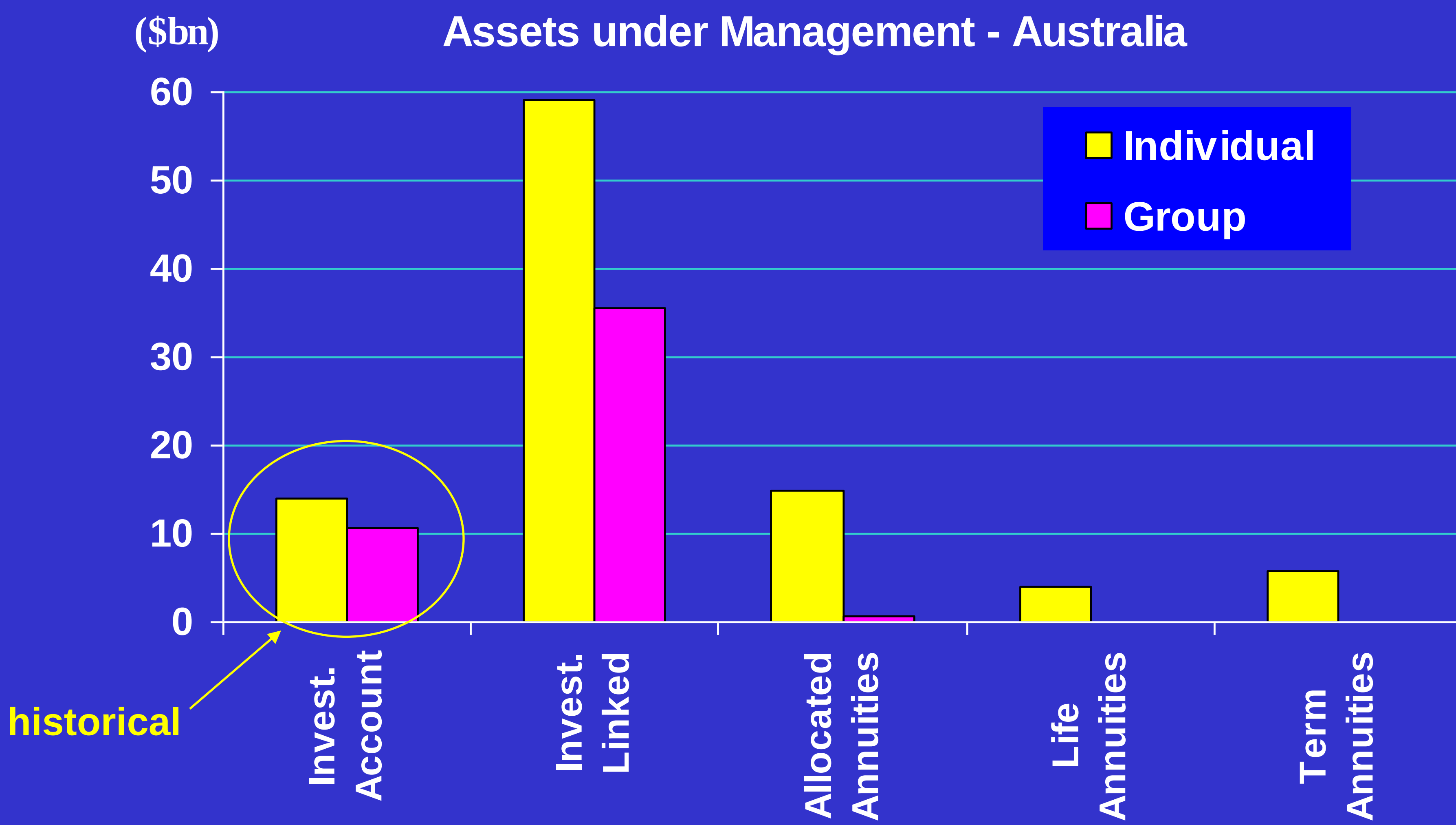
Policyholder draws regular income (within specified limits) from account

Policyholder bears risks

Immediate Annuities Types

Product	Key Features
Lifetime: - Single Life	Payments - which may be level or indexed - continue while the life insured remains alive, and cease on death
Lifetime: - Joint Life	Payments continue while all lives insured remain alive. Generally reduce to a lower level on the first death, and cease on the last death.
Term Certain	Payments cease at the end of a fixed term
Term Life	As for Lifetime Annuity, but has a minimum term

Investment and Annuity Business



Source: Life Office Market Report – APRA June 2000

Other Terms for Classifying Products

Life products may be classified in various ways:

- **Participating** or **Non-participating**
  - Participating - policyholders share in profits (usually at least 80%) but take on some of the risks
  - Non-participating - shareholder takes all profits but bears all risks
- **Ordinary** / **Superannuation** / **Exempt**
  - Refers to tax status (Australia)

Investment Trends

Australia & New Zealand

- Investment Account policies are no longer sold
  - strong capital guarantees mean that other contract terms must be very restrictive
- Trend towards ‘Masterfund’ products, offered outside of the statutory funds

Asia

- Unit linked business is generally not accepted by the regulators
  - must offer capital guaranteed ‘traditional’ or ‘investment account’ style business

Masterfund Business Structures

- Investment Masterfunds
  - structured as a unit trust where the MF investor owns a unit in the MF entitling them to a share of selected underlying asset pools of the MF <u>or</u>
  - structured as a wrap/administration service (non trust) where the underlying assets are held directly by the investor but managed/administered by the wrap provider
- Superannuation Masterfunds
  - always structured in trust form to attract superannuation fund regulatory and tax status
  - often personal & corporate divisions
  - covers superannuation accumulation phase
  - often with an allocated pension division for retirement income phase

Masterfund Investment Structures

Varying investment structures:

- invested in wholesale unit trusts - acquires units in an underlying investment vehicle which holds the assets
- historically invested in statutory funds of a life company through the purchase of an investment policy with the assets held by the life company
- direct holdings of assets by the MF which are managed under investment mandates placed with internal and external fund managers

Masterfund Investment Styles

Investment Styles:

- internal and/or external investment options
- inflows placed with fund managers:
  - actively managed investment styles
  - index/passive investment style
  - hybrid - passive with active overlay
  - other combinations
  - based on investor choice or
  - mandated allocations chosen by the MF provider

Masterfund Investment Options

Investment Options:

- extensive or limited investment options
- sector specific
  - property
  - cash
- pre-mixed packages
  - growth
  - balanced
- ala carte menu options - ultimate customer choice
- or a combination

Masterfund Trends

- Masterfunds are the fastest growing investment form, outstripping the retail unit trust in terms of fund inflows
- In an environment where there is a substantial decline in the use of life companies as the preferred investment medium
  - flexibility, transparency, simplicity and tax drivers

Distribution

Distribution Channels (Australia)

- Branch network
  - salaried sales force
- Third party distributors
  - IFAs, brokers and agents, external dealer groups
- Specialist product / corporate teams
  - Business superannuation and Group Risk
- Direct
  - telephone, mail, online

Branch Network

Salaried sales force - internal support (POS, paraplanners)

- **Investment consultants**
  - simple product set, packaged solutions, no advice, largely event driven eg. ETP rollovers
- **Financial planners**
  - broader, more complex product set, tailored financial advice, ongoing service
- **Business superannuation consultants**
  - product specialists for corporate sector
- **Accredited risk writers - risk insurance sales specialists**
  - personal insurance lines eg. life cover, TPD and trauma

Third Party Distributors

- Agents and brokers
- Independent financial advisers (IFAs)
- Mortgage originators
- External dealer groups
  - Client ownership and management
  - running their own business - some product provider support
- significant volume

Specialist Sales Teams

- Corporate / business market focus
- Product / service specialists
- Expertise

Direct

- History as sales / retention supplement
  - telephone and direct mail to an active selling force
- Online growing in importance but off a very low base

Sales by Distribution Channel

	Australia	NZ	Asia	Total
Network/ Aligned	60%	40%	~100%	65%
Corporate	5%	5%		5%
Third Party	35%	55%		30%

* Network/Aligned includes Direct sales

Business currently being written

Product	SH Earnings Drivers	Guarantee	Aus	NZ	Asia
Risk	Premium – Claim – Expense	High	✓	✓	✓
Traditional	Up to 20% of Profits, including investment return	High			✓
Annuities	Pricing Margins (investment return, expense, mortality)	High	✓		
Unit Linked	Fees – Expenses	Nil	✓	✓	
Masterfund	Fees – Expenses	Nil	✓	✓	

Business in force - Australia

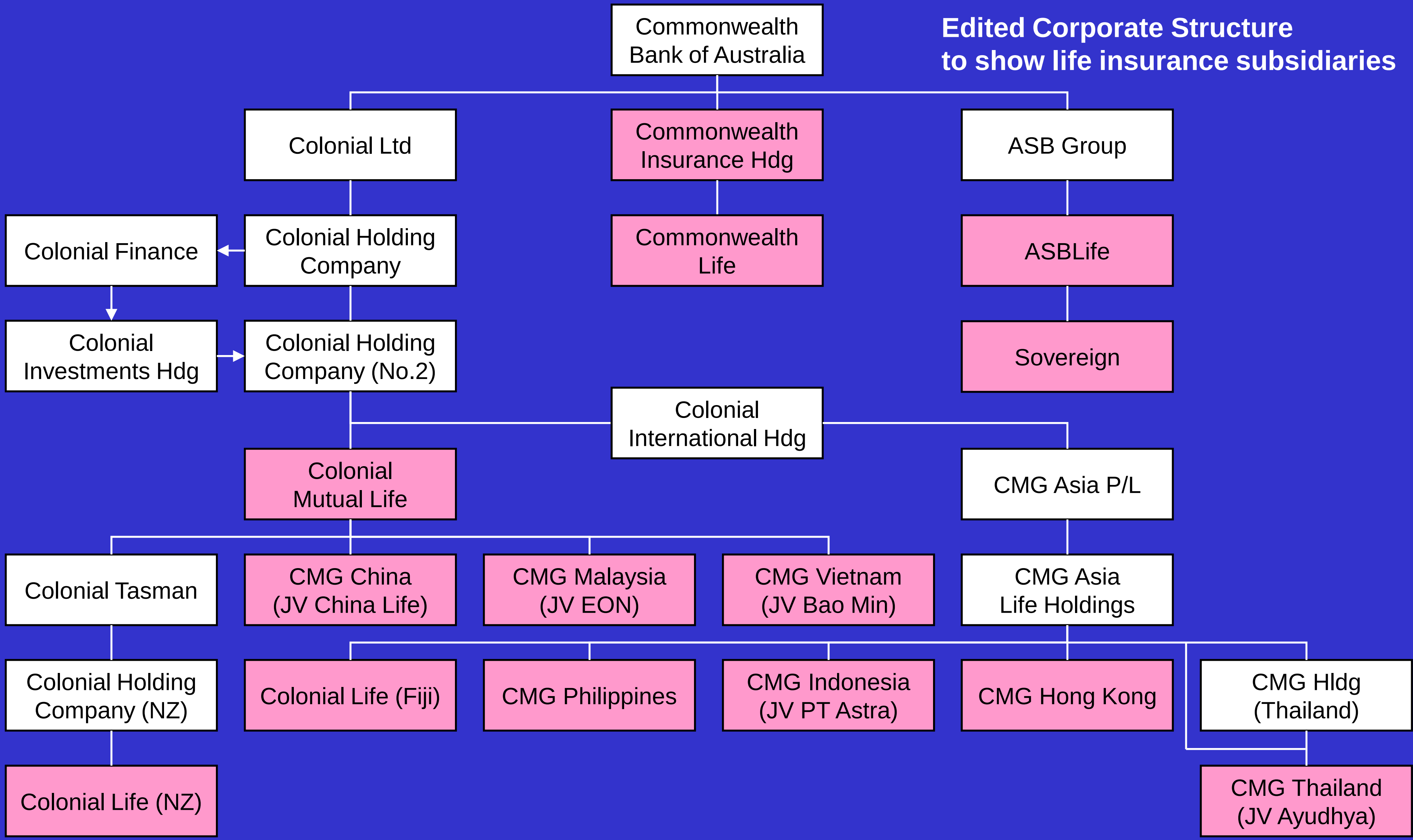
Product	Earnings Drivers	Guarantees	Liability
Traditional - Par	20% of profits including investment return	Medium	$1.8b
Risk	Premium – Claim – Expense	High	small
Investment Account - Par	20% of profits including investment return	Med - High	$1.4b
Investment Account – NP	Fees - Expenses	High	
Immediate Annuities	Pricing Margins (investment return, expenses, mortality)	High	$1.4b
Allocated Annuities	Fees - Expenses	Nil	$0.6b
Unit Linked	Fees - Expenses	Nil	$17.5b

Accounting for Life Insurance

Patrick Edwards

- The Group's Corporate Structure
- Life Funds
- Accounting for Life Insurance
- Appraisal Value
- Regulatory Capital for Life Companies
- Capital Management
- Risks in Life Insurance

The Group's Corporate Structure

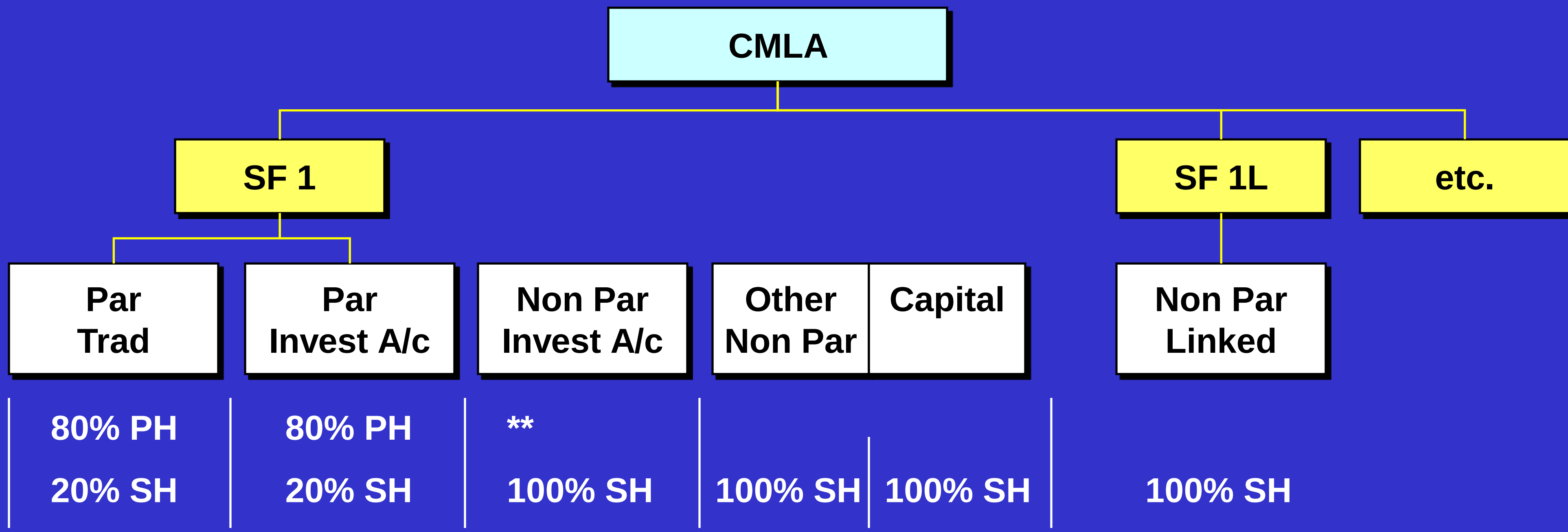


Life Funds

- In Australia, 'statutory funds' are required under the Life Insurance Act
- Life companies usually maintain several statutory funds
- Overseas, business is usually commingled in a single fund relating to life insurance

Life Funds

- We also encourage establishment of **subfunds** to separate the interests of policyholders and shareholders, eg:



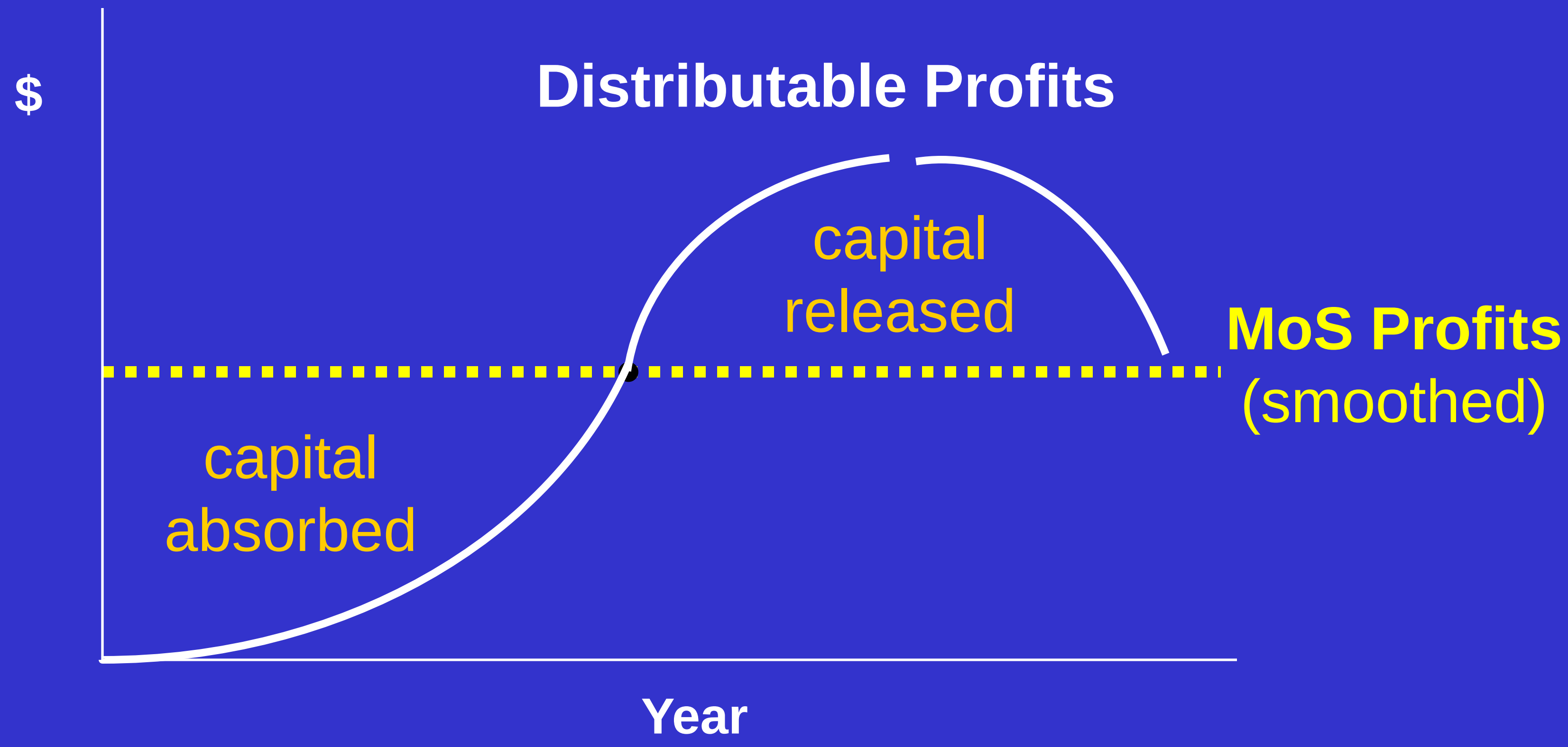
** smoothed earnings to PH

Accounting for Life Insurance

- AASB 1038 introduced June 2000
- Assets and liabilities marked to market
- Best estimate of liability is the *present value* of future benefit payments, plus present value of net expenses (future expenses less future premiums)
- Margin on Services (MoS) recognises profits in line with the provision of services and receipt of income
- Profit is deferred and amortised over the life of a policy but losses are recognised immediately

Distributable Profits

- MoS profits are earned fairly evenly over the life of a policy. Distributable profits reflect capital requirements.



Appraisal Value

- A life insurance company must also mark to market its holdings in any subsidiary life companies
- '**Appraisal Value**' (AV) is a measure of the value of a life company and is used to support the Directors' valuations. It comprises:

  1. Net Tangible Assets

  2. Value of Inforce Business
     - present value of future margins
       <u>less</u> cost of tying up capital (discount rate > earning rate)

  3. Value of future New Business
     - present value of expected margins on expected future new business

Valuation Assumptions

- ‘Best estimate’ assumptions used for both MoS and AV
- Assumptions are updated each year to reflect experience trends
- MoS <u>spreads</u> the effect of changes in assumptions
  - where profit margins exist, there will be little or no immediate profit impact - the effect is spread by adjusting *future* margins
  - where no margins exist, the impact is capitalised (ie. loss recognition or reversal)
- AV capitalises the future impact of all changes
  - present value of revised cashflows

Appraisal Value Uplift

- Businesses owned by life companies are held at market value (Appraisal Value)
- The “profit” earned on these businesses is the dividend received and the increase in AV (less capital added)
- For clarity, the Group’s reports the accruals profit (MoS earnings) and the balance of “profit” separately (AV Uplift)

Regulatory Capital Requirements for Life Companies

- Each country is different (no equivalent of Basle Accord)
- In Australia, there is a two tier approach:

  solvency and

  capital adequacy

  Both solvency and capital adequacy are tested at a statutory fund level

Solvency Standard

Defines minimum capital required to meet **guarantees and obligations** under a range of adverse circumstances

- Assumes fund closed to new business
- Solvency position is disclosed in financial statements
- Solvency basis is (deliberately) quite prescriptive

Capital Adequacy Standard

- Defines minimum capital required to meet
  obligations and reasonable expectations
  under a range of adverse circumstances
  in the context of a viable ongoing operation

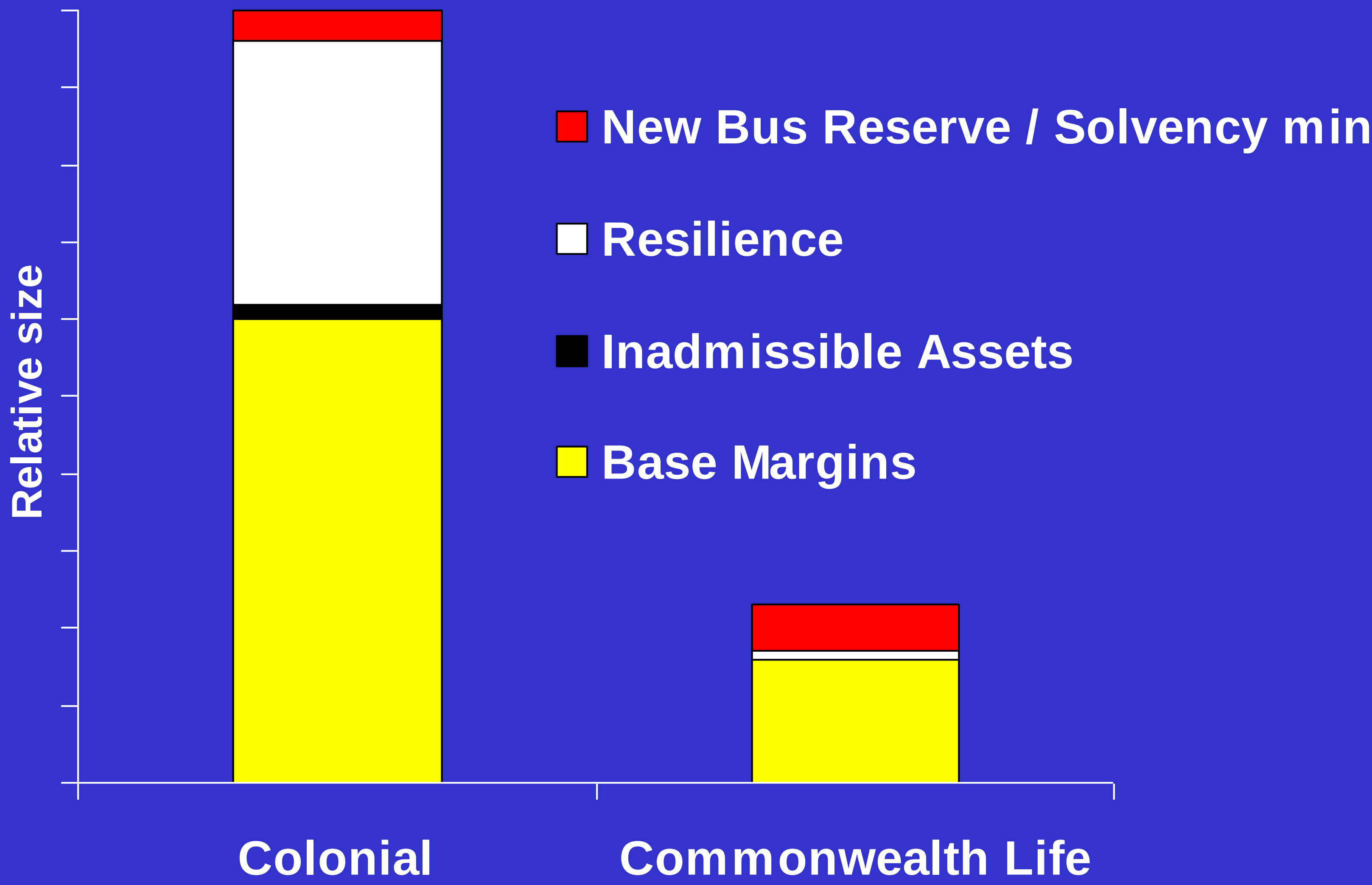
- Capital Adequacy is <u>not</u> disclosed in financial statements (but is advised to APRA)
- Can only transfer profits and return capital from a Statutory Fund if the fund is capital adequate

Capital Adequacy Components

	Reserve	
	Base Liability	Best Estimate + adverse margins
+	Current Termination Value	Apply as minimum
+	Other Liabilities	Non-policy items
+	Resilience	Mismatching reserve
+	Inadmissible Assets	Concentration risk; related co's
+	New Business	Future financing strain

Capital Adequacy cannot be less than Solvency

Capital Adequacy Components

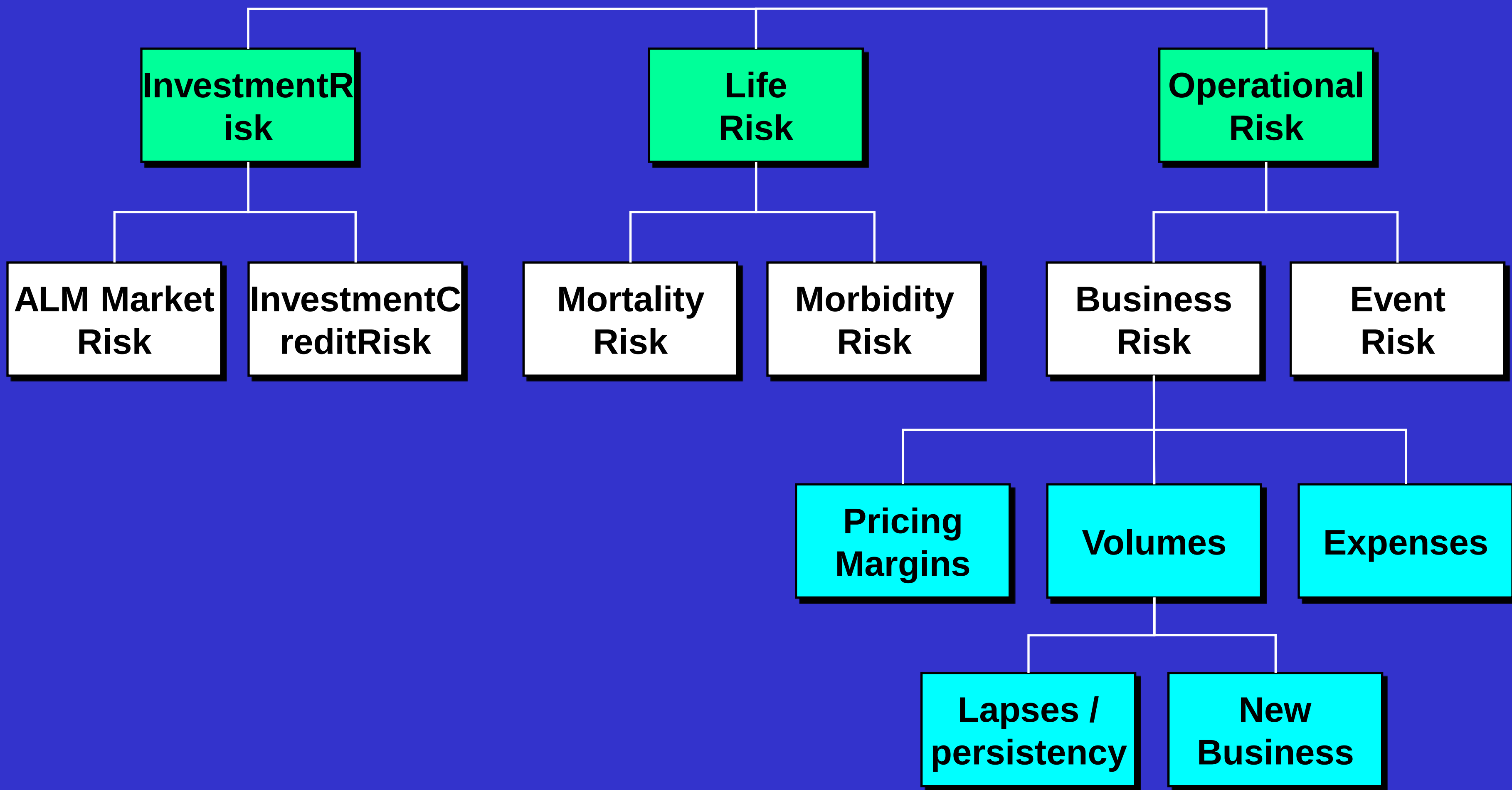


Capital Management - within Life Co

Total Assets

Excess	Distributable
Target Surplus	Working capital + smooth fluctuations
Life Act Reserving: Solvency & Capital Adequacy	Essential, tied-up capital Non-distributable

Risks in Life Insurance



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