SUPERANNUATION PRACTICE COMMITTEE

Discussion Note: Self-insurance Arrangements and Superannuation Prudential Standard 160

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A. Purpose and status of Discussion Note

1. Superannuation Prudential Standard SPS 160 Defined Benefit Matters ("SPS 160") – and the related Prudential Practice Guide SPG 160 Defined Benefit Matters ("SPG 160") – deal with a range of matters affecting defined benefit funds, including self-insurance arrangements. It is expected that any actuary providing advice in respect to a defined benefit fund, or sub-fund, will have detailed knowledge of SPS 160 and SPG 160. This Discussion Note is based on, and refers to, the June 2013 version of SPS 160 and the November 2013 version of SPG 160.

2. In addition, as part of the Stronger Super reforms in 2013, superannuation legislation was amended to place new restrictions on self-insurance and the types of insurance provided by superannuation funds.

3. This Discussion Note was prepared by the Superannuation Practice Committee ("SPC") of the Actuaries Institute ("Institute") and is intended to assist actuaries in understanding the legislative requirements and in providing advice to an RSE licensee ("trustee" in this Discussion Note) in relation to self-insurance arrangements, particularly the requirements of SPS 160. Note that other material prepared by the SPC relating to SPS 160 includes:

   - Information Note: *Shortfall Limit in Superannuation Prudential Standard 160* – regarding advice to trustees on determining an appropriate shortfall limit; and

   - Discussion Note: *Actuarial Requirements of Superannuation Prudential Standard 160* – regarding the requirements of SPS 160 other than in relation to self-insurance arrangements.

4. This Discussion Note has been prepared for actuaries dealing with superannuation funds that are regulated under the SIS Act and therefore subject (inter alia) to the SIS legislative restrictions on self-insurance and to the requirements of SPS 160. However, some of the information provided may be helpful for actuaries dealing with self-insured arrangements for exempt public sector superannuation schemes (i.e. schemes that are exempt from regulation under the SIS Act).

5. Professional Standard PS 400 *Investigations of the Financial Condition of Defined Benefit Superannuation Funds* ("PS 400") has specific requirements for actuarial investigations of funds with self-insured benefits.

6. This Discussion Note does not represent a Professional Standard or Practice Guideline of the Institute.

7. This Discussion Note does not constitute legal advice. Any interpretation or commentary within this Discussion Note regarding specific legislative or regulatory requirements reflects the expectations of the Institute but does not guarantee compliance under applicable legislation or regulations. Accordingly, Members should seek clarification from the relevant regulator and/or seek legal advice in the event they are unsure or require specific guidance regarding their legal or regulatory obligations.

8. Feedback from Institute Members is encouraged and should be forwarded to the SPC via Paul Shallue (paul.shallue@mercer.com).

9. This is the second version of this Discussion Note. The first version was dated February 2014. The main changes incorporated into this second version are to remove or update material which has become redundant or requires amendment due to the passage of time, legislative changes and the withdrawal of Practice Guideline 499.01 *Self Insurance for Superannuation Funds*. Paragraph 6 has also been added in accordance with current Institute policy.

B. Introduction

10. As part of the Stronger Super reforms, the Superannuation Industry (Supervision) Act 1993 (Cth) (SIS Act) and the Superannuation Industry (Supervision) Regulations 1994 (Cth) ("SIS Regulations") placed restrictions on self-insurance and the types of insurance provided by superannuation funds.

11. In addition, APRA set out requirements for funds that self-insure in SPS 160.

12. Funds which self-insure must also meet the requirements of Prudential Standard SPS 250 *Insurance in Superannuation* in regard to their insured (including self-insured) arrangements. However, these additional requirements are not dealt with in this Discussion Note.

13. Section C of this Discussion Note provides information on the restrictions in the SIS Regulations on self-insurance and on the permitted types of insured benefits, along with comments on implications and the treatment of matters such as funding shortfalls.

14. Section D provides information on the SPS 160 requirements for funds that self-insure, along with comments on implications and matters such as the treatment of claims provisions and insurance reserves for the calculation of funding status measures and the frequency of detailed reviews of self-insurance arrangements.

15. APRA may also impose additional restrictions on a fund's ability to provide self-insurance as part of the trustee's licence conditions. Any such restrictions are not considered in this Discussion Note.

C. SIS Regulations requirements

C.1 Definition of "insured benefit"

16. The term "insured benefit" is defined in SIS Regulation 4.07C:

> "***insured benefit***, for a member, means a right for the member's benefits to be increased on the realisation of a risk."

17. A fund can provide an insured benefit via external insurance or (where permitted) via self-insurance.

18. There is no definition of a 'risk' in the SIS Regulations. Clearly this is intended to cover death and disability risks. The SPC's understanding is that it would also cover ill-health risks (that is, additional benefits on ill-health would be considered "insured benefits"), but that it is not intended to apply to retrenchment/redundancy risk (that is, additional benefits on retrenchment/redundancy would not be considered "insured benefits").

19. Nor is the meaning of 'risk' in relation to the definition of insured benefit considered to extend to other employer defined benefit ("DB") funding risks, such as the risk of a member attaining the eligibility age for an early retirement benefit or the risk that the member exercises a more costly pension rather than a lump sum option.

C.2 Restrictions on types of insured benefits

20. Under SIS Regulation 4.07D, a fund can only begin providing an insured benefit to a member (for example, a new member or an existing member who does not already have that insured benefit) if the insured benefit relates to:

- death; and/or
- permanent incapacity; and/or
- terminal medical condition; and/or
- temporary incapacity

AND, in respect of the latter three types of benefit, the circumstances in which a member becomes entitled to each of these benefits would meet the corresponding SIS Act condition of release.

Note: An exception applies to benefits approved under section 62(1)(b)(v) of the SIS Act where the approval was granted before 1 July 2014 – refer SIS Regulation 4.07D(3)(b).

21. Other types of insured benefits can be maintained for a particular member where that benefit was being provided for that member on 1 July 2014. The restrictions on the provision of insured benefits include self-insured arrangements.

C.3 Restrictions on self-insurance

C.3.1 SIS Regulations requirements

22. SIS Regulation 4.07E places the following restrictions on self-insurance:

    (a) No fund can provide insured benefits for accumulation members through self-insurance (except in limited circumstances where the Commonwealth or a State government provides or guarantees the insured benefits); and

    (b) Defined benefit funds can provide insured benefits for defined benefit members (including new defined benefit members) through self-insurance only if the fund self-insured such benefits on 1 July 2013 (and so long as APRA did not prohibit self-insurance for that fund as a condition of its licence). According to an APRA Modification Declaration of Regulation 4.07E dated 31 March 2014, successor fund transfers maintain the ability to self-insure in the same circumstances as the original defined benefit funds.

23. Note that the ability to continue self-insuring defined benefit members only relates to the particular types of risks which were self-insured as at 1 July 2013 ("permitted self-insured benefits" for ease of reference). It does not extend to new types of self-insured risks. For example, a fund which was self-insuring death and permanent incapacity (but not terminal medical condition) risks as at 1 July 2013 would not be able to introduce benefits

on terminal medical condition or temporary disability unless these new benefits were fully insured by an insurance policy issued by an insurer.

24. However, a trustee is able to amend the formula for calculating the amount of the permitted self-insured benefits after 1 July 2013 (subject to paragraphs 36 and 37 of SPS 160, in particular paragraph 36(b) thereof – refer Section D.1 below).

C.3.2 Funding shortfalls not self-insurance

25. Funding shortfalls in a defined benefit fund are not considered to result in new or increased self-insured benefits, provided that there is a reasonable expectation that the sponsoring employer(s) will meet the funding shortfall.

26. Where there is a funding shortfall, it is expected that the employer contribution program will be directed towards eliminating the funding shortfall, usually over a period of time. If extra insurance was also required as a result of the funding shortfall, this would create duplication and unnecessary costs (not only insurance premium costs, but also the administrative costs involved in the insurer and the fund administrator amending the insurance formula, calculating the updated cover for each member and administering any resulting underwriting requirements). There could also be adverse consequences for members – for example, if the insurer declined the additional insurance amount and this was required to be offset in the event of the member's death.

27. It would also result in insured benefit amounts that do not meet the SIS Regulations definition of "insured benefit". Consider the following example:

    (a) a fund has insurance risks in respect of lump sum death and disablement benefits;

    (b) the fund's insurance strategy is to fully insure its death and disablement risks;

    (c) its funding strategy is to maintain vested benefits coverage of at least 100%;

    (d) the fund has external insurance equal to the member's lump sum death and disablement benefit less their vested benefit;

    (e) for members over age 60, the member's lump sum death and disablement benefit is equal to their vested benefit;

    (f) the fund's vested benefits coverage falls to 98% and hence total death and disablement benefits exceed the sum of fund assets and external insurance cover by 2% of vested benefits;

(g) if the shortfall of 2% of vested benefits was considered to constitute self-insurance, then it would apply equally to members over age 60 as to members under age 60. Yet members over age 60 do not have an "insured benefit" under the SIS Regulations, as they have no right for their benefits to be increased on the realisation of a risk.

28. Hence it seems clear that funding shortfalls below 100% vested benefits coverage are not self-insurance. Further, for the reasons discussed above, the SPC considers that funding shortfalls arising in relation to a target funding level set above 100% of vested benefits should also not be regarded as self-insurance.

29. For example, if the funding target is 100% of accrued retirement benefits and:

(a) the employer contribution program is directed at maintaining at least this level of coverage; and

(b) the fund has external insurance equal to the member's lump sum death and disablement benefit less their accrued retirement benefit,

then any funding shortfall below 100% of accrued retirement benefits would not generally be regarded as constituting self-insurance.

30. Nevertheless, there may be situations where the actuary considers it appropriate to recommend an increase in the level of insurance coverage in response to a funding shortfall, having regard to all the relevant circumstances including:

(a) the level of the shortfall;

(b) whether there is a change in the target funding level;

(c) the expected period to restore the target funding level; and

(d) the employer's willingness and ability to bring forward any additional contributions which may be required to fund the shortfall (if any) relating to exits, including deaths and disablements.

31. Where there is not a reasonable expectation that the sponsoring employer(s) will meet the funding shortfall, a range of broader issues would need to be addressed.

C.3.3 Reasonable insurance benefit approximations do not give rise to self-insurance

32. In many funds which externally insure, the insured amount is equal to the death or disablement benefit less an amount representing the member's funded interest. The choice of insured benefit formula depends on both the benefit design and the funding target.

33. For example, a fund with a funding target of 100% of vested benefits could reasonably externally insure the total death or disablement benefit less the vested benefit. It may also be reasonable in this case to externally insure the total death or disablement benefit less the accrued retirement benefit, if the accrued retirement benefits are not significantly higher than vested benefits.

34. A consequence of this is that, where a fund has no external insurance for a benefit which falls within the definition of "insured benefit" (such as an ill-health benefit) equal to the accrued retirement benefit, then it does not necessarily constitute self-insurance.

35. Another specific example of insured benefit approximation is where a lump sum amount is insured in relation to pension benefits. This is discussed further in Section C.3.5 below.

36. It is expected that the actuary would consider the appropriateness of the external insurance formula and the materiality of any potential differences between the sums insured arising from the formula adopted and the excess of the death and/or disability benefits over the funding target. Provided the actuary is satisfied that the insurance arrangements are such that adverse death and disablement experience would not be expected to have a material adverse impact on the financial position of the fund, it is appropriate to consider that there is no self-insurance.

C.3.4 Waiving of offset clauses

37. Most funds have offset clauses that enable the fund to reduce a member's death or disablement benefit where external insurance or self-insured cover is declined or restricted in some manner.

38. Some funds which are generally fully insured may have decided, by agreement between the sponsoring employer and the trustee either in particular cases or in all cases, to waive the offset clause and provide the full benefit, even though a member's insurance cover is restricted in some way and the insurance claim will be restricted in some circumstances.

39. Such arrangements would be considered to result in self-insurance.

40. It is permissible to continue self-insuring such uninsured risks for defined benefit members, subject to the regular actuarial control and other requirements of SPS 160 (including the members' best interests test) in the following cases:

    (a) where the member concerned was similarly self-insured at 1 July 2013; or

    (b) where all the following applied at 1 July 2013: the member was not self-insured but the fund self-insured the relevant risk for some defined benefit members and it was the trustee's policy to provide the full benefit in such circumstances.

41. Where such self-insurance is either not permitted or no longer considered appropriate by the trustee, a possible means of continuing to provide full benefits to members who have restricted external insurance cover without considering the benefit to be self-insured, would be as follows:

    (a) the employer commits to a benefit augmentation where necessary which would be funded by additional employer contributions; and

    (b) the full benefit would not be payable if the employer did not fund any shortfall in the member's benefit at the time the insured event arose.

42. Note that such additional employer contributions (or allocations from a reserve) may be treated as concessional contributions which could have adverse tax implications for the member or their beneficiaries.

C.3.5 Self-insurance and defined benefit pensions

43. Where the relevant benefit being insured is a defined benefit pension, such as a lifetime pension, it will generally only be possible to externally insure a lump sum amount. In such cases, the trustee and employer sponsor are accepting the investment risk and longevity risk in respect of the pension.

44. The trustee may also be accepting contingent risks that should be reflected in the lump sum insured amount – for example, where members/beneficiaries have various benefit options or the actuarial value depends on further contingencies (for example, a lump sum may be payable on the death of a disablement pensioner prior to age 65 or the value of a spouse pension may depend on how many dependent children the member had at death). In such cases, it is necessary to make assumptions in order to determine an amount to insure. It is expected that any assumptions made for this purpose would be considered reasonable and appropriate having regard to the circumstances. For example, it may be appropriate to assume:

(a) a proportion of pensioners will have a spouse at death without determining how many members are currently married; and/or

(b) an average number and age of children at death without determining how many children each member currently has.

45. It is expected that the appropriateness of the assumptions would be considered having regard to the number of members entitled to the relevant benefits (and hence the likelihood of actual experience being in line with the assumptions), as well as the consequences for the fund's financial position of actual experience varying from the assumptions. Thus, for smaller funds, it might be assumed that all members will have an eligible spouse at death and the spouse will opt for the most valuable benefit, which may differ from the funding assumptions.

46. Provided these options/contingencies are taken into account in determining the insured amount, and the actuary is satisfied that the insurance arrangements are such that adverse death and disablement experience would not be expected to have a material adverse impact on the financial position of the fund, it is appropriate to consider that there is no self-insurance.

D. SPS 160 requirements

D.1 Self-insurance provisions of SPS 160

47. Paragraphs 36 and 37 of SPS 160 set out APRA's requirements in relation to self-insurance in defined benefit funds.

48. Paragraph 36 of SPS 160 states:

> "An RSE licensee that is permitted to self-insure insured benefits must:
>
> (a) maintain reserves or have other arrangements approved by APRA in place to fund current and future self-insurance liabilities;
>
> (b) attest annually that, in formulating and maintaining its policy in relation to self-insurance, the RSE licensee continues to act in the best interests of beneficiaries; and
>
> (c) develop a contingency plan for an orderly transfer of insurance assets and obligations, for activation in the event that the Board

> has decided that, by self-insuring benefits, the RSE licensee is no longer acting in the best interest of beneficiaries as a whole."

49. Paragraph 37 of SPS 160 states:

> "An RSE Licensee that self-insures benefits must ensure the ongoing actuarial oversight of the reserves and self-insurance arrangements via, at a minimum, the regular investigation required under paragraph 14. Regular actuarial reviews must provide sufficient information about the maintenance of adequate insurance reserves or other arrangements for funding of self-insured benefits. The actuarial review must also provide sufficient information on the self-insurance arrangements to demonstrate the extent and adequacy of the actuarial oversight undertaken on these arrangements."

50. Paragraphs 38 to 42 of SPG 160 provide guidance on the above requirements.

D.2 Requirement for reserves or other arrangements

51. Paragraph 36 of SPS 160 requires that reserves must be established and maintained or alternative arrangements must be approved by APRA.

52. Prior to the introduction of SPS 160, a reserve approach rarely applied in relation to defined benefit members (exceptions include cases such as where defined benefit members may elect to have voluntary additional cover).

53. An alternative arrangement for which approval could be sought from APRA, in respect of self-insurance arrangements relating to defined benefit members, is that:

    (a) provisions relating to incurred claims, including pending and Incurred But Not Reported ("IBNR") claims where the amount is material, are either included in the value of liabilities for funding calculations (including funding status measures such as vested benefits) or deducted from the available asset value; and

    (b) allowance for the expected cost of future self-insured claims is included in the future benefit projections and the recommended employer contribution program.

54. Where reasonably expected fluctuations in self-insured claims may have a significant impact on the fund's financial position, it would be expected that the actuary would comment on this in the triennial actuarial investigations as required by PS 400.

55. PS 400 has specific requirements in respect of actuarial investigations.

D.3 Frequency of review of self-insured arrangements

56. The reference in paragraph 37 of SPS 160 to regular investigations would include both triennial and annual investigations (as required under SPS 160 for the particular fund) and hence any annual investigation report would need to include a review of the self-insurance arrangements.

57. For many funds, only triennial actuarial investigations are required under SPS 160 and the SPC considers that a detailed review of the self-insured arrangements will also usually only be necessary once in every three year period. This may be via (A) the triennial actuarial investigation under PS 400 or (B) a separate review relating specifically to the self-insurance arrangements which should be referenced from the actuarial investigation.

58. Where funds are required under SPS 160 to undertake actuarial investigations more frequently than triennially (for example, annually), it would generally be considered sufficient for the non-triennial actuarial investigation reports to meet the requirements of paragraph 37 of SPS 160 by a combination of the information provided directly in the annual investigation report and by reference to the more detailed information in the previous triennial actuarial investigation report. Similarly, in case (B), it would generally be considered sufficient for the regular investigation reports to meet the requirements of paragraph 37 of SPS 160 by a combination of the information provided directly in the report and by reference to the more detailed information in the report on the previous review of the self-insurance arrangements.

59. In particular, it would often not be necessary to review experience and undertake a detailed IBNR calculation more often than every three years.

60. Nonetheless, where significant funding issues are being addressed and monitored as part of an annual actuarial investigation regime, more detailed analysis of the self-insurance arrangements may also be appropriate on a more frequent basis.

D.4 Self-insurance reserves/other arrangements and funding calculations

61. As indicated in Section D.2 of this Discussion Note, in the case of a defined benefit fund that does not maintain self-insurance reserves, and for which APRA has approved an "other arrangement", usual practice is for provisions relating to incurred (including IBNR) claims to either be included in the value of liabilities or deducted from the available asset value. This applies both to funding calculations for the purpose of determining future contributions and to the calculation of funding status measures such as vested

benefits coverage (including for the purpose of determining if a fund is in an unsatisfactory financial position).

62. The determination of appropriate provisions for incurred (including IBNR) claims may have regard to the variability of the amounts and their materiality for the plan's financial position. A more detailed assessment will usually apply at the triennial reviews of the self-insured arrangements, with a short-hand approach (based on the results of the previous detailed assessment) applying between triennial reviews.

63. Where a fund utilises self-insurance reserves, these reserves can usually be divided into at least two components:

    (a) an incurred claims (including pending and IBNR) component, which relates to events which have occurred; and

    (b) an allowance for claim fluctuations, which relate to future events.

64. Pricing and premium reserves will generally not be relevant to DB arrangements.

65. In a large defined benefit fund, claim fluctuations (excluding a catastrophe) may be very small relative to the reserve required for pending and IBNR claims and/or to total accrued liabilities. This amount may also be very small relative to contribution requirements, with contribution requirements regularly needing adjustment to fund for any variation in financial and other demographic experience. In such circumstances, it may reasonably be determined that it is not necessary to hold specific reserves for the second component.

66. In calculating funding indices (including in determining if a fund is in an unsatisfactory financial position), or recommending employer contribution rates, it is appropriate to exclude the incurred claims reserve (that is, component (a) in paragraph 62 above) from the available assets.

67. However, in the case where the fund also maintains a reserve for component (b) in paragraph 63 above (that is, for future claim fluctuations), this reserve does not need to be excluded from the available assets for the purpose of calculating past service funding indices, because it does not relate to past service liabilities and is not needed if the fund were to be terminated.

68. It is sufficient for the actuary to calculate the first component in triennial reviews and assume it remains unchanged in between reviews, unless this is unreasonable in the circumstances. It would not be unreasonable to expect that the amount of the IBNR

would not materially increase over the inter-valuation period – unless significant membership changes or other events occur.

D.5 Prudential Practice Guide SPG 160

69. Paragraph 40 of SPG 160 states:

> "SPS 160 requires that an RSE licensee ensure that all self-insurance arrangements have actuarial oversight. In assessing the recommended level of self-insurance reserves to be held, or the adequacy of other arrangements, APRA expects an RSE actuary would consider, amongst other matters, the level of insurance cover, the risk profile of the insured group (based on, for example, age, gender, type of employment etc.), possible catastrophe scenarios and past claims experience."

70. Paragraph 41 of SPG 160 provides an indication of the information that APRA considers might demonstrate adequate actuarial oversight:

> "APRA expects the minimum level of actuarial oversight of self-insurance arrangements to be via the periodical (normally triennial) actuarial investigations. The range of factors that might demonstrate the adequacy of reserves or other arrangements would usually include information on the self-insured risks, as well as an explanation of the method for determining the risk reserve or provisions for self-insured claims (including incurred but not reported claims) and how potential variability in claims experience is catered for. The report would also be expected to include consideration of catastrophe risk, e.g. the extent to which geographical spread of members mitigates such risk, or whether catastrophe insurance should be taken out."

71. Under standard actuarial practice, 'actuarial oversight' is taken to include more specifically (as a minimum):

    (a) Quantification of the extent of self-insurance and consideration of the potential risk this poses to (i) members' benefits, (ii) the employer's funding requirements and (iii) the fund's overall financial position;

(b) Regular analysis of relevant claims experience (compared with the expectations underlying the funding/pricing recommendations) and the impact of this experience on funding and/or solvency;

(c) Identification of self-insurance costs for funding purposes (for example, for inclusion in employer contributions);

(d) Determination of suitable provisions for incurred claims (including IBNR);

(e) Consideration of the need (if any) for conservatism in setting insurance funding levels and the need for protection against potential catastrophe; and

(f) Consideration of the need (if any) to hold any specific insurance reserves.

72. In regard to catastrophe risk, in many cases it is highly unlikely to be feasible for a fund to hold reserves sufficient to provide meaningful protection against a major catastrophe. However, the actuary would be expected to consider and assess the risk of various types of catastrophe scenarios (taking into account the specific circumstances such as the concentration of self-insured risks at particular locations and any special risks associated with the locations and/or the type of work undertaken at those locations) and include the results of this assessment in advice regarding the adequacy of the self-insurance reserves or arrangements.

73. In some cases, actuaries may consider recommending that the trustee investigates the availability and cost of catastrophe insurance.

74. It is expected that the results of this assessment, and the employer sponsor's views about the risk and impact of a catastrophe on its funding obligations, would be taken into account by the trustee in its annual determination of whether or not continuation of the self-insurance arrangements is in members' best interests.

D.6 Trigger events for interim review

75. Paragraph 42 of SPG 160 states:

> "While the triennial review may provide the context and occasion for the minimum level of oversight, APRA also expects that an RSE licensee and an RSE actuary would identify events or conditions that would trigger an interim review of self-insurance arrangements, e.g. a large adverse movement in asset values leading to a sudden deterioration in the

> financial position of the fund, or a significant adverse claims event or experience."

76. In any assessment of self-insurance, it is considered good practice for the actuary to consider specifying events which should trigger an interim review of the self-experience arrangements in advance of the next regular actuarial investigation or separate three yearly review of self-insurance arrangements (where applicable). Such events could include:

    (a) the self-insurance reserve falls below a certain amount (or a certain percentage of premium) or certain % of recommended reserve;

    (b) a material change to the total amount of insured benefits or the formula to calculate those benefits;

    (c) a material increase in claim amounts or the occurrence of a major claims event; and

    (d) a material change in the membership.

77. The SPG 160 examples of trigger events include a large adverse movement in asset values. This will generally be more relevant to the overall funding position than to the adequacy of the self-insurance arrangements, but may be relevant to the latter for some funds.

78. There may also be circumstances, such as where self-insurance is immaterial, where specifying trigger events may not be necessary. In determining any triggers, it may be appropriate to consider whether annual or triennial reviews take place.

79. Where triggers are specified, it is important that monitoring for those triggers occurs.

END OF DISCUSSION NOTE