PROBLEMS OF THE AUSTRALIAN LIFE INSURANCE INDUSTRY

Ray Palmer (Australia)

Introduction

The aim of this paper is to summarize the present position of the life insurance industry in Australia from the viewpoint of an overseas visitor who has detailed knowledge of life insurance in his own country but who knows nothing of Australian conditions.

Type of Contract

Leaving aside contracts issued in connection with retirement benefit plans, most policies issued are either whole life assurances or endowment assurances. Most (about 90%) of these policies participate in profits using the reversionary bonus system.

Number of Offices

There are 46 life offices of which five are purely reinsurance companies. Easily the largest is the Australian Mutual Provident Society. The larger offices tend to be mutual and the balance proprietary.

Minimum Basis of Valuation

The legislation governing life insurance is the Life Insurance Act 1945-1973. The Act requires that valuations of policy liabilities must be made once every five years, but in practice valuations are made annually.

Section 49(2) of the Act requires that the basis of valuation adopted "shall be such as to place a proper value upon the liabilities, having regard to the mortality experience among the persons whose lives have been insured by the company, to the average rate of interest from investments and to the expenses of management (including commission) and shall be such as to ensure that no policy shall be treated as an asset".

This provision is right and proper. It places the onus on the actuary to determine the proper value of liabilities. It clearly requires the actuary to exercise his professional judgment bearing in mind the purpose for which the valuation is performed.

However, Section 49(3) of the Act provides that "the value placed upon the aggregate liabilities . . . shall not be less than it would have been if it had been calculated on the Minimum Basis. . . ." Further, Section 49(4) provides that the actuary who makes the valuation "shall certify whether, in his opinion, the value placed upon the aggregate liabilities . . . is not less than the value which would have been placed upon those aggregate liabilities if it had been calculated on the Minimum Basis. . . ."

The Act does not specify the purpose of the Minimum Basis. When introducing the Bill in 1945 the then Treasurer, the Hon. J. B. Chifley, stated that the objects of the legislation included "to set up adequate machinery for dealing with any company that fails to maintain the required minimum standard of solvency". Referring to the Minimum Basis of valuation, he said that "this minimum basis cannot be called a severe one in current conditions, and no solvent company should have any difficulty in complying with it".

The Minimum Basis specifies a modified net premium valuation as follows:

Mortality	A24/29 (the mortality of assured lives in the United Kingdom in 1924-29).
Interest	3½% per annum.
Valuation Premium	Pure net premium adjusted to allow for initial expenses of one year's valuation premium subject to a maximum of 3% of the sum insured.

Under the Act, the directors of a life office have to certify whether the assets shown in a balance sheet are fully of the value stated. The meaning of value is not defined but it has been generally agreed that it is the lower of cost or market value. More recently some directors have taken value for fixed interest as being redemption value or amortisation value; this has not been challenged by the authorities.

While the Minimum Basis was reasonable in the early 1950s, it is certainly not reasonable today. Valuation strain (defined as the excess of the valuation reserve over the funds accumulated from policyholders' premiums) is high for whole life policies at young entry ages, for long-term endowment assurances, for without profit policies and for low-bonus policies. The valuation strain is particularly high at the first valuation date after issue of a new policy.

Since the Second World War, the business of Australian life offices has grown rapidly. This rapid expansion has made it difficult to establish the reserves required by the Minimum Basis and at the same time make equitable bonus allocations between succeeding generations of policyholders.

The problems created for life offices by the Minimum Basis have become more serious as time passes. The majority of Australian offices have weakened their published valuation bases down to the Minimum Basis.

The position for some years has been that unless an office has access to outside funds such as additional shareholder capital, or is a branch of an overseas office, it cannot expand rapidly except possibly at the expense of its present policyholders. Current rates of inflation give the opportunity for rapid new business growth, indeed such growth is necessary in order to keep overhead and other expenses at a reasonable level in relation to premium income. But such growth is severely limited by the Minimum Basis.

The Institute of Actuaries of Australia and New Zealand, and organisations representing life offices, have been making representations to government for many

years with the aim of having the Minimum Basis brought up to date, but without success. An edifice erected with pride by its protagonists has become a monstrous immovable monument retaining for its maintenance an ever-increasing proportion of the funds of the generations of policyholders it was designed to protect. Life offices are forced to reduce rates of growth. Many waste productive effort devising contracts which have the technical effect of reducing valuation strain but which are not necessarily in the interests of policyholders. Reversionary bonuses are declared at lower levels than are equitable, thus reducing the capacity of life offices to compete for public savings. Some offices are resorting to declaring part of their reversionary bonuses in terminal bonus form (i.e., payable only on claims occurring before the next valuation) in the expectation that the Minimum Basis must surely soon be relaxed.

While the Government has stated that it is aware of the situation, there are no signs of immediate relaxation. So life offices which are quite solvent by normal actuarial standards, are in the position of taking unnatural and increasingly drastic steps in order to meet solvency standards imposed in 1945 by well-meaning legislators.

Life Office Income Tax

The basis of taxation of Australian life offices is complex. Investment income from retirement benefit business is free of tax provided the statutory 30/20 ratio is met. The 30/20 statutory ratio is the requirement that if investment income is to be tax-free, at least 30% of assets must be public securities (Australian Government and State securities) including at least 20% of assets represented by Australian Government securities.

For many years until 1973 the effect of the income tax legislation was, for broad practical purposes, that investment income above 3½% of actuarial reserves (commonly known as the Section 115 deduction) was taxed. The Labor Government successively reduced the figure of 3½% to its current level of 1% during its 1972-75 period in office. The present tax rate is 42½%. The long-term nature of life insurance business was given no recognition in these changes and even the life offices have not pointed out that policies in force with premiums calculated at 4½% or 5% interest remain viable on their original terms only because market interest rates are currently well above 7%-8%.

Expenses incurred in the administration of life insurance business are deductible for income tax purposes but expenses incurred in the acquisition of new business are not deductible.

Personal Income Tax

For many years individual taxpayers received a tax deduction on life insurance premiums on policies on their own lives or the lives of their spouses. At the time the Labor Government came to power the maximum deduction was $1,200, including any contributions to a superannuation fund. There was speculation that the Government would remove the deduction but the Treasurer turned out to be more subtle than that. He produced amended tax scales and at the same time gave every individual taxpayer a tax reduction of 40% of $1,350, namely, $540. Any taxpayer who could claim expenses of a certain nature (including the previous life insurance and superannuation deductible allowance of up to $1,200) exceeding $1,350 would receive a further tax reduction (rebate) of 40% of the excess. Few taxpayers would be eligible for this additional rebate. Thus at one stroke the Treasurer altered the tax deduction (at a marginal tax rate) to a 40% rebate and eliminated for most taxpayers the tax incentive to effect personal life insurance.

The current Liberal Government has indexed the various components of the tax scale except that, significantly, it left the $1,200 allowance unaltered. The Liberal Government did not resotre part or all of the previous Section 115 deduction. No wonder that the life insurance industry believes that it has been abandoned by politicians to die a slow lingering death.

Consumerism and Public Relations

Increasingly it is being said that the days of life insurance are numbered. More specifically what people are saying is that life insurance is losing its popularity. What they probably mean is that the products the life insurance industry has been offering for decades are on the way out. Similar comments have been made about certain motor cars, such as Volkswagen Beetles and Leyland Minis, which nevertheless have continued to sell year after year, although perhaps in reducing numbers.

The life insurance industry offers, of course, a unique service, namely, financial security for a policyholder's dependants in the event of his death. Notwithstanding the development of government welfare services the demand for this service will continue.

However, the Australian life insurance industry, especially that part of it concerned with marketing, derives most of its income or profit not from the life insurance service but from savings contracts usually sold in conjunction with, or as part of, life insurance contracts. In the savings field the industry does not have a monopoly and, indeed, its competitive position at the present time is rather weak. If positive action is not taken it seems certain to become weaker. Economic conditions in the last few years and the activities of bodies set up to protect consumer interests have caused a greater appreciation among members of the public of investment returns from different savings media. There is an increasing trend towards more critical evaluation of the product on offer, and its cost. There is intensified competition between the various financial institutions to attract the savings of the community.

The products currently being offered by the life insurance industry are not adequate to meet the challenge presented by other savings media, principally because the proportion of premium which goes in expenses is too high. If selling and administration costs were lower the basic product would compete better. Like other industries the life insurance industry has had to contend with overall increases in costs due to inflation, but other industries in general are not saddled, as the life insurance industry has been, with having to continue to administer contracts issued long ago which contain inadequate expense loadings. Fortunately computers can lighten the load, and efficiently used, they do.

If we regard whole life insurance, endowment insurance and endowment as being savings-type policies, and the rest of the new business as being term (which most of it is), then from the Australian Life Insurance Commissioner's Annual Reports we see that whereas in the three years to 31 December 1972 the proportion of Ordinary new business annual premiums on new savings-type policies was fairly steady, being 94.8% in 1972, by 1975 it had become 89.8%. In other words, "term" business had risen from 5.2% to 10.2% of all new business, using annual premiums as the measure.

There are a number of reasons why there should be a swing to term insurance. To the public, term insurance, having a much smaller savings content, is likely to be more attractive when inflation rates are high. To shareholders and life office managements, term insurance has the advantage that it requires less financing. Nevertheless the industry is not likely to vacate the savings market entirely (although one or two offices may do so) and it will have to compete with other institutions to attract savings. Recent evidence has shown that despite the inflationary conditions we have experienced, in Western World economies individual savings deposits have continued at their previous levels, or even at higher levels. Whether life offices can siphon off these deposits into longer term commitments is another matter. To achieve this a deep rethink about the basic product is needed. Is it right to continue to charge premiums without telling the prospect how much of the premium goes in expenses? With the increasing pace of change in personal circumstances, plus inflation, a policy may suit the policyholder at the date it was sold but may be quite unsuitable a year or so later. Is it reasonable that on early surrender the surrender value should be only a small proportion of premiums paid? While the policyholder may be told that the low surrender value is much less than the premiums he has paid, the policyholder can retort, and sometimes does, that the payment of commission was not mentioned when the policy was sold to him. For other savings media either there is no expense deduction, or a stated expense deduction is made. Orthodox life insurance policies are almost the only savings media where expense charges which will be applied on realisation are not disclosed on sale. That the transition to public exposure of expense charges is not impossible is demonstrated in the retirement benefit field by deposit administration and managed fund contracts where the administration and investment charges are clearly stated.

National Compensation

Under the auspices of the Labor Government Mr. Justice Woodhouse of New Zealand chaired a Committee which recommended in 1974 a national compensation scheme for Australia similar to the current national compensation scheme in New Zealand with which he was involved. In essence the plan was to abolish the existing workers' compensation insurance system and to introduce a comprehensive scheme under which a person totally incapacitated (from any cause) would receive an income of 85% of taxable earnings, with a maximum of $500 per week until recovery or age 65. Widows of deceased men would, subject to certain qualifications, receive a pension of 60% of the pension which the husband would have received if he had been incapacitated. Clearly the Woodhouse Committee's proposals, had they been implemented, could only have adversely affected the life insurance industry's new business potential.

An Australian Government Insurance Office

In 1975 the Government introduced a Bill for an Australian Government Insurance Office. Initially the plan was that the A.G.I.O. would write both life insurance business and general insurance business, but Government enthusiasm for the life insurance part of this venture seemed to wane fairly early. Until the introduction of the A.G.I.O. Bill the life insurance industry seemed mesmerized by the various attacks on it. Little or no attempt had been made to gain public sympathy. The A.G.I.O. Bill introduction seemed to be a spur to action and the life offices conducted an advertising campaign aimed at gaining public support.

Conclusion

So the Australian life offices have had an undue share of problems lately. Income tax has increased and the Minimum Basis of valuation has not been brought up-to-date. Both have combined to reduce bonuses, or at least prevent bonus increases, in a period when interest rates have been high and, traditionally, high bonus rates would have been expected. Consumerism has appeared on the life office scene; criticism of the industry is seemingly coming from many quarters.

To me, an interested observer standing right at the edge of the stage as it were, the impression is that the Australian life office industry does not really know why it has been under attack, is resentful that it is under the spotlight and has defended its practices by rationalisation rather than reasoned arguments. While an individual actuary would first analyse the problem, come to a logically reasoned solution and then attempt to put it into effect, the offices as a whole appear not to have analysed their problems but to have assumed that their current practices and systems are faultless. I do not know to what extent members of the actuarial profession have been involved in this process, but I hope they have, and will, use their best powers of persuasion not only on the Government, to change the Minimum Basis, but also to influence the life offices to have a good hard look at themselves and to adapt themselves to public needs.