PRUDENTIAL PRACTICE GUIDE

LPG 240 Life Insurance Risk and Life Reinsurance Management

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About this guide

Prudential Standard CPS 220 Risk Management (CPS 220) sets out APRA's requirements of APRA-regulated institutions in relation to risk management, including for life insurers. This prudential practice guide aims to assist life companies in complying with those requirements in relation to insurance risk and reinsurance management and, more generally, to outline prudent practices in relation to good life insurance risk and reinsurance management.[1]

Subject to the requirements of CPS 220, life companies have the flexibility to configure their life insurance risk management framework and their reinsurance management in the way most suited to achieving their business objectives.

Not all of the practices outlined in this prudential practice guide will be relevant for every life company and some aspects may vary depending upon the size, complexity and risk profile of the life company.

[1] A reference in this prudential practice guide to reinsurance should be taken to include retrocession.

Life insurance risk

1. Life insurance risk includes the risk that inadequate or inappropriate product design, pricing, underwriting, claims management and reinsurance management will expose a life company to financial loss and the consequent inability to meet its liabilities.

Product design

2. Product design involves the introduction of a new product or the enhancement or variation of an existing product. There are a number of risks involved in product design, development, management and potential obsolescence. Inadequate or failed processes can expose a life company to financial loss.

3. In order to manage these risks, the risk management framework would typically include the following elements:

   a) processes to ensure that product design has access to sufficient staff with appropriate experience and expertise;

   b) consideration of the life company's willingness and capacity to accept risk;

   c) clearly defined and appropriate levels of delegation for approval of all material aspects of product design;

   d) the nature of life insurance business that the life company is to underwrite including:

      i) the types of risks that may be underwritten and those that are to be excluded (death, disability, income, TPD, trauma);

      ii) the classification criteria for those types of risk to be underwritten and those to be excluded;

      iii) the nature of any guarantees or options provided (including both financial and insurance options);

      iv) fee and benefit structures; and

      v) the approach to reinsurance in the different types of life insurance business to be underwritten;

   e) setting a business case for new or enhanced products, including analysis of the potential market, competition and proposed distribution plan;

   f) market testing of the proposed product;

   g) processes for ensuring appropriate pricing (including the need to obtain advice from the Appointed Actuary);

h) processes to ensure that policy documentation and other disclosures are adequately drafted to give legal effect to the proposed level of coverage under the product;

i) an implementation plan for the product, including milestones (and including a process to ensure that all relevant policies and procedures are updated to reflect the requirements of the new or enhanced product);

j) post-implementation review;

k) processes for collection of statistical and other information which will facilitate investigations of experience and assist in planning the direction of the business (including processes to ensure that such information can be reliably provided to reinsurers if relevant); and

l) methods for monitoring compliance with product design policies and procedures.

Pricing

4. The pricing of a life insurance product will be driven by a number of factors including market and competitive pressures, regulation, taxes and expected profitability and capital consumption and will take into account actuarial advice. It will also involve the estimation of claims costs and other business costs arising from the product and the estimation of investment income earned from cash flow and reserves. Pricing risk may occur where the claims, discontinuance rates, expense costs, tax allowances, investment parameters or value of any options or guarantees used in the pricing of a product are inaccurately estimated and may expose the life company to the risk of financial loss.

5. In order to control and mitigate the risks associated with pricing the product, the life company could consider including in the risk management framework the following elements:

a) processes to ensure that the area responsible for pricing has access to sufficient staff with appropriate experience and expertise;

b) identification and assessment of risks involved in the pricing process;

c) clearly defined and appropriate levels of delegation for approval of all material aspects of pricing;

d) scenario testing to identify the impact of changes in assumptions such as claims, discontinuance rates, expense costs, tax allowances or investment parameters on the profitability of the product at various price levels;

e) a process for the involvement of key stakeholders in the pricing decision;

f) a process for sourcing data and deriving initial assumptions;

g) a process for monitoring, and the ability to monitor, deviations of experience from that assumed (this would ordinarily include regular assessments of the life company's experience of mortality, disability and other claim and recovery rates, and of discontinuance experience for different product types); and

h) methods for monitoring compliance with pricing policies.

Underwriting

6. Underwriting is the process by which a life company determines whether or not to accept a proposal for insurance and, if accepted, the terms and conditions to be applied and the level of premium to be charged. Weaknesses in the underwriting process and in the types and levels of controls and systems can expose a life company to the risk of incurring claims beyond the level assumed in pricing. This may threaten the long-term viability of the life company.

7. In order to control and manage the risks associated with underwriting, the risk management framework would typically include the following elements:

   a) processes to ensure that the area responsible for underwriting has access to sufficient staff with appropriate experience and expertise;

   b) measures to understand and mitigate risk accumulations and concentrations, for example, multiple policies on the same life and high group life coverage in single locations;

   c) the process for setting approval authorities and the definitive limits to those authorities (including procedures for escalation to more senior underwriters where a decision is beyond delegated authority);

   d) details of the formal risk assessment process in the underwriting of life insurance, consistent with product design and pricing, including:

      i) procedures for the identification of applicants who are eligible to be accepted at standard rates and conditions;

      ii) where applicants cannot be accepted at standard rates and conditions, clear procedures for either accepting the applicant at varied rates or conditions or refusing the applicant;

      iii) statements of the type and extent of evidence required in order to make the above assessments; and

      iv) the method(s) by which emerging experience is taken into consideration in the underwriting process;

   e) processes for management of compliance issues including privacy and protection of confidential medical information;

   f) clear documentation of service standards;

g) methods for monitoring compliance with underwriting policies and procedures such as:

   i) reviews by area heads or portfolio management;

   ii) peer review of policies underwritten (including details of the staff responsible for undertaking the peer review, the frequency of such reviews and the reporting arrangements for the results);

   iii) for group risks, assessments of procedures and systems to ensure the quality of information provided to the life company is of a suitable standard; and

   iv) in the case of reinsurers, audits of ceding companies to ensure that reinsurance assumed is in accordance with treaties in place.

Claims management

8. Claims settlement is the process by which life companies fulfil their contractual obligation to policy owners. Weaknesses in the controls and systems surrounding the claims management process can expose a life company to claims beyond the level assumed in pricing and may threaten the ongoing viability of the life company.

9. In order to manage the risks associated with claims management, APRA envisages that the risk management framework would include the following elements:

   a) processes to ensure that the area responsible for claims management has access to sufficient staff with appropriate experience and expertise;

   b) clearly defined and appropriate levels of delegations of authority;

   c) criteria for accepting or rejecting claims;

   d) processes for managing the claims handling process, including the procedures to be triggered when a claims notification is made to the life company, including:

      i) verifying the contractual obligation of the policy to pay the claim;

      ii) making an assessment of the claims liability quantum;

      iii) levels of evidence required; and

      iv) ensuring the claims settlement process is handled promptly and efficiently within the terms of the policy;

   e) processes for management of compliance issues including privacy and protection of confidential medical information;

   f) clear documentation of service standards;

   g) dispute resolution procedures; and

h) methods for monitoring compliance with claims management processes and procedures such as:

   i) reviews by area heads or portfolio management;

   ii) peer review (including details of the staff responsible for undertaking the peer review, the frequency of such reviews and the reporting arrangements for the results); and

   iii) in the case of reinsurers, audits of ceding companies to ensure that the value of claims paid is in accordance with treaties in place.

Reinsurance management

10. Reinsurance management is the process of selecting, monitoring, reviewing, controlling and documenting a life company's reinsurance arrangements. Such arrangements may be used by life companies to manage large risks which lie outside the life company's risk tolerance, to reduce profit volatility and for capital management and financing purposes. Entering into such arrangements requires the consideration of actuarial advice.

11. A life company's Risk Management Strategy would ordinarily include a statement of the life company's approach to the use of reinsurance including the acceptable uses of limited risk transfer arrangements.

12. In relation to reinsurance management, a life company's risk management framework would typically include the following elements, where relevant (some of these considerations will be more relevant to new business and others to existing business):

   a) processes to ensure that the area responsible for reinsurance management has access to sufficient staff with appropriate experience and expertise;

   b) definition and documentation of the life company's objectives and strategy for future use of reinsurance and management of the reinsurance arrangements for existing business, reflecting the life company's appetite for risk;

   c) processes for reviewing policies and procedures for reinsurance management in the light of the life company's business activities, as well as current market, and contractual, conditions and the frequency of that review;

   d) processes for selecting, implementing, monitoring and reviewing reinsurance arrangements, including:

      i) processes for implementing any reinsurance arrangements identified as necessary during the product development process;

      ii) methodologies for the selection and ongoing monitoring of reinsurance participants, including the consideration of diversification and the reinsurers' creditworthiness;

iii) processes for setting and monitoring concentration limits for credit risk exposures to particular reinsurance counterparties;

iv) processes for ensuring that complete and accurate information can be provided to reinsurance counterparties in a timely manner;

v) procedures for the processing of reinsurance premiums and the collection of reinsurance recoveries arising under those arrangements; and

vi) identification and management of aggregations of risk;[2]

e) processes to ensure accurate and complete reinsurance documentation is in place;

f) processes for the independent review of compliance with policies and procedures relating to reinsurance management and the frequency of that review; and

g) consideration of the risks arising from reinsurance for both the Australian and the overseas operations of the life company that could impact on the Australian operations of the life company.

[2] This may include giving consideration to the use of catastrophe reinsurance if concentrations of risk beyond the risk tolerance of the life company are identified.