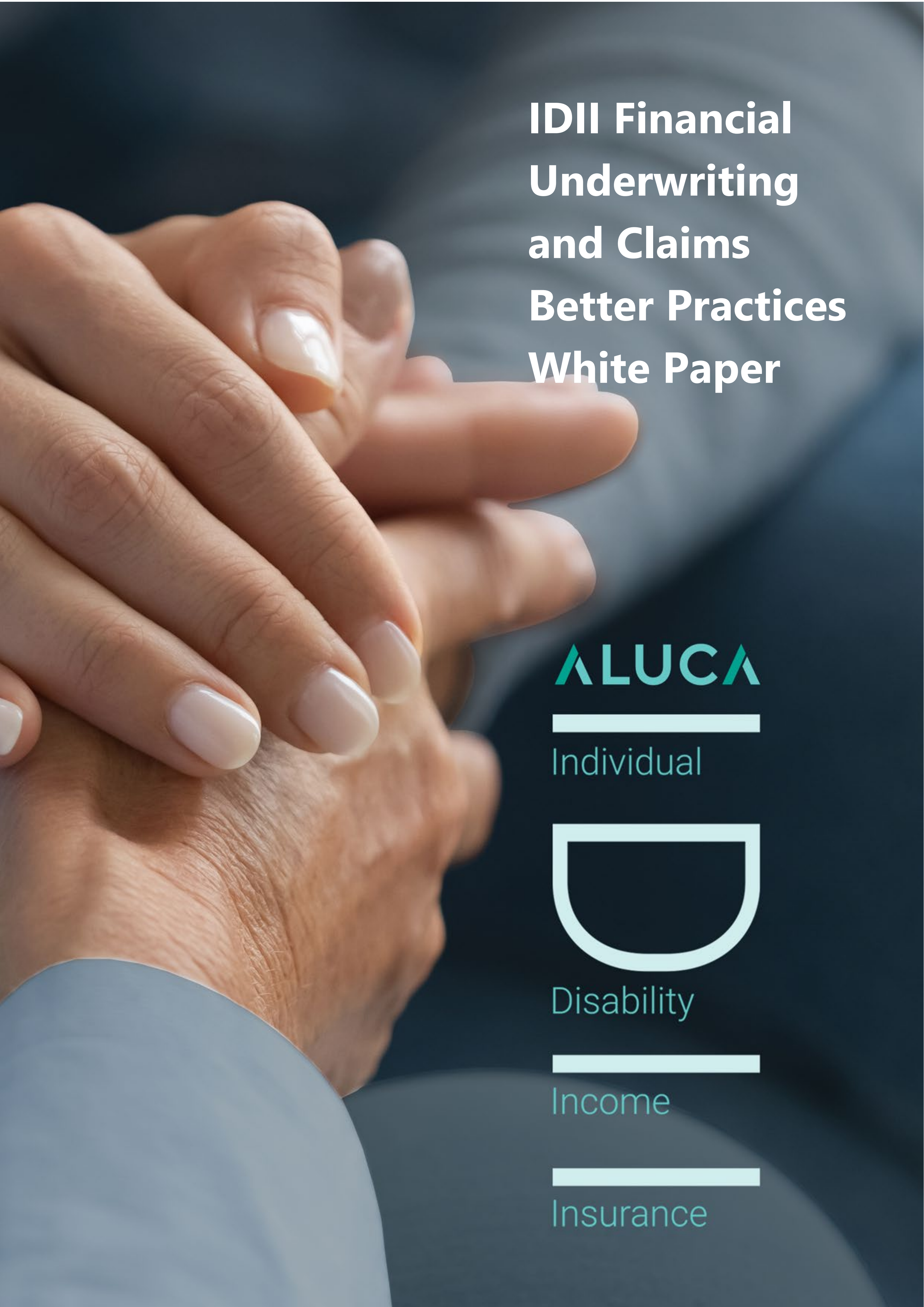

IDII Financial Underwriting and Claims Better Practices White Paper

ALUCA

Individual Disability Income Insurance

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1. Disclaimer

This report is produced for the information of ALUCA members. The Australian Individual Disability Income Insurance (IDII) Financial Underwriting and Claims Better Practice Guidelines White Paper relates to the Australasian Life Underwriting Claims Association (ALUCA) Ltd.'s view in respect of a potential framework. It is the user's prerogative whether to accept the views detailed in this document. Whilst ALUCA has made best efforts to ensure the accuracy of any content, it can accept no responsibility for any action of others arising from the content of this report. Readers should therefore ensure they take the appropriate legal, taxation, actuarial, financial and any other advice where necessary before making any decisions in this respect. ALUCA accepts no responsibility for any errors or omissions in this report, or for any consequence of any suggested actions or conclusions detailed in the report, or actions or conclusions inferred by anyone reading the report.

Please note that the report's recommendations require consideration in consultation with an insurer's individual objectives. The aim of this paper is not to prescribe standardised underwriting and claims philosophies, rather to provide a reference paper for potential solutions which help insurers assess the gaps and level of risk in their underwriting and claims philosophies. This paper aims to share ideas and good practice but does not suggest anything that might conflict with anti-competition legislation or regulation.

2. Executive Summary

The IDII Financial Underwriting and Claims Better Practice Guidelines have been developed collaboratively by an ALUCA IDII Working Group, comprised of cross-industry Forensic Accountants, Underwriters and Claims professionals. The group was formed to address the ongoing sustainability of Individual Disability Income Insurance (IDII), and more specifically, the sustainability issues in the financial underwriting and claims area based on recommendations from APRA's thematic review and the Actuaries Institute Disability Insurance Taskforce.

To address the problem, the ALUCA IDII Working Group reviewed the financial underwriting and claims practices across their respective 8 life insurers and reinsurers. In addition, 30 informal meetings were conducted with stakeholders in the development of this paper.

Overall, the ALUCA IDII Working Group is supportive of the Actuaries Institute Disability Insurance Taskforce and has considered their recommendations in developing the underwriting and claims guidelines in this paper. Within these guidelines, a solution to the problem is provided via better practices industry recommendations for prudent financial underwriting and claims assessment of IDII products. These recommendations aim to assist the life insurance industry with long-term market sustainability while meeting the financial needs of customers. In addition, this paper outlines some practical applications, actions and recommendations for insurers, including a range of tools and risk matrix options.

The ALUCA Working Group identified 5 key areas they believed would have the biggest impact on the issue of IDII sustainability from a financial underwriting and claims perspective developing key better practice approaches and suggested recommendations for each. These included:

1. **Income definitions and treatment** (*Section 7*).
   Better practices include:

   - Clearly define Insurable Income, Ongoing Business Income and Passive Investment Income
   - Remove reference to "personal exertion" from calculation methodologies and from the policy conditions
   - Use the customer's share of adjusted net profit as a basis for calculating a monthly benefit and also pre and post-disability income
   - Include an ongoing business income offset clause in the policy conditions
   - Clearly articulate the basis on which the monthly benefit will be calculated to the customer at every possible opportunity throughout the application process
   - Create a clear philosophy on passive investment income and ensure the underwriting process adheres to this.

2. **Financial profiling, questioning and financial evidence collection** *(Section 8)*.
   Better practices include:

   - Profiling of insurable income, ongoing business income, passive investment income, income fluctuations, working hours, occupation and duties, gaps in employment, basis of employment and macro-economic factors
   - Obtaining appropriate information via the application process in all areas
   - Validating evidence provides more accurate assessments, particularly for more complex business structures
   - Underwriting and claims philosophies should be the same and align to the policy conditions
   - Standardised calculators to assist in achieving consistency in calculations.

3. **Significant income calculation adjustments** (*Section 9*).
   Better practices include:

   - Depreciation: it's a legitimate expense, it shouldn't be added back in calculating insurable income
   - Income splitting should only be considered as an addback to the extent that the function doesn't have to be replaced

- SGC Superannuation should be paid to superfunds where possible
- Self-employed superannuation payments could be included as an addback when calculating insurable income. However, where there is a super rider benefit or option on a policy for self-employed these payments should not be included in calculating insurable income
- Policy conditions and underwriting and claims philosophies should be designed to address government subsidies provided.

4. What to consider financially should the industry consider a **policy term expiry** (*Section 10*).
   Better practices include:
   - Regular collection of information provides tighter control, assuming insurers can act on this information
   - Gathering information and reviewing the customer's financial and occupation position at least every 5 years.

5. Underwriting and claims solutions where there is a crossover between **IDII and personal TPD** (*Section 11*).
   Better practices include:
   - Methodologies for assessing a customer's personal disability insurance needs should consider both long term IDII and personal TPD holistically
   - Consideration of a joint product offering combining IDII and personal TPD into one product.

A sustainability matrix for each of the paper's key recommendations and better practice approaches to these 5 key areas can be found in the next section (section 3).

Finally, as well as any appropriate amendments to approaches and practices, it is important that:

- All professionals in life insurance underwriting, claims and rehabilitation roles are appropriately trained and qualified, with such qualifications being transparent to the wider community. ALUCA recognises appropriately trained and qualified members via its professional industry accreditation program – CPLI (Certified Professional Life Insurance)
- There should be a transparent industry standard Competency Framework underpinning relevant training solutions. This has been addressed via ALUCA's Life Insurance Competency Framework
- All practical work performed by life insurance underwriting and claims professionals should be measured against community standards and expectations, as well as legal and regulatory requirements

3. Sustainability matrix summaries

The following tables provide an indication of risk associated with the approach taken.

3.1 Income definitions and treatment (see section 7 for further details)

Use of the term "personal exertion income" in policy wording

Variation	Description	Risk Rating
Avoid use of the term "personal exertion income" in policy wording and customer contracts.	No reference to "personal exertion income" and instead state clearly what exactly has been classified as 'insurable income'.	**Low risk**- better practice proposed.
Continue practice of using the term "personal exertion income" in policy wording.	Life insurer continues using the term "personal exertion income" in policy wording and customer contracts, a term which is very difficult to define.	**High risk –** ambiguous and open to interpretation. At claim stage, if an insured person becomes totally disabled, it could be argued that none of their income on claim is related to "personal exertion" as they are not working or exerting their earning capacity.

Ongoing Business Income

Variation	Description	Risk Rating
An offset for Ongoing Business Income is contained in the policy AND The insurer has an information brochure to make it abundantly clear to the customer that their benefit at claim stage could be significantly reduced by any direct or indirect ongoing amounts they earn, receive or are entitled to receive from the business.	Preferably the replacement ratio method of offset is used so that the 60% or 70% replacement ratios are maintained. I.e. only adjust the benefit amount payable such that the benefit amount and the amount of Ongoing Business Income combined do not exceed 60% or 70% of pre-disability income.	**Low risk**- better practice proposed.
An offset for Ongoing Business Income is contained in the policy BUT no customer information is provided to the customer to		**Medium risk**- Maintains appropriate replacement ratios but could result in a bad customer experience.

explain how this may impact any future claim.		
An offset for Ongoing Business Income is NOT contained in the policy and instead an Ongoing Business Income clause is to be determined and applied at the time of underwriting.	Life insurer continues using the offset clause only for circumstances such as the business having 'X' number of income-producing employees or underwriter discretion.	**High risk –** the business structure could have significantly changed between the time of underwriting and claim. Application of clause is up to discretion of underwriter. If the clause was not applied, the risk of the 70% replacement ratio being exceeded is high.

Passive Investment Income

Variation	Description	Risk Rating
Passive investment income disclosures (both for net asset position and amount of passive investment income) are gathered for all customers for all levels of cover. A percentage of passive investment income above a $ amount (suggest $100,000) or % (suggest 30%) of the 'insurable income' amount is offset at the time of underwriting.	E.g. only *(insurers should consider appropriate % points in accordance with their book)* Once passive investment income exceeds say 30% of 'insurable income' then 30% of this is offset from the benefit amount insured.	**Low risk**- better practice proposed. This method recognises a potential impact to the protectiveness of the usual replacement ratios and reduces them down at outset, offering a further financial incentive to "return to work" in the event of a claim.
Passive investment income disclosures are gathered at stepped thresholds depending on the customer's age and a percentage of passive investment income is offset.	E.g. *(insurers should consider appropriate $ & age bands in accordance with their book)* net investment asset levels of: Up to age 35 - $1,000,000 36 to 45 - $2,500,000 46 to 55 - $3,000,000 56+ - $3,500,000 Assume returns of 3% to 5%.	**Low risk**- considers decreasing need for IDII protection as wealth is created over time however doesn't consider relativity to 'insurable income'.
Scaling back of IDII benefits is only considered at high benefit levels or at	E.g. *(insurers should consider appropriate $ & age bands in accordance with their book)* > $20K IDII per month	**Medium risk –** this doesn't consider relativity of passive investment income to 'insurable income'. Customers already have a

high net asset or passive income thresholds.	> $5 million net investment assets > $250,000 passive investment income per annum.	source of stable income they can rely on in the event of disability, and support required from an insurer to replace 'insurable income' is lower. This runs the risk of diminishing the protective nature of the replacement ratios.

3.2 Financial profiling (see section 8 for further details and also the financial profiling check-list)

Verification of income and review of trends

Variation	Description	Risk Rating
Thorough financial profiling, so a strong understanding of the client's needs are ascertained.	Financial profiling of the following is recommended: • Self-employed or employed • Personal exertion income, ongoing business income and passive investment income • Income fluctuations • Working hours and working from home • Occupation and duties • Gaps and frequent changes in employment history • Newly self-employed • Economic factors	**Low risk**- better practice proposed. Financial profiling forms the basis of the assessment of whether there is potential over or under-insurance. Methodologies used to calculate 'insurable income' should mirror one another at both stages of the process. Consistency could be achieved by using standardised calculators, assisting underwriters and claims assessors in determining income amounts.
The financial limits for self-employed customers are set at lower amounts than those for employed customers	Insurers should consider setting lower limits for when financial evidence is required for self-employed individuals than the limits set for employed customers. Insurers should collect data around incorrect income disclosures (comparing application disclosures with income at the time of claim) to be able to identify occupations, etc which are at higher risk.	**Low risk**- the risk of a customer believing their income levels are different from those calculated per policy terms and potentially paying premiums on amounts which may not be paid at time of claim is higher for self-employed customers. Also, volatile income is common for self-employed customers.
Financial limits under the current Indemnity products are set a high	With indemnity-only contracts, the ALUCA Working Group found it is	**High risk –** the impact of inaccurate income disclosures at time of

levels because the risks of inaccurate income disclosures are mitigated given income will be verified at the time of claim. Review of only 1 year's income amount is being performed.	now more important than ever to review financial evidence and verify income amounts, especially for self-employed customers. For the Insurer, over-inflated income amounts might be supported based on just the last 1 or 2 years' income if income trends are not considered.	underwriting could lead to the customer potentially paying for benefits they are unlikely to be able to claim. For self-employed customers we recommend obtaining income disclosures for at least the last 2 years and where income is volatile for even longer periods.

3.3 Income calculation adjustments, or "add back" items (see section 9 for further details)

Depreciation and motor vehicle adjustments

VARIATION	DESCRIPTION	RISK RATING
Recognise depreciation and motor vehicle expenses as legitimate business expense in 'insurable income' calculations.	No adjustment is made to 'insurable income' calculations in respect of depreciation or motor vehicle costs	**Low risk**- better practice proposed.
Continue current practice of adjusting the depreciation cost and adding back a percentage of motor vehicles expenses in the 'insurable income' calculation.	Life insurer continues applying their current approach to adding back depreciation and a proportion of motor vehicle expenses, which would result in inconsistent 'insurable income' calculations between each life insurance company and potentially result in a dilution of the replacement ratio.	**High risk –** inconsistent approach across industry and income is inflated. Customer could be compensated for more than actual financial loss. Claims approach might differ from that applied at the time of underwriting.

Instant asset write off adjustment

VARIATION	DESCRIPTION	RISK RATING
Recognise an asset write-off cost as a legitimate business expense.	No adjustment is made to 'insurable income' calculations in respect of instant asset write-offs.	**Medium risk**- could lead to an understatement of 'insurable income'.
Recognise an asset write-off cost over the useful life of the asset.	Add back the value of asset written off and recognise the depreciation expense over the useful life of an asset – see calculation in section 13.4 Appendix 4.	**Medium risk –** though arguably this is a best practice approach, it has inherent implementation risk due to the complexity of this methodology.

Continue the current practice of adding back assets written off in 'insurable income' calculations.	Add back asset write-off expense to 'insurable income' calculations.	**High risk –**income is inflated resulting in higher replacement ratios being offered and the client being potentially better off financially on claim.

Remuneration to immediate family members

VARIATION	DESCRIPTION	RISK RATING
Implement guidelines and appropriate processes to identify family members working in the business.	Ensures a consistent approach is applied at both time of underwriting and claim and within the business areas.	**Low risk**- better practice proposed.
Continue current industry practice.	Inconsistent approach in adjusting remuneration paid to family members.	**High risk –**income is inflated or deflated, potentially resulting in customers being financially better off on a claim or possibly being under-insured in the event of a claim.

3.4 What to consider financially should there be a policy term expiry (see section 10 for further details)

Contract term review

VARIATION	DESCRIPTION	RISK RATING
Obtain information about occupation and all categories of current income (personal exertion income, ongoing business income and passive investment income) at least every 5 years.	Ask questions such as the following: 1. Whether someone is employed or self-employed 2. Current 'insurable income' (personal exertion income + ongoing business income) 3. Current occupation and hours worked 4. If self-employed, whether ongoing business income would be expected to continue, how much and for how long? 5. Current amount of passive investment income	**Medium risk** - However, this recommendation relies on legislative changes permitting action to be taken in relation to renewed disclosures. It is also important to explain clearly to the customer that should they decrease their policy, any future increases would be subject to further underwriting.
Obtain new disclosures of 'insurable income' and occupation changes only.	Ask questions such as 1 to 3 above.	**Medium risk** - potential misunderstanding of what is or isn't 'insurable income'. Customer may no longer have an IDII insurable need if there is considerable ongoing

		business income or passive investment income.
Continue to offer annual policy renewals up to age 65/70 based on previous/original disclosures, with an option to take up CPI increases on the amount insured.	Details provided in policy renewal letters about the risk of over or under-insurance.	**High risk** of charging premiums that may not be directly linked to the Benefit Amount payable at claim.

3.5 Crossover between IDII and other living benefits (see section 11 for further details)

VARIATION	DESCRIPTION	RISK RATING
Consideration of a joint product offering.	Combining IDII and personal TPD into one product. This would provide some certainty around income being replaced under the IDII cover until a more informed decision can be made about the permanency of the disability.	**Low risk** - better practice proposed.
Offsetting IDII cover held from personal TPD amounts.	Limit combinations of IDII and personal TPD cover to a maximum 110% of an insured's earned income, multiplied by the number of years left until retirement (suggest age 65) over both personal TPD/IDII benefits.	**Medium risk** – Looks at the combined IDII and TPD cover amount and addresses the overlap issue but doesn't address the reducing needs reflecting a shorter period to retirement. Implementation of the 110% rule at 5yr reviews will make this lower risk (5yr review is yet to be finalised at time of writing).
Return to more commonly accepted global multiples to derive (Own Occ / Suited E.T.E) TPD cover levels will reduce this risk.	Apply multiples of 10 to max 15 x 'insurable income' to determine (Own Occ / Suited E.T.E) TPD cover. Additional TPD cover (on top of the Own Occ / Suited E.T.E) TPD can be offered under a severe/catastrophic definition TPD basis.	**Medium risk** – lower multiples reduce risk of wind-fall scenarios and double-up with IDII.
Continue to offer IDII at 60% or 70% income replacement ratios and personal TPD at 100% of	Looking at the 2 products separately without consideration of the overlapping intent.	**High risk** of wind-fall scenarios.

income x current income multiples.		

4. Background

The IDII market has been challenging for life insurers over a sustained period. Deteriorating claims experience together with declining interest rates have resulted in poor product profitability. APRA reported that the Australian IDII industry lost approximately $3.4 billion over the 5-year period to Sept 2019, which includes $1 billion over the 9 months to Sept 2019[1]. Benefit inflation and more generous underwriting terms reflecting a competitive marketplace have been commonplace across insurers. A succession of price rises in response to poor economic outcomes has resulted in affordability issues for customers, and this has led to questions about the product's ongoing sustainability.

These issues resulted in APRA conducting a thematic review into IDII. On 30 September 2020, APRA published their *Final IDII Sustainability Measures* to improve IDII's sustainability and profitability.

APRA expected the measures to manage riskier product features to have been addressed by 1 October 2021. However, there are areas of risk management across both underwriting and claims that can be further improved, which lie directly outside the realm of the product wording. That said, the requirement to have prudent underwriting and claims practices aligned with an insurer's unique product terms and conditions is critical for overall sustainability going forward.

APRA's intervention in the IDII market presented a unique opportunity for the industry to address sustainability issues and better practice in the financial underwriting and claims areas.

In parallel, the Actuaries Institute Disability Insurance Taskforce (Taskforce), established prior to APRA's intervention, conducted an independent review of issues in the IDII market. Their objective has been to assess the many Retail IDII market factors with the aim of effecting significant change.

The Taskforce sought to provide guidance and frameworks to assist industry participants on how to address IDII sustainability challenges, considering APRA's objectives and intervention measures.

ALUCA believed it would be helpful to members if a Working Party was to examine the implications from APRA's thematic review and the Actuaries Institute Taskforce's work and produce a document for members to identify the areas of greatest impact towards IDII sustainability. They were tasked to look at this from a financial underwriting and

[1] Source: Actuaries Institute/KPMG, 'Disability Income – An International Comparison', Jan 2020. Actuaries Institute, 10 February 2020, https://www.actuaries.asn.au/Library/MediaRelease/2020/DisabilityInc.pdf

claims perspective to provide practical applications, actions and recommendations for insurers with a range of tools and risk assessment options.

APRA's thematic review and the Actuaries Institute IDII Taskforce covered a wide range of areas specific to the ongoing sustainability measures for IDII. Whilst any matter in respect of IDII is of interest to ALUCA and its members, this report is limited to addressing better practice financial underwriting and claims benchmarks.

5. Working Party Membership

ALUCA's Working group was led by national ALUCA Board member Jo Hetherington who advertised for working group volunteers via ALUCA's membership in January 2021. A strong response was received, and the group recruited comprised risk specialists with forensic accounting, financial claims, and underwriting backgrounds. Their brief was to address the sustainability of the IDII product in the retail market space and review the recent Actuaries Institute IDII papers released for public comment which contained recommendations for ALUCA to consider financial underwriting benchmarks. The Actuaries Institute identified financial underwriting and financial assessment as a core skill requiring development as these impact the sustainability of IDII hence ALUCA's working group comprised these core skills.

ALUCA wishes to thank all the volunteers irrespective of whether they made the final Working Party membership. The Working Group comprised the following ALUCA members:

NAME and ROLE	COMPANY
Jo Hetherington, Head of Financial Health	TAL Limited
Srikumar Ravikumar, Financial Health Manager	TAL Limited
Shane Burdack, Senior Underwriting Consultant	Swiss Re
Ted Voges, Forensic Accountant	SCOR
Eimear Smith, Senior Technical Underwriting Consultant	SCOR
Tony Baker, Forensic Accountant	Independent
Peter Jones, Forensic Accountant	Cogent Management (Independent)
Monique Luu, Forensic Accountant	ML Forensics (Independent)
Amanda Stow, Principal Underwriter	ZURICH
Rachel Smith, Senior Underwriting Consultant and Training Lead	RGA
Ryan Katzen, Claims Specialist	Swiss RE

It is important to note that the above individuals were acting in their roles as insurance professionals and members of ALUCA, rather than representing any views of their employers. As with all working groups, this report contains a consensus of views after much discussion and debate.

6. Document Overview

6.1 Purpose of This Document

ALUCA provides a platform to educate, develop and connect life insurance professionals and raise the professional standards of the industry.

As highlighted by the Actuaries Institute, rising complexities of the IDII product combined with declining affordability and accessibility for consumers has led to insurers losing vast sums on IDII business. Some insurers and reinsurers have effectively withdrawn from the IDII global market, which is at risk of failure. A significant problem the industry faces is the complexity that exists in the financial calculations that sit behind determining customer benefits and ensuring that the principle of indemnification for no more than the customer's actual financial losses are met. This is especially true in respect of self-employed customers.

The purpose of this document is to introduce an industry framework for prudent financial underwriting and claims assessment of Individual Disability Income Insurance (IDII) products to assist with their long-term market sustainability whilst at the same time meeting the financial needs of customers.

With the move to a more sustainable product design, the industry should carefully ensure complete transparency about what is and isn't covered, so there is no surprise to the customer as to the benefit amounts, they are covered for and are likely to receive on claim. At the heart of this it is ensuring the customer understands that the amount they are insured for is the maximum sum they can be indemnified for, and that under certain circumstances the benefit they actually receive on claim may be less.

The ALUCA IDII Working Group has developed this paper to:

- Explore a number of underwriting and claims philosophies, to investigate which will better support the insurability principles outlined in the Actuaries Institute's work towards future sustainability[2].
- Offer a risk matrix to assist companies with identifying and measuring the multitude of risks associated with different underwriting and claims practices to be considered in conjunction with an insurer's individual target market, product and risk appetite. This document establishes a better practice framework and maps the risk of deviations from it.
- Promote consistency across underwriting and claims practices, enhancing transparency and fairness to customers by discussing a range of approaches to managing sustainability from a financial profiling perspective.

6.2 What This Document Means for Insurers

There are often significant differences in the levels of cover amounts Insurers are offering as IDII, due to variations in philosophies and understanding of a customer's financial affairs.

The ALUCA IDII Working Group has therefore recommended better practice financial underwriting and claims guidelines to distinguish differences more clearly in calculating **'insurable income' at the time of application and at the time of claim** (commonly referred to as pre-disability income and post-disability income).

This document outlines the process ALUCA is recommending for IDII product sustainability, offering a range of better practice measures in terms of financial assessment and profiling, all of which requires consideration in consultation with an insurer's individual objectives and target market. The aim of this paper is not to prescribe standardised underwriting and claims philosophies, rather to provide a reference paper for potential solutions which help insurers assess the gaps and levels of risk in their underwriting and claims philosophies.

[2] Actuaries Institute Document A-2: IDII Final Recommendations s9.4 Develop Industry financial and occupational underwriting benchmarks, **ALUCA** should develop industry underwriting benchmark (as a risk management tool for life insurers) in relation to financial and occupational underwriting topics such as:

- Potential for overlap in different types of living benefit covers (e.g., IDII, critical illness and TPD).
- Underwriter focus on job duties (rather than job title); and
- Revalidation of policyholder financial and occupational details at least every five years.

Life Insurers should adopt the Sustainability Guide and assess their current practices against the industry underwriting standards.

6.3 Document Sections

As outlined earlier, ALUCA's Working Group identified five key areas that they believed would have the biggest impact on the issue of IDII sustainability.

The document is grouped into the following five key areas:

Section 7 Income definitions and treatment

Section 8 Financial profiling, questioning and financial evidence collection

Section 9 Significant income calculation adjustments, or "add-back" items

Section 10 What to consider financially, should there be a policy term expiry

Section 11 Underwriting and claims solutions where there is a crossover between IDII and other Personal Insurance living benefits

7. Income Definitions and Treatment

7.1 Background

The Actuaries Institute have identified 3 types of income as follows:

- Personal exertion income (referred to by the Actuaries Institute as "personal income")
- Ongoing business income (referred to by the Actuaries Institute as "unaffected business income")
- Passive investment income (referred to by the Actuaries Institute as "passive income")

It is typically the personal exertion income of a customer which could be affected in the event of illness or injury. The collective experience of the ALUCA Working Group is that it is rather simple to separate personal exertion income and passive investment income, however determining ongoing business income at the time of underwriting is virtually impossible. Notwithstanding this, we understand the impact ongoing business income could have on sustainability of life insurance, and we examine this further and set forward proposals and potential alternate solutions to this problem later in the paper.

Throughout this report, the combination of **personal exertion income and ongoing business income** (which are extremely difficult/impossible to calculate separately for self-employed customers) are **referred to as 'insurable income'.** 'Insurable income' at the time of underwriting is the combination of personal exertion income and ongoing business income which is determined to be regular and sustainable based on the review of a customer's historical earnings. 'Insurable income' at the time of claim (commonly referred to as pre and post-disability income) is the combination of personal exertion income and ongoing business income based on actual income amounts derived during the period of time relevant to the policy terms.

A suggested definition of 'insurable income' is provided in Appendix 13.1

7.2 Personal Exertion Income

'Insurable income' at its core relates to a customer's income from personal exertion. It is therefore necessary to explore what income from "personal exertion" means. Unfortunately, the concept of "personal exertion" is not clearly defined anywhere and is therefore open to interpretation.

"Personal exertion" as a concept in Australian Tort Law has been addressed by the personal injury field, with some of the ALUCA IDII Working Group members having practiced as loss estimation experts in this area in the past. Many of the principles from personal injury case law addresses quantifying damages around the full or partial loss of an individual's personal exertion income and are therefore also suitable for defining and calculating personal exertion income for insurance purposes, especially for self-employed individuals. These principles are represented in the guidelines and tools (e.g. calculators) used by the life insurance industry.

It is also important to point out that there is a difference in the assessment of 'insurable income' at application stage, and the calculation of benefit level at claims stage. 'Insurable income' at underwriting is based on the applicant's "*usual regular income*", whilst at claim time income is being determined based on *actual income for a set period* based on the policy definitions (for example, pre-disability income for 12 months prior to claim or monthly post-disability income). Apart from these differences, the principals of, and the approach to financial assessment of income should be the same at both underwriting and claims stages.

Usual regular income represents the income a customer is likely to continue earning into the future and is usually determined by reference to the income they have earned in the past, unless of course their circumstances have recently changed (for example, if they were promoted or started a business), in which case their likely future income should be estimated based on their changed circumstances.

At application stage, we are trying to establish what financial loss the customer is likely to suffer in the future in the event of an accident or illness, and have the policy respond to indemnify them against a proportion of that loss. The customer should not end up in a better financial position (or breach the intended income replacement ratios) whilst on claim and insurance benefits should not deliver any type of financial windfall to the customer. This principle of indemnification sits at the heart of the purpose of and need for insurance. The customer (and their adviser) should be made aware, and reminded, of it at every opportunity, particularly around indemnity disability income insurance products.

From an underwriting perspective, it is very important to note that the financial assessment of what a person's 'insurable income' is, is not merely a calculation that is based on numbers alone, but that it includes a significant number of other important considerations; refer to section 8.4 'Holistic Risk Profiling'.

Typically, ‘insurable income’ is easy to determine for an employee, however much more difficult when it comes to self-employed individuals. This is due to higher income volatility as well as the complex tax minimisation and asset protection strategies often implemented by accountants, lawyers, and/or financial advisers. This causes the earned income of a customer to be spread between themselves, their family members, and a multitude of legal entities like companies, partnerships, or trusts. It is only through gathering the correct information that we can unwind these strategies and re-assemble the complete puzzle of what their true income is. Often this involves using income calculators and making several adjustments (commonly referred to as “add backs”) to determine ‘insurable income’. Section 8 deals with these considerations.

Because of this inherent complexity, it is crucial for insurers to be aware that, when it comes to self-employed customer’s, many of these individuals and even their financial advisers are unaware of how to calculate ‘insurable income’ for insurance purposes, and often put forward one of the following measures as a proxy:

- *Their taxable income as indicated on their individual tax returns*. This may differ significantly from their ‘insurable income’, as it may include investment income or losses. If they are self-employed, they may have complex business structures in place which often spreads their total income between themselves, their family members and other entities like companies or trusts. This means that their personal taxable income also excludes these amounts, thereby ignoring profits or losses within these other entities.
- *The business profit alone of the business(es) they operate*. We cannot determine a self-employed person’s ‘insurable income’ by looking at the profits their business generates alone. Because of tax minimisation and asset protection strategies some of the business income and/or expenses may have been shifted elsewhere.
- *The salaries or other amounts a self-employed individual’s business pays them*. This often represents a discretionary amount depending on cashflows and tax minimisation strategies, and whilst it forms part of their income, it could even be paid whilst the business is making losses.
- *The dividends from a company or the drawings from a partnership*. These payments have no nexus with the business or customer’s current year income, and in the case of dividends even represent after-tax rather than pre-tax income. A business owner can pay themselves dividends or drawings from prior year profits or even from capital, hence it has no bearing on the current performance of the business or income they derive.

Insurers should be cautious when accepting and relying on income disclosures from self-employed or high net worth individuals, as there remains a real risk that their income disclosure will not be aligned with ‘insurable income’ for IDII policy purposes.

7.2.1 Recommendations

It is recommended that care be taken when referring to "personal exertion" in formulating policy definitions of income, as what represents personal exertion income for a self-employed individual can be easily misconstrued to mean only the income they themselves generate, rather than their share of the total income from the business, which may have many other owners or employees contributing to the business income.

Calculation of 'insurable income' for self-employed individuals is often a complex process, as it requires consideration of their share of the business profits and a raft of other adjustments which may be required (refer section 9 Income Calculation Adjustments). We propose insurers develop and document thorough, detailed underwriting and claims philosophies and guidelines, including assessment calculators and tools, which are to be used and adhered to when determining 'insurable income' in terms of the policy intentions and definitions. These should cover all potential adjustments, add backs or calculation issues and challenges, while promoting consistency between underwriting and claims to ensure fairness to the customer. It is important to make sure that underwriters and claims assessors are adequately trained on how to use the calculators and to make sure that they understand the underlying formulas so that they can explain calculations to customers.

At Appendix 13.1, we have drafted one proposed income definition, labelled 'Insurable Income', which includes the following characteristics for consideration in protecting replacement ratios while offering valuable cover to customers:

- Represents a single income definition covering both employed and self-employed individuals. This allows customers changing between being employed and being self-employed and vice versa post contract inception
- It considers the Actuaries Institute recommendation to not insure above normal/unusual amounts of bonus, commissions, and overtime
- Includes superannuation as 'insurable income', because it represents part of the insured's actual loss, promotes fairness and consistency between employed and self-employed customers and a level playing field between group and retail customers
- Includes the customer's share of net profit from their business, regardless of whether this profit is distributed to them or not. This is especially important at claims time where claimants in the past have argued that since they have not received the income, it should not be offset
- Sates that the calculation is 'after the deduction of expenses <u>necessarily incurred</u> or <u>normally required</u>…'. The terms necessarily incurred or normally required allow for the 'add back' adjustments to be made (see section 9) without specifically listing add back items. It is recommended not to specifically list add back items because those that might be deemed unnecessarily incurred in generating the income would not be a precise list.
- Alerts business owners with complex structures where revenues and expenses have been accounted for in multiple entities, that we will have to consider all these entities in calculating their 'insurable income'
- Allows the inclusion of multiple occupations
- Excludes passive investment income

By their very nature, indemnity IDII policies have the risk that benefits received at claim stage may be lower than the insured benefit, having the effect that the benefit level merely represents the maximum amount the insurer may have to indemnify the customer for, subject to the policy definitions. It should therefore be transparent, clearly articulated and explained to customers and advisers that:

- The principle of indemnification means that the customer should not be in a better financial position when on claim (or in receipt of an amount in excess of the intended replacement ratio(s), from all sources)
- The insurer is not responsible for setting the insured person's benefit level, nor for the risk that the insured person may be underinsured or paid benefits less than the insured benefit level at claim stage. These are principles inherent to indemnity disability products
- Income volatility post application can have a significant impact on the benefits payable at claim stage, and it is therefore important for the customer to regularly assess whether their benefit level is appropriate. Customers should also consider any risks involved in giving up existing cover levels if income is volatile or expected to increase again in the future as full underwriting may be required to restore previous cover levels

- There is a difference in the assessment of 'insurable income' at application stage, and the calculation of their benefit level at claims stage. 'Insurable income' at underwriting is based on the applicant's "usual regular income", whilst at claim time income is being determined based on actual income for a set period based on the policy definitions (i.e. pre-disability income for 12 months prior to claim or monthly post-disability income). Apart from these differences, the principles of, and the approach to financial assessment of income should be the same at both underwriting and claims time

To avoid dilution of the replacement ratio, all retail IDII benefit payments should seek, where possible to:

- Withhold PAYG and transfer the tax payable on benefits to the ATO where it is possible and practical to do so
- Withhold and pay the appropriate Superannuation Guarantee proportion of all benefits into the claimant's super fund

7.3 Ongoing Business Income

Ongoing business income only relates to self-employed customers. As indicated before, the collective experience of the ALUCA Working Group is that it is rather simple to separate personal exertion income and passive investment income. However, practically determining and separating out ongoing business income at application stage is difficult and almost always dependant on too many uncertain factors.

In their paper, the Actuaries Institute provides a calculation method[3] which takes an estimate of the amount of ongoing business income ("Unaffected Business Income") at the time of application and uses this to reduce the benefit offered. This solution addresses the protection of replacement ratios, however, by limiting the cover at application time, it may result in a customer being under-insured at claim time.

Refer to Section 13.2 Appendix 2 for comparison calculation examples of the different offset approaches that could be used. All adequately protect the intended replacement ratios, however some might result in conservative positions in circumstances where a customer is underinsured which may leave the insured exposed. Insurers and Advisers should ensure they clearly flag the role of offsets or other adjustments (which are applied at claims stage), so the customer is aware of the possibility of an offset up-front when they acquire the policy.

[3] Set out in the insurable benefits examples at paragraph 1.3.6 of the reference product and shown in appendix 13.2 below

The different offset approaches include:

- An Income Replacement Ratio (IRR) method of offset (i.e., only offset to the amount whereby 60%/70% of pre-disability income is exceeded)
- Offsetting all of the ongoing business income
- Actuaries Institute Taskforce Reference Product proposed method
- Offsetting a proportion of the ongoing business income (i.e., 75% consistent with the Partial Disability calculations)
- Ongoing business income offset included in policy terms (offset at time of claim) but also reduced from the benefit insured at the time of underwriting

A self-employed individual's 'insurable income' is calculated by reference to their share of the adjusted net profit of the business they operate. At time of underwriting, determining which proportion of this income may continue when on claim is extremely difficult. The business may change significantly between underwriting and claims stages or a customer taking out the policy as an employee and later becoming self-employed. Neither the underwriter, customer nor the adviser has a crystal ball that can predict what would happen to the customer's or their business' income at claim time. Unfortunately, it really depends on so many factors, including:

- Their family's ability to substitute or support them within their business
- Ability for others to step in and perform the role of the customer without significant loss of revenue
- Pre-determined succession plans which may be triggered by the insured person's absence. In some circumstances buy/sell agreements may force customers into selling their business if they cannot return to work at full capacity after a period of time (typically 12 months)
- Financial impacts (loss of value) of holding onto the business too long if the future health of the insured person is uncertain

All these factors contribute to it being difficult to determine ongoing business income upfront. Except for some very rare cases (e.g. where the revenue is largely driven by factors outside the claimant's influence and control, for example a retail store), business owners and their businesses are unique and driven by their personal goals, concerns and values. Some important commonalities between business owners are summarised in the below diagram, these bring to life and further inform how exposed business owners are.

Business owners are generally very exposed as their business can be their largest asset, with business debt often secured by personal guarantees. The business also generally represents their family's main source of income and their super or retirement nest egg. The decisions they make around their business at claim time are very difficult to predict. For example, at claim time it may make sense for a customer to hold onto the business in certain instances where a return to work may be possible, meaning they may receive a proportion of the ongoing business income (which could very easily be a loss too). However, in more severe cases where a return to work is less certain, it may make sense to sell or close the business to prevent future loss of value, in which case there will be no ongoing business income. Of course, these decisions and impacts become even more complex when there are multiple business partners involved.

We acknowledge that these issues need to be considered and underwriters need to be provided with clear guidance around how to minimise risk, however the arbitrary categorisation of income as ongoing business income by underwriters may lead to significant under or over-insurance.

We also acknowledge that, depending on the circumstances at claim time, there is a risk that a customer may not be entitled to any benefit, or may be only entitled to a reduced benefit, raising concerns around the customer paying for a benefit they may never receive. This risk is inherent due to the nature of an indemnity policy, and there are definite worst-case circumstances where the customer could lose all their income or their entire business and end up being entitled to full benefits. We commonly see individuals trying to protect against this worst possible outcome, as the future is so uncertain. The policy should respond to protect the integrity of the replacement ratio and all parties should be fully aware of the process in the event of a claim occurring. This is no different to insuring a vehicle basing the insured amount on the total potential loss in the case of theft or write-off but providing for a lesser payout where there is repairable damage.

Historically, most underwriters would place an "ongoing income offset clause" on the policy to prevent the client being financially better off on claim, where there was an indication of ongoing business income. Effectively this ongoing income offset clause embedded the loss indemnification principle into the contract and enabled claims assessors to reduce benefits down to the actual loss suffered in these situations. Challenges around underwriters being responsible for applying this clause in the past have been:

- The clause was not consistently applied in situations where it was required. It was wholly dependent on the opinion and skill of the underwriter to assess the case and determine if it was appropriate to apply the offset. Often pressure was also applied to offer cover without an offset clause
- It is quite easy to misrepresent what would likely occur at claims time, due to the associated uncertainties and quite easy to support changes in situations at claims time, so usual remedies are extremely difficult to rely upon
- Because of the way the clauses and the other definitions in the policy were interacting, claims had difficulties enforcing the offset
- This process offered no protection where the disability income benefits were put in place whilst the customer was still an employee, and only later became self-employed.

7.3.1 Recommendations

To be more consistent, upfront and transparent, we recommend future better practice around ongoing business income should include:

- Obtaining adequate disclosure and validation to ensure the business structure is clearly understood at outset, inclusive of obtaining an indication of sources and levels of ongoing income and the duration of it
- Ensure an ongoing business income offset clause is included into the standard policy wording. History tells us that this cannot be managed by underwriting alone, the product must respond in order to embed the principle of indemnity and protect the integrity of the replacement ratio
- A mechanism to offset any sale proceeds in respect of the business from future monthly benefit payments in a reasonable and fair manner. The ALUCA Working Group were unable to reach a consensus as to whether to recommend offsetting the proceeds from the sale of the business. The ALUCA Working Group recognised that on selling the business interest, the customer is realising a proportion of their future earnings for which they were insured. However, it was also recognised that business owners often do not have any form of official Superannuation vehicle in play, and their business or the premises the business operates from could be their proxy superannuation vehicle
- Make it abundantly clear to the customer that their benefit at claim stage could be significantly reduced by any direct or indirect ongoing amounts they earn, receive or are entitled to receive from the business
- Calculate the 'insurable income' amount to include their share of the business profits and not reduce the amount for the ongoing business income. There are 2 reasons for this recommendation:
    - if the ongoing business income element (or what is believed could be this amount) is subtracted from the insurable benefit and an ongoing business income offset is built into the policy wording then this amount could be offset twice, depending on the policy wording
    - there is no robust, transparent and reasonable way to quantify possible on-going business income at underwriting/application stage
    - it is likely that if an individual is not working in their business, they will eventually need to sell their business interest (or wind-up the business) at which point the financial loss suffered would include all of the individual's share of business profit
- Alternative underwriting levers which could be considered to mitigate this are:
    - underwriting should consider adjusting policy waiting periods to match needs. Where a business owner indicates that in the short-term there will be little impact to their income, underwriting could consider pushing out the waiting period to match the need. This could save a significant amount of claims time and resources, because a great deal of assessing activities in the early stages of a claim is likely to result in no or little benefit payable, because there was little expected impact to revenues in the short-term. On

the flip side, longer waiting periods can mean that claims assessors are less likely to be able to help with the health side of the claim. For this reason, the Actuaries Institute Reference Product moved away from longer-term waiting periods; or

  - a customer could consider substituting IDII with another complimentary product (e.g. keyperson replacement policy covering the market rate wage of a replacement for the customer's role) if this will result in a better match of the customer's needs.

To further promote transparency and understanding, insurers could consider providing all self-employed customers at time of underwriting with a brochure containing examples explaining these principles in detail, and possibly requesting them to sign a declaration that they understand the impact and agree to it.
Also, where customers inform the insurer that they have moved from being employed to self-employed, it may be good practice to follow this same process to ensure they are alerted.

7.4 Passive Investment Income

As indicated in paragraph 6.1 above, 'insurable income' (personal exertion income and ongoing business income combined as these 2 types of income cannot be easily split) should exclude passive investment income. Passive investment income relates to any income from investments which are not related to a customer's occupation, and which will be unaffected by their disability. The amounts typically include:

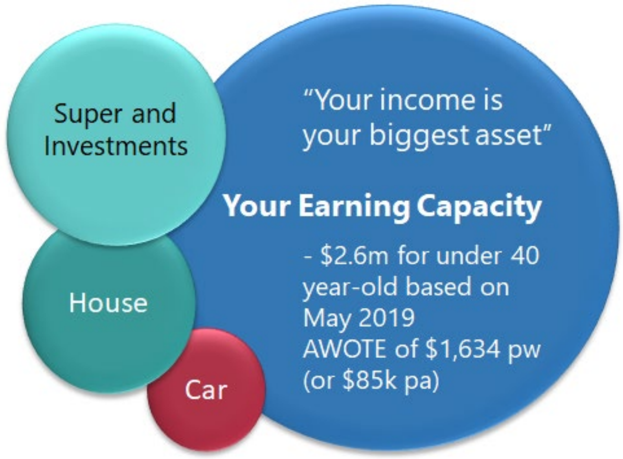
- Dividends from investments (please note that the net profit or loss from a business directly or indirectly owned and run by self-employed customers which are related to their occupation may be included in 'insurable income')
- Rental income
- Interest income
- Royalty income
- Annuity income
- Capital gains from investments

When considering passive investment income, it should be done on a "net" basis, that is, after deducting all expenses incurred in earning the passive investment income. However, consideration of expected future profits should be made at the time of underwriting where there are large debts, such as on significant investment property portfolios. Where there are large debts and significant interest expenses causing very low or negative returns then consideration of expected future net returns after debts are paid down should be made.

Currently it is common practice for insurers to ignore any investment income considerations for IDII benefits below $20k IDII per month. From an underwriting perspective, insurers currently only consider net investment income if the net investment assets (net of investment debts) are greater than $5 million, or net investment income is greater than $250k per annum. These parameters are very high.

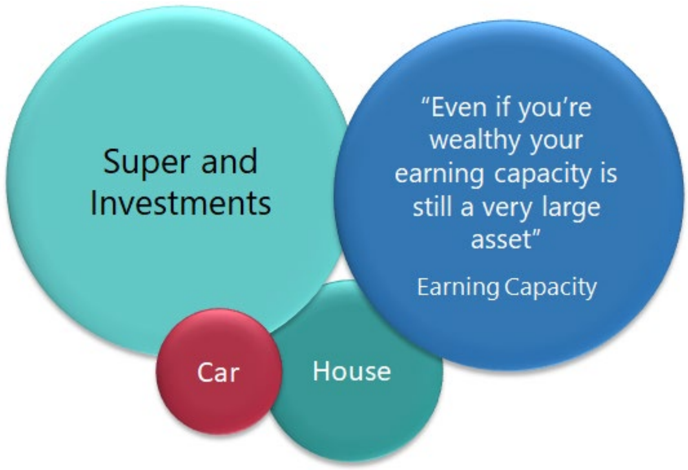
The Actuaries Institute's sustainability guide's proposal is to gather passive investment income details for all customers, and for this to form part of the benefit calculation for 'insurable income'. This means any level of passive investment income may lead to reduced replacement ratios at outset and at claims time.

For most individuals who are building their wealth, their net investment income is so small it is incidental to their 'insurable income', and their earning capacity dwarfs any investment or other assets (see picture below).



Even wealthier and older customers generally continue to leverage their 'insurable income' and any spare equity to access more debt, to support their future investment strategies. We only have to consider Australia's obsession with investment property to understand that most wealth creation strategies are based on borrowing against your income and any spare equity to buy more property. This cycle generally continues as long as there is 'insurable income' to leverage, which means it only ceases after retirement. Generally, a customer's 'insurable income' therefore underpins and funds any investment strategy and there is little, if any, net investment income to consider. In fact, customers' investment strategies and portfolios may be so reliant on their 'insurable income' that any significant loss thereof may result in the liquidation of part, or all of their investment portfolio. Arguably this increases the importance of disability income cover for these customers.

There will be some instances where a customer does have significant investments (net assets) and does earn (or has the potential to earn) significant net investment income when compared to their 'insurable income' (see diagram below). In these circumstances, it may be prudent to potentially limit the benefits offered, especially when the passive investment income is above a certain threshold or represents a significant proportion of 'insurable income'. These customers already have a source of stable income they can rely on in the event of disability, and hence the support required from an insurer to replace 'insurable income' is lower. That said, there is also a counterargument that their loss of 'insurable income' still represents a loss that should be insurable. It's appropriate to support affordable and sustainable cover for the whole pool of insured customers, both those who claim and those who don't claim and to also support a need to return to work where the customer's health allows that. Returning to work has been shown to support good well-being (including mental well-being), however, a customer's motivation to return to work could be compromised by significant levels of ongoing investment income. Unfortunately, there is no data confirming this and the assumption is purely anecdotal.



7.4.1 Recommendation

It is prudent for insurers to request information from all applicants, regardless of the proposed benefit level, around their financial position, net investment assets and passive investment income. If systems permit this information could be captured in application forms and Underwriting Rules Engines for all customers. Consideration towards reducing benefits may be given where:

- The proportion of passive investment income compared to 'insurable income' is greater than a certain percentage (suggest 30%), or
- Net investment income is above a certain $ value threshold (suggest $100,000), but a significantly lower threshold than the currently accepted $250,000 per annum
- A customer's net investment asset position is such that the potential to easily generate investment income in the future (particularly in the event of IDII claim) is very likely

The Actuaries Institute's example considers all passive investment income. Another option would be to consider passive investment income when it's relative to the 'insurable income' and therefore more likely to reflect a potential risk to the replacement ratios used by insurers, and potentially reduce monthly benefits at outset to mitigate this risk. E.g.

Benefit = (replacement ratio scales x 'insurable income') – (passive investment income x X%).

Example:

'Insurable income' (personal exertion income + ongoing business income) - $200,000

Passive investment income - $100,000

X = 30%

Replacement ratio = 70%

Benefit = (70% x $200,000) - ($100,000 x 30%)

Benefit = $140,000 - $30,000

Benefit = $110,000 (or $9,166.67 per month)

We recognise that whatever approach is taken, collecting appropriate information around a customer's passive investment income and assets is important. When identified as a potential issue, we recommend increasing the underwriting due diligence to ensure an accurate and clear picture of an applicant's overall financial position and income streams is obtained before any adjustments to benefits offered is made. Furthermore, we advise caution around assuming unrealistic rates of investment returns on the customer's net investment assets. Traditionally 5% was assumed however in the current economic environment and in the short to medium term investment returns are likely to be much lower, depending on the class and type of asset.

8. Financial Profiling

8.1 Background

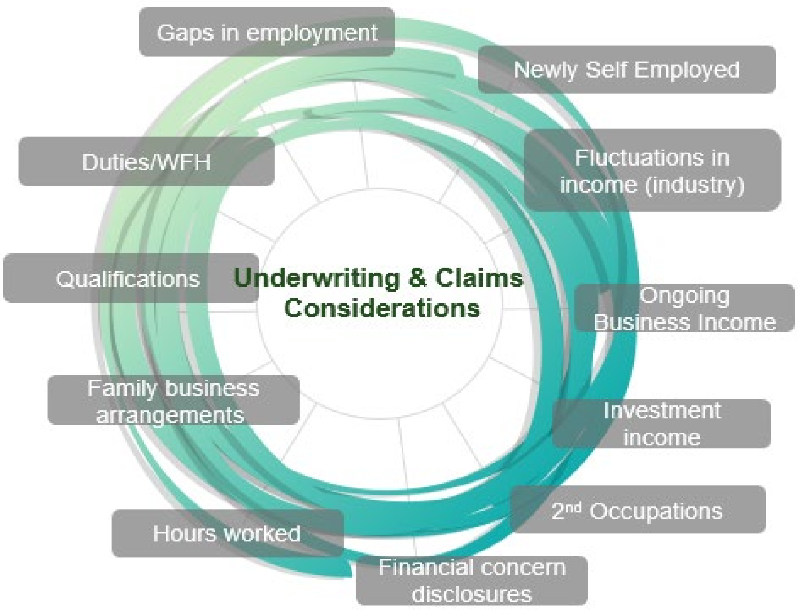
Thorough financial profiling frameworks are required to ensure appropriate underwriting and claims decisions are being made by insurers. This includes obtaining appropriate and sufficient information to profile a risk, as well as having clear guidelines on how to interpret the information collected. Thorough financial profiling frameworks are required to ensure appropriate underwriting and claims decisions are being made by insurers. This includes obtaining appropriate and sufficient information to profile a risk, as well as having clear guidelines on how to interpret the information collected. However, this does need to be balanced with operational costs at the time of underwriting, coupled with the overall customer experience. Risk profiling does not necessarily mean an increased question set for all customers. Intelligent rules engines offer the opportunity to identify those that potentially reflect increased risk in the top line questioning and only drill down further when deemed necessary. Validating evidence can offer further mitigation to ensure the underwriter is assessing the risk appropriately and that the customer receives cover that addresses their needs. There may be an opportunity for the industry to revisit how mandatory financial evidence is determined moving forward. Models could adapt to focus on validating information at underwriting time for riskier financial profiles while at the same time boost straight through processing outcomes for more straight forward cases, perhaps using intelligence about incomes, occupations, hours worked, ages, etc.

8.2 Problem

Current financial profiling differs depending on the insurer's individual frameworks, leading to large differences in outcomes for life insureds. Differing outcomes also arise from the difference in the information obtained to profile the risk. As the intention of the product is similar across the industry, this suggests improvements can be made across in the industry with regards to how information is collected to profile a risk appropriately and how this information is then interpreted, in the context of the macro environment. Often risks are accepted with very limited information, raising the risk to insurers which may also lead to suboptimal outcomes for the customer in the event of a claim.

It is generally accepted that financial profiling an employed individual is quite straight forward, however further complexities arise when assessing self-employed individuals.

The ALUCA Working Group has identified different areas requiring attention for claims and underwriting professionals when assessing a risk, as presented in the diagram below.



8.3 The Collection of Financial Evidence

For the insurer's approach to be equitable, similar questions should be posed at the underwriting and claims stages of the customer journey. The evidence to validate these disclosures should also be the same. Methodologies used to calculate 'insurable income' and pre- and post-disability income should mirror one another at both stages of the process.

Employed customers usually have a straightforward income history. With the introduction of indemnity contracts, insurers need to manage the upfront operational costs associated with underwriting the risk, as financial information will be obtained at claims time to validate payments, in accordance with policy terms. Notwithstanding this we believe that in certain circumstances upfront collection of evidence and holistic financial underwriting may assist in managing client expectations as well as reducing the risk of over insurance and dilution of replacement ratios.

Insurers need to be cautious when accepting and relying on income disclosures from self-employed or high net worth individuals, in case they are disclosing an income amount that is not aligned with how the insurer determines 'insurable income' under the policy conditions. Identifying high-risk factors at application stage may indicate complexity in a customer's affairs, where a detailed assessment of earnings may benefit both the insurer and customer. The following factors usually point towards such situations:

- Complex business structures
- Multiple entities
- Family trusts or other investment vehicles or entities
- High net worth individuals
- Multiple income streams from different sources, and difficulty understanding whether they are related to the customer's personal exertion
- Income in personal income tax return is very different from disclosed income
- Recent change of occupation or business
- Recent change in shareholding in a business
- Family businesses
- Succession planning advice

8.3.1 Requesting Mandatory Financial Evidence

Exactly when to mandate financial evidence for IDII cover to verify customer disclosure is currently and will remain a contentious area.

It is apparent that there will be some pressure on insurers via distribution channels to relax mandatory financial evidence triggers going forward based on the fact that IDII new business written in our market is now all indemnity natured cover (with the definition of indemnity tightened further from 1 October 2021). ALUCA's view is that any such pressure needs to be resisted. It should be stated that it is also ALUCA's view that some current mandatory financial evidence triggers for indemnity IDII cover in our market is arguably too lenient now.

The following Better Practice considerations are therefore recommended for setting mandatory financial evidence triggers for IDII covers:

- An insurer should be able to (or should strive to be able to) gauge the average Monthly Benefit (M.B) in their IDII portfolio by:
- Broad Occupational class
    - Professional white collar
    - Other white collar
    - Skilled tradesperson
    - High risk skilled manual workers
    - Special risk unskilled manual workers
- Then set M.B thresholds at which point verification of the disclosed income is reasonable in line with their business' own risk appetite
- It is also ALUCA's view that differentiating between an employee and a self-employed/business owner in setting these thresholds is a very worthy consideration to address the potential for innocent misrepresentation by self-employed/business owners as outlined earlier in this section

8.3.2 Recommendation

These recommendations require consideration in consultation with an insurer's individual objectives. The aim of this paper is not to prescribe standardised underwriting and claims philosophies, rather to provide a reference paper for potential solutions which help insurers assess the level of risk in their underwriting and claims philosophies.

Carefully designed question sets may be deemed sufficient to manage a large portion of applicants at underwriting time. In addition, applying methodical monthly benefit levels for mandatory financial evidence, particularly in respect of self-employed customers, offers more certainty and less risk around the figures insured.

Designing question sets with a behavioural economics lens is beneficial and stands to provide better quality disclosure.

Offering explanations to the customer regarding the terms used throughout the application process also leads to more reliable information and offers transparency to the customer, greatly assisting in managing their expectations.

(refer appendix 13.3 Risk Profiling Checklist)

8.4 Holistic Risk Profiling

More complexity is generally presented when dealing with self-employed individuals, particularly when large businesses are involved with multiple income generators, varied income streams, cyclical and varying performance, or structures with multiple entities.

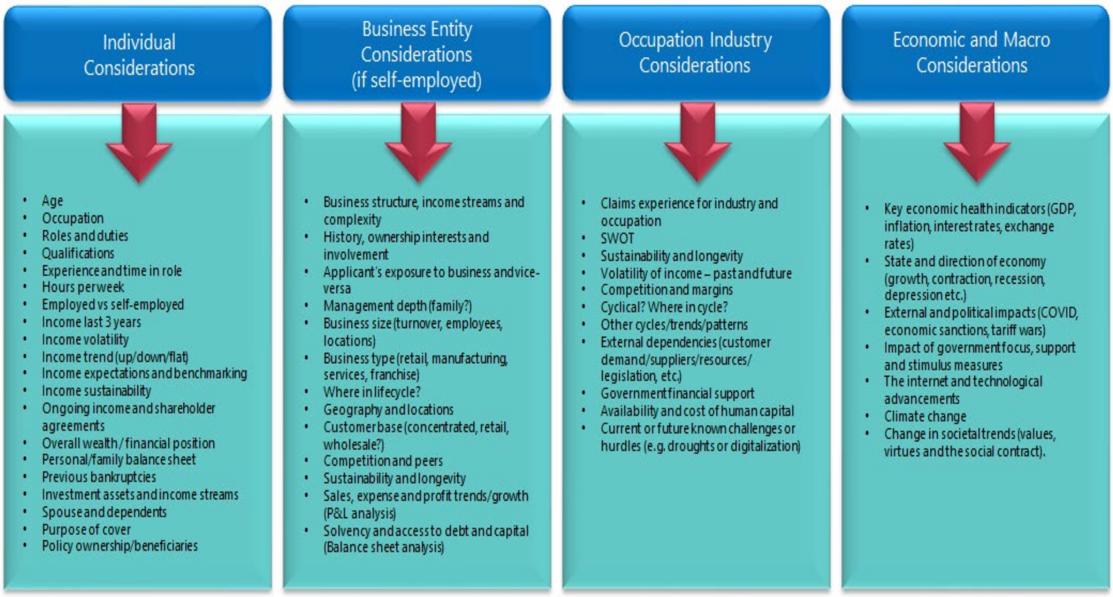
Calculating 'insurable income' is one aspect of financial underwriting, however there are multiple other contextual considerations when underwriting financially. Much of these will not be assessed at claims stage, so it is important that a solid understanding is achieved prior to policy inception. These contextual factors inform an underwriter as to the risk associated with an individual business in the context of the environment in which it operates. These include economic and macro considerations, occupational and industry considerations, the business entity itself and the individual considerations.

8.4.1 Recommendation

More comprehensive and detailed questioning is prudent when underwriting self-employed customers, elucidating information across a range of relevant areas. Independent validation of a customer's disclosures in instances like these, offers tighter control over ensuring the customer's insurance is reasonable considering their business structure.

Internet searches can prove invaluable to provide further insight into a business or an industry in which it operates.

A solid understanding of macro factors stands to provide better risk profiling:



8.5 Profiling Passive Investment Income

Few industry insights are available regarding the impact passive investment income has on claim duration. However, anecdotally there's some suggestion it may impede a return to work focus for a claimant. The life insurance industry ceased obtaining much data on this aspect of potential risk several years ago.

When passive investment income is comparative to 'insurable income', the protective value of replacement ratios may lessen. Insurers may find it advantageous to have internal methodologies in place to identify and manage such scenarios.

There are large operational complexities when we bring passive investment income into consideration. In asking customers to disclose their net investment asset position and their net investment income, care should be taken around the accuracy of the disclosures customers make. A few examples of common disclosure accuracy problems include:

- Assets are often overvalued based on hubris or unreal expectations (e.g., optimistic property values), or undervalued based on historical cost, which results in a skewed picture of the net investment assets of the customer
- The value of the business is often included in their investment assets. However, the business is not related to investment income and is more aligned to their personal exertion income which will be considered separately
- Investment assets purchased (and the relative debts serviced) by the major family income earner are often owned in other family member names (including non-working spouse) or associated family entities and hence are not disclosed.
- Holiday homes or other assets that could generate income but are said not to be are excluded
- Personal and investment debts are often combined and not easy to separate

Underwriters should also take care not to assume a “blanket” return on all assets. In the past a 5% net investment return was commonly assumed, however given the current and medium-term economic situation, actual returns may be significantly lower.

8.5.1 Recommendation

To provide insights into the role passive investment income may play in claim duration, it’s recommended that insurers recommence capturing this information at application time. This information should ideally be captured in a structured way, so it can be used to overlay claims experience in years to come and better inform the industry about the role passive investment income may play in claim duration.

Obtaining a client’s net investment asset position in addition to their net passive investment income at application and claim time is prudent.

A clear explanation regarding what passive investment income refers to is recommended, so the customer is clear on what is being asked of them. It should be made clear that information is sought from all indirectly held assets (e.g. assets held via investment or family trust entities), not just directly or personally held assets.

Underwriting and claims practices should ensure that financial evidence from all entities, including investment entities, is being obtained in conjunction with assessments. Care needs to be taken to make sure the right framework and methodology is in place to assign or allocate relevant share of these investment entities or assets. This needs to be clear, simple and practical to implement for both underwriting and claims.

Some product conditions may also include a methodology for considering such income in calculating an insurable payment at claims time. If this is the case, then the underwriting philosophy should reflect the policy conditions to ensure fairness and transparency to the customer. If this is a product feature, then this should be clearly communicated to the customer to ensure there are no surprises in the event of a claim.

8.6 Profiling Fluctuating Income

Historically, insurers have obtained 2 years' financial disclosures, however this doesn't inform the insurer about true fluctuations in income. To understand the impact of fluctuating income, an underwriter and claims assessor needs to understand the environment in which the business operates and have evidence to identify if true fluctuation occurs as opposed to a downward trend in performance. They will also need to see at least 3 years' income figures to understand the cyclical performance, and in certain circumstances a longer period may be required.

8.6.1 Recommendations

Obtaining three years of financial disclosures, or two years plus the current year-to-date details, can be insightful and beneficial in profiling risk.

There are known industries prone to large fluctuations (such as farming, construction and technology). Such volatile, cyclical or seasonal industries may need more scrutiny. Obtaining independent validation of trends and figures via financial evidence would be beneficial in such scenarios.

It is recommended that policy terms allow calculations to be performed using an average of monthly 'insurable income' generated over a period/financial year rather than looking at performing the calculations on a discrete monthly basis and only offsetting 'insurable income' generated in a particular month. This will allow for the smoothing out of 'insurable income' generated in business where income is seasonal with some periods with little revenue and other periods where the majority of income is generated.

8.7 Profiling Working Hours & Working from Home

Identifying the typical numbers of hours worked by the individual is important, coupled with identifying if there is flexibility in working arrangements should a disability occur.

We continually see disparities in disclosure at claims time regarding working hours, in comparison to underwriting. Excessive work hours can be difficult to maintain long term and can present a risk for "burn out". Insurers should determine at what point the risk is deemed too excessive to insure.

8.7.1 Recommendations

Questions should identify usual hours worked, including additional on-call work, which is usual in the context of the business, whether business performance relies upon these hours being worked weekly and if additional hours are worked from home.

If product features limit the insurable benefit to "X" hours per week, then underwriting philosophies must complement this to ensure the customer is not potentially over-charged.

8.8 Profiling Occupational and Duty Change

Historical product definitions consider the main income-producing duty or duties associated with a customer at the time of claim. However, the premium is charged and the risk measured at the time of underwriting. We continuously see large differences in what's presented at claims time in comparison to the time of underwriting. We operate in an ever-changing world with an increasing trend of individuals changing occupations, jobs, the rise of the gig economy, the speed of digitalisation and those working in multiple jobs concurrently and we expect this to continue. The long-standing nature of our insurance contracts poses challenges on managing these evolving risks. An opportunity to regularly review this has been recommended by APRA, however we face some legislative and operational barriers to this currently. Nonetheless, obtaining detailed information on the duties of a customer at outset and at claims stage stands to add value.

8.8.1 Recommendations

To assist with underwriting a risk appropriately and managing a claim effectively, the following information may be valuable:

- The role(s) and the usual duties
- The duration in the role(s) and similar role(s)
- The qualifications held
- The intention and likelihood of changing occupation(s) and role(s)
- The industry in which they operate
- The ability to conduct the role(s) remotely

Understanding if a client has multiple roles and the duties associated with these roles is beneficial, particularly with 'Experience, Training and Education' definition inclusions.

8.9 Profiling Gaps or Frequent/Foreseeable Changes in Employment

Obtaining historical information on a customer's occupation history can provide valuable insights for the underwriter and claims assessor. A history of multiple short-term roles or large gaps in employment can indicate an unstable work history, which is concerning when considering occupational based products. It may indicate a casual or contracting basis of employment, which may also present some increased risk to the insurer. As our contracts are long duration contracts and we're challenged with basing the long-term risk on historical performance, it's reasonable to investigate any individuals with a potential unstable work history more closely, to ensure a good understanding of the risk is achieved. This also offers claims professionals an opportunity to consider possibilities for 'return to work' strategies.

8.9.1 Recommendations

A possible solution that may be considered is to obtain information on a customer's occupational history. This could include details on any gaps in employment and the reason for these, if there's been any prior claims, performance challenges at work, work environmental challenges posed by the job to the individual, any immediate or known intention to change jobs or roles, the basis of employment, as well as an understanding of the reason behind any frequent changes in occupation.

8.10 Profiling Ongoing Business Income

Any business income that continues in the event of a disablement is deemed ongoing business income. The challenge which presents itself is that this is not an exact science and is reliant on multiple factors and it is not until claim time that this becomes truly apparent. At underwriting this aspect of the risk is speculative, as it is not possible for a life insured to provide an accurate indication of this figure. It is also not possible for industry experts to calculate an accurate figure. Furthermore, the amount is likely to taper-off/vary over the period of a claim and is not a static amount. This poses a problem for underwriting professionals, as there is no way of validating this figure at outset. Insurance is about protecting for the worst outcome. Considering this, we commonly see disclosures from applicants suggesting no income would continue in the event of a claim. While this may not be truly accurate, it is an understandable position adopted by an applicant. The insurer is tasked with making decisions at outset which reasonably reflect the position disclosed by the applicant, based on the overall profile of the business.

8.10.1 Recommendation

To protect the insurability principles and promote a 'return to work' focus, it is recommended that questions be posed to identify the possibility of ongoing business income, the level of it, for how long it will continue, the reason for it continuing, and methodologies to be put in place to mitigate this such as determining whether there even is an insurance need and including ongoing business income offsets in the product design.

Underwriters may find it beneficial to have information on:

- The size of the business
- The number of employees
- How many employees contribute to revenue creation

- If individuals in the business have similar skill sets to the person to be insured, the industry in which the business operates
- The location of the business;
- How it transacts business
- The business succession plan

An internet search may assist with gaining a deeper understanding of a business and its operations. It also stands to validate disclosures provided. This is particularly prudent and should be standard underwriting practice where the business is likely to have an internet profile. If it's a family business, often others are equipped with maintaining the operational side of the business without much deficit.

Including an explanation to the customer that this will be offset at the time of claim is recommended, to ensure all parties are aware of misrepresenting disclosures. A clear explanation of ongoing business income is also recommended, to ensure the customer is aware of what is considered ongoing income at the time of claim.

Extending the waiting period could be a solution which allows underwriters to better match how the policy will respond to the customer's disclosed likely loss of business income in the case of total disablement. Consideration of the appropriate waiting periods is therefore an essential part of risk profiling self-employed applicants with potential ongoing income. However, this does need to be balanced with the pros and cons longer waiting periods can pose for claims assessments as noted above.

8.11 Profiling When There Are Financial or Business Concerns

If a business owner has previous or current business concerns, then underwriting philosophies should inform the underwriter to assess cautiously. Knowing this at claims stage can also assist in managing the claim effectively. A prior history of bankruptcy, liquidation, receivership, administration or a recent downward trend in business profits or assets may indicate an increased risk for insurers. Previous or current/pending complaints, disputes, litigation, licencing issues and court cases also warrant further investigation and scrutiny, noting the potential impact on mental health, the long-term viability of the role or business, or the likelihood of achieving a return-to-work goal.

8.11.1 Recommendation

Information could be sought from the customer to inform the underwriter and claims assessor about any bankruptcy, liquidation, receiverships, administrations, decreasing performance, prior or current formal complaints, disputes, litigation, licencing issues or court cases.

It is recommended that clear underwriting guidelines be in place to assist with consistency on assessing such risks.

8.12 Profiling the Newly Self-Employed

These customers present a potential increased risk of financial failure and bankruptcy, due to the absence of an established performance in the business.

8.12.1 Recommendation

Questions answered by the customer should reveal how long the business has been operational, what an individual did prior to setting up this business and identify if there are any qualifications, experience or skills which offer future protection against business failure.

Postponement of an application for a period may be an appropriate way to manage perceived risk, until a time when the business and individual has an established financial operating performance.

Alternatively, a specific clause may be beneficial where there's more certainty around future performance, which protects against a customer claiming against historical income but considers income from the newly established business only, for early claims.

9. Income Calculation Adjustments/ "add backs"

9.1 Background

Calculation of 'insurable income' for self-employed people is based on the insured share of:

A – B + C

A (**Gross business income** *excluding passive investment income*)

– B (*all* **business expenses**)

+ C (**Adjustments/add backs -** which are any expenses not necessarily incurred in running the business, and any items which are income in nature such as wages and super. *See proposed Insurable Income definition in Appendix 13.1 which uses the words necessarily incurred or normally required in terms of what expenses are deducted and therefore allowing these expenses to be added back*)

While the adjustments to determine 'insurable income' depend on individual circumstances, some of the most common or significant adjustments include depreciation expenses and remuneration paid to spouse.

Over the years, life insurance companies have changed the methodology adopted for adjusting 'insurable income', resulting in varied income calculations between insurers having regard to the same underlying base information. This section of the document provides a rationale for the recommended better practice approach to the following add-backs:

- Depreciation (including asset write-offs)
- Remuneration paid to immediate family members (commonly referred to as income splitting)
- Superannuation
- Other items (such as motor vehicle expenses, donations & fines)
- Government subsidies, grants and support (we note that since COVID-19 these have proliferated and are now much more commonly present in the net profits of most self-employed individuals)

9.1.1 Recommendation

These recommendations require consideration in consultation with an insurer's individual objectives. The aim of this paper is not to prescribe standardised underwriting and claims philosophies, rather to provide a reference paper for potential solutions which help insurers assess the level of risk in their underwriting and claims philosophies.

If any extraordinary adjustments are applied to determine 'insurable income' at the time of policy inception (underwriting process), these should consistently be applied throughout the claims process in calculating pre-disability income and post-disability income of the insured. This will provide consistency in the add-back philosophy both at underwriting and claim stage and uniformity in benefit entitlement calculations where there is a dependency on income earned by the insured customer during those periods when a customer is on claim.

9.2 Depreciation and its Treatment in Income Calculations

What is depreciation?

In addition to normal operating expenses, businesses need to purchase fixed assets to produce goods or deliver services. Examples of fixed assets are buildings, furniture, office equipment and machinery. When an asset is used, its value decreases due to normal wear and tear, efflux of time and obsolescence. Depreciation is an accounting method of recognising the reduction of the recorded cost of an intangible or tangible asset used by the business in a systematic manner, until the value of the asset becomes zero or negligible. Although there is no cash out-flow relating to depreciation, it is a cost required to produce the goods or deliver the service.

Instant asset write-off

Since financial year 2015, several small businesses have been claiming a tax incentive whereby the entire cost of acquiring a fixed asset can be written-off as an expense in the year of acquisition, instead of applying the depreciation principle of recognising the reduction of the cost of an asset over its useful life. This tax incentive scheme has been availed by several businesses who meet eligibility criteria. Since COVID-19 it has been expanded significantly and nearly all business will be eligible to instantly expense their assets for tax purposes until at least the end of the 2022 financial year. This means it is likely that we will see a significant decrease in depreciation expenses and a significant increase in instant asset write-offs, resulting in much greater variation in net profits from one year to the next.

Treatment of depreciation/instant asset write-off in income calculations

To determine the 'insurable income' of the customer, it has been general practice by life insurance companies to add-back either the full amount or a portion of the depreciation expense or instant asset write-offs to net profits of the business. In doing so, the customer's income is inflated, as the cost of the fixed asset required by the business for production of goods and/or delivery of service is not recognised.

There seems to be a lack of consistency among insurers in the value of depreciation expense that is added-back, which results in different 'insurable income' amounts being calculated for the customer by two different insurers, even though they are adopting the same underlying financial information (see table below).

		Insurer A	Insurer B
Revenue	a	100,000	100,000
Less: expenses			
Operating expense		40,000	40,000
Depreciation expense		35,000	35,000
Total expenses	b	75,000	75,000
Net profit (before depreciation add-back)	c = a - b	25,000	25,000
Add: Depreciation (see notes)	d	5,000	20,000
Income	e = d + c	30,000	45,000

Note:
Insurer A limits depreciation expense add-back to 20% of net profit before depreciation add-back;
Insurer B limits depreciation expense add-back to 20% of turn-over (gross revenue)

9.2.1 Recommendation - Depreciation

As depreciation expense is a necessary cost for the reduction in value of fixed assets used by the business to produce goods and/or deliver services, it is recommended that life insurers do not add-back any depreciation expense to calculate 'insurable income'. An individual doesn't receive this income while working, so it seems incongruent with the indemnification principle that they should receive it in the event of a claim.

While many small businesses have availed a tax incentive to instantly write-off assets, thereby reducing taxable income, there are merits in adding back the value of asset instantly written off and recognising the depreciation expense over the useful life of an asset. While this would be an ideal methodology to calculate 'insurable income', it is recognised there are inherent operational challenges in implementing this recommendation by life insurers during ongoing management of a claim (Refer to Appendix 13.4).

Considering the operational challenges in implementing the ideal methodology of de-recognising assets written and instead substituting with depreciation expenses, it is recommended that life insurance companies consider instant write-off of depreciable assets as a business expense, and no adjustment is made in the income calculations. This would be a simpler method of calculating 'insurable income' and aligned to Australian tax laws.

Note: As businesses have been allowed to avail the instant asset write-off tax incentive effective since 2015 financial year, any claim where pre-disability income was calculated in the pre-2015 financial year did not include this. In such circumstances, the insurer should exercise caution to determine if the instant asset write-off is to be recognised as an expense and make appropriate adjustments if required in the calculation of post disability income.

9.3 Remuneration to Immediate Family Members

When calculating 'insurable income' for self-employed persons, it is important to enquire if any family members are working in or are in receipt of remuneration from the business. Small businesses often use a technique commonly referred to as 'income splitting', where income is split between the main income generator and a family member/s to minimise the family's overall tax burden. If an income splitting arrangement exists, then further adjustments to the 'insurable income' calculation will be required to ensure the remuneration paid to the family members is commensurate with their efforts.

Across the life insurance industry, currently income splitting arrangements are not always being recognised, and if they are recognised, different practices are being applied to adjust 'insurable income' calculations. The below scenarios are indicative of income splitting arrangements that require adjustment to 'insurable income' calculations:

- Family member is not working in the business, yet is in receipt of wages, superannuation or share of profits from the business, or has an ownership interest in the business only for tax minimisation and/or asset protection purposes. [This could restrict the amount business profits available to the business owners and lead to reduced 'insurable income' amounts].
- Family member is working in the business but is not being remunerated at a level commensurate with market value. [This could increase the business profits available to the business owners and lead to increase 'insurable income' amounts].

- In circumstances where the customer and their spouse/partner are 50/50 owners in a business where they both work full-time, each of their roles and duties will need to be considered to ensure the income attributed to the customer and their spouse/partner is representative of their personal exertion efforts. For example, in a plumbing business, one party may be the main income producer, while the other performs administrative duties. If we are to attribute 50% of the profits to each individual, (where they are indeed each 50% owners of the business and were entitled to a 50% share of the profits of the business), we may determine higher or lower 'insurable income' amounts for the individuals compared to their true earning capacity and personal exertion income levels. In this instance, spouse/partner 1 is the income generator of the business and spouse/partner 2 performs full-time administrative duties, therefore 100% of the profits of the business should be attributed to spouse/partner 1's "personal exertion" efforts and spouse/partner 2's earnings are to be based on the market rate wage amount required to replace them in the business.

9.3.1 Recommendation - Remuneration to Immediate Family Members

Underwriting and claims philosophies should aim to identify the following:

- Whether any family members of the customer are working in the business paid or unpaid
- The roles and responsibilities of each of the family members who are working in the business
- The level of personal exertion effort and remuneration paid (if any) for the work performed by the family member
- If a family member is working in the business, seek information to understand if the work performed by the family member can be performed by existing staff in the business. If the family member was unable to work in the business, would the business need to employ another person to perform the work performed by the family member.

Where family members are involved in the business, Life Insurance companies should formulate a view as to whether the role performed by each family member is primary or incidental to the operations of the business.

The most equitable solution identified is that income producing family members should be entitled to a share of profits from the business, while income for family members performing incidental activities or administration roles should be based on market comparable rates. Refer to Section 13.5, Appendix 5 for examples a number of income splitting arrangements and a better practice guide for calculation of income under each scenario.

9.4 Superannuation

When calculating 'insurable income' for employees or self-employed persons, superannuation contributions and salary sacrifice to super will need to be included. However, personal superannuation contributions claimed as a deduction in the individual's tax return is not to be included in 'insurable income' calculations, as these contributions are made from post-tax income to reduce tax liability and do not form part of a customer's income.

9.4.1 Recommendation - Superannuation

For employed customers, Super Guarantee Contributions, Reportable Employer Superannuation Contributions and Salary Sacrificed Super Contributions should be included in 'insurable income'. However, as per APRA[4], insurance benefits related to superannuation contributions should be paid into a superannuation fund and not to the claimant. The Group has agreed that this is best achieved by a Rider Benefit on an IDII policy that covers superannuation which is then paid directly into the complying super fund.

A self-employed person may choose to pay zero or any amount into super. Hence, any superannuation amount paid on behalf of the customer expensed through the business should be added back to the 'insurable income' figure so long as it has not been included in a separate superannuation ride benefit or option. Consideration could be given at claims time to pay an amount directly into their super fund based on an average of their contributions 2 years prior to claim.

9.5 Other Adjustments

While determining regular earnings, other adjustments are made by adding back items such as a portion of motor vehicle expenses, donations and/or fines recorded as an expense in the profit and loss account.

9.5.1 Recommendation – Other Adjustments

It is recommended that life insurance companies do not add-back a percentage of the value of motor vehicle expenses claimed as deduction for tax reporting purposes (but could consider an add back where it is clear that a second vehicle used by a non-working spouse/partner is being expenses through the business), but add-back donations and fines, which would align with tax treatment of these expenses.

It is also recommended that life insurance companies engage accounting professionals with relevant industry experience to formulate an approach for the treatment of extraordinary expenses to determine 'insurable income'.

[4] APRA IDII Product Measure 2: Income Replacement Ratio

2.4 where superannuation contributions are excluded from income at risk, any insurance benefits related to these contributions can be paid in addition to the above income replacement limits. In all instances, insurance benefits related to superannuation contributions should be paid into a superannuation fund and not to the claimant.

9.6 Government subsidies, grants and support

Government support of businesses is common, for example apprenticeship grants, R&D assistance or fuel or tax rebates. In most instances these grants are allowed to be included in the calculation of the business' insurable income if it relates to the generation of income and hence personal exertion of the insured.

Recently the Coronavirus pandemic has presented a significant challenge to global and local economies. The Australian Federal Government and State and Territory Governments have responded by providing temporary economic support packages to individuals, businesses and the broader community. At the time of writing this paper there are new government stimulus payments emerging all the time so we hope to capture the essence of these similar to the categories of support as discussed below. Some of the main income subsidy and stimulus scheme payments have been as follows:

Income replacement grants and wage subsidies (such as JobKeeper & JobSaver payment schemes)

Business income replacement and wage subsidy grants are for businesses which have had their income significantly affected (usually requiring a 30%+ reduction in revenue). The wage subsidy programs from the Federal Government to support businesses to cover the costs of their employees' wages so that employees can retain their job and continue to earn an income are usually assessable as ordinary income

of the business eligible to receive payments. Therefore, such subsidies should be treated as business income/'insurable income'. However, in circumstances where the business has received wage subsidies (such as JobKeeper) for either the insured themselves or their non-working spouse, such job-keeper subsidies should not be included in calculation of earnings on the basis that such subsidies have not been received to cover the costs incurred by the business, but are related to discretionary expenses incurred by the business.

One-off income boosts (such as Cash Flow Boost Payments and Disaster payments)

The cash flow boost payments from the Federal Government support businesses to manage cash flow and retain their employees. The cash flow boost payments will be automatically applied to reduce tax liabilities when eligible businesses lodge their monthly or quarterly Business Activity Statements (BAS). All cash flow boost payments are tax free. Therefore, cash flow boosts should not be treated as business income/'insurable income'.

Eligible Grants Programs

The eligible grants programs should be reviewed to determine specific grants provided by each state and territory.

In general, some State and Territory Governments provide support for businesses to continue operating such as rent, utility bills, replacement stock and deep cleaning of premises in order to reopen. These cash payments from the government are assessable income (other than where there are specific exceptions) and subsequently any costs incurred can be claimed as deductions. Therefore, cash payments should be treated as business income/'insurable income' and ongoing business income for offset purposes.

Income Support for Individuals

The Australian Federal Government has temporarily expanded income support payments such as JobSeeker payments, Sickness Allowance, etc. JobSeeker criteria will provide payment access for permanent employees who are stood down or lose their employment and also for sole traders, casual workers and contract workers who meet the income tests as a result of Covid-19. Any consideration as to whether to include these payments in 'insurable income' will need to be assessed in accordance with the relevant policy definitions.

10. What to Consider Financially Should there be a Policy Term Expiry

10.1 Background

At present, most IDII policies in the market are yearly renewable term contracts, with the underlying terms and conditions set for an extended period of time, typically until retirement age of the policyholder. Guaranteeing terms and conditions for such extended periods causes significant difficulty in designing sustainable products that will continue to meet the needs of policyholders without unexpected and material premium changes.

APRA communicated the finalised sustainability measures for IDII in September 2020, which included the introduction of a policy contract term measure[5]. The purpose of this is to keep products in step with changing circumstances, both in respect of changes in the circumstances of individual policyholders and broader societal and economic changes. Such a mechanism is expected to moderate the extent of premium increases that may otherwise be needed.

APRA's measure on Policy Contract Term is not intended to curtail the ability of life insurance companies to offer policy contracts for a limited contract term and without a renewal option, should this be sought or preferred by policyholders. If and when a

[5] **APRA IDII Product Measure 3: Policy Contract Term**
With effect from 1 October 2021, APRA expects that life companies only offer new IDII contracts where:
3.1 the policy contract is for a term not exceeding five years;
3.2 the policy contract may allow the policyholder the right to enter into new policy contracts upon the expiry of the existing contract for further periods (not exceeding five years), without a medical review, on the terms and conditions applicable to new contracts then on offer by the life company. Changes to the policyholder's occupation, financial circumstances and dangerous pastimes should be updated on renewal and reflected in the new policy terms and conditions; and
3.3 if and when the terms and conditions of IDII products are changed, such changes need to be endorsed by the board after consideration of advice from the appointed actuary. The advice should assess, among other factors, the impact of the IDII product changes on the sustainability of the product and fairness to existing policyholders with a renewal option (if applicable).

life insurance company offers a renewal option, there is no expectation from APRA that there be medical underwriting at renewal. However, other underwriting factors (e.g. occupation and financial circumstances) need to be considered at renewal, consistent with APRA's expectation outlined in the measure above.

To provide life insurance companies with more time to implement the policy contract term measure, APRA has decided to postpone the implementation of the measure until 1 October 2022.

10.2 Problem – "set and forget"

Currently, a customer is financially underwritten either with financial evidence or based on financial disclosures. A policy is issued based on 'insurable income' and occupation at the time of policy inception, but this information may not be looked at again for many years or until the time a claim may occur.

There could be a big shift in 'insurable income' and/or occupation between policy inception and claim. This means that incorrect premiums may be charged and a customer could be completely unaware of the amount they will actually be paid should there be a claim.

Example

At the time of policy inception, a customer is a salaried lawyer earning $200,000 per annum. They insure for 70% of this amount being for a monthly benefit of $11,667.

2 years following policy inception the customer ceases their employed role and starts up their own business as a café owner.

3 years following this there is an accident, and the customer needs to make a claim on their IDII. The customer might not realise that should something happen, they will not be paid the $11,667 per month they think they are insured for because under the Indemnity Policy only the last 1 or 2 years income is considered, and for self-employed this is after expenses.

10.2.1 Recommendations

These recommendations require consideration in consultation with an insurer's individual objectives. The aim of this paper is not to prescribe standardised underwriting and claims philosophies, rather to provide a reference paper for potential solutions which help insurers assess the level of risk in their underwriting and claims philosophies.

10.2.1a Obtain renewed disclosures at least every 5 years

At each 5 year policy renewal, here are 5 suggested questions that could be posed:

1. Are you employed or self-employed/a business owner?

   Use simple and clear wording about what each of these are such as:

Self-employed /a business owner means that you directly or indirectly own any part of the business you work for (excluding shares in listed companies).

2. What is your current income?

   Provide hints on how to calculate income for employees and self-employed.

3. What is your occupation and have your primary duties and responsibilities changed?

4. If you are self-employed/a business owner, would you expect any of your business income to continue should you be unable to work? If yes, how much and for how long?

   Provide information here to let the customer know that Ongoing Business Income/Unaffected Business Income will be offset from the benefit amount payable.

   Consider increasing waiting periods or consider whether IDII insurance is still required.

5. What is your current amount of investment income per annum?

   Prompt the customer to think about whether this income would be enough to live off and to think about whether they still have a need for IDII.

Annual updates for the 5 questions above should be available online and should be easy to make.

10.2.1b Permit updates to/revisions of the contract at least every 5 years where income or occupation changes occur.

The Benefit Amount insured should ideally be reviewed annually where there is an increase or decrease in income, however there are operational complexities and costs associated with this.

In instances where the client could support further insurance, full underwriting is required. For decreases in income, benefit amounts could be decreased without underwriting.

The Insurer could suggest that the customer contact their Adviser to obtain the appropriate financial advice. It is important to have some process to notify the adviser that based on annual renewal disclosure the life insured either:

a. supports their existing cover;
b. supports their existing cover and may also be able to increase it; or
c. no longer supports the existing cover in force and clearly articulate what this means in the event of a claim being submitted. Ie that that benefit payable if they claimed in the next year could be below the insured amount and that they may wish to consult with their client to see if a different level of cover would meet their long-term needs. They would also need to advise that if cover was reduced, any future increase in cover would need to be underwritten.

Premiums could be adjusted annually where a change in benefit amount or occupation is requested by the customer and if there is a price differential between employed and self-employed. This recommendation is subject to legislation permitting such changes to be made.

The above recommendations are in line with those set out in section 1.3.12 of the Actuaries Institute Document C-2 .

11. The Cross-over of IDII Benefits with Other Personal TPD / Living Benefit Insurance

11.1 Background

As maximum levels of both IDII and TPD cover have risen over time, the potential overlap of these insurance needs has been highlighted as an area that may be impacting on overall IDII claims experience.

Historically, the combination of TPD cover written concurrently with long term IDII cover was considered at the point of underwriting and at outset triggered either the TPD or IDII cover calculations being adjusted (downward) relative to the level of overall combined morbidity cover in place or being proposed. However, a competitive retail insurance market has seen this practice no longer form part of any current insurers overall risk considerations.

We have addressed the concerns of this potential cross-over in disability coverage in the following sections and offered some remedies, but we would also like to point out that:

- The majority of people don't significantly over-insure themselves. Insurance is expensive and individuals generally spend available income on other commitments. The perception of the trade-person with $5,000,000 TPD is likely not a common reality. There will always be exceptions, but these are exceptions, not the norm
- We have limited insight into the data and have to provide a clear and concise picture of what the dual claims experience across both IDII and TPD cover really looks like and over insurance impacting claims duration may only be anecdotal
- The majority of IDII claims are short-term claims, but the majority of the cost comes from a small number of long-term claims which are usually the ones with the larger TPD payouts.

We have not considered CI/Trauma products as having a potential impactful cross over due to the fact that these products have inherent risk mitigation elements, namely they:

- Require diagnosis of a specified condition rather than a requirement for an inability to work
- Remain prohibitively expensive
- Have lower sum insured caps.

11.2 Problem

There has been concerns raised that an individual's IDII claim duration (and hence return to work) could be negatively impacted from over-insurance caused by having overlapping IDII and personal TPD cover in place. This could be even more significant that realised when the TPD amount is not taxable.

To address this, we have considered:

1. Whether there is a potential for over-insurance - the so-called "windfall"
2. The option of a combined temporary and permanent disability product
3. Options/offsets available to remedy this potential "windfall" situation at underwriting stage.

11.3 Is There Potential for Over-insurance, or the so-called "windfall"?

To answer this question, we need to understand what claims look like in different scenarios.

Clearly these examples are simplified and represent the extreme ends of a spectrum, but they illustrate a valuable point.

Scenario 1 (excluding CPI and inflation for simplicity): *Claim age 45 – electrician – Income $100,000* *Knee injury, can no longer squat or kneel which are requirements of his own occupation* *IP (@ 70% replacement ratio) = $5,833.33 per month ($70,000 pa) – to age 65* *TPD own occupation = $2,000,000* *Lost income due to being unable to work = 20* years @ $100k = $2M Total benefit paid by insurer = $3,400,000	*Scenario 2 (excluding CPI and inflation for simplicity):* *Claim age 45 – Builder – Income $100,000* *MVA resulting in brain injury & irreversible paraplegia* *IP (@ 70% replacement ratio) = $5,833.33 per month ($70,000 pa)– to age 65* *TPD own occupation = $2,000,000* *Lost income due to being unable to work = 20 years @ $100k = $2M* Total benefit paid by insurer = $3,400,000

Scenario 1 and Scenario 2 are the same technically, but we wouldn't necessarily class them both as a "windfall". Scenario 2 results in the individual being unable to work and much more costly to the family, as the home is likely to need modification and they may well need professional care for a lengthy duration. Return to work is likely to be impossible or not expected. However, Scenario 1 suggests that the individual could return to work in a different role if motivated but their potential overall insurance portfolio payments may well provide the incentive not to do so.

Further to the above the TPD benefit amount insured is not automatically reduced over time. After a few years the TPD amount may become too high. Take the above examples but the claim occurs when the customer is instead age 55 but the TPD amount of $2m is still in force. This gap gets even bigger once we consider TPD indexation (typically 5%) vs inflation. The insured's lump sum need is likely to reduce over time as mortgages are paid down and children become independent. This is not something that can be fixed in the area of financial underwriting but is something that could be looked at in the product design.

11.3.1 Recommendation

It may be prudent to attempt to mitigate the risk of over-insurance for more subjective claims, where the individual may not truly be "Totally and Permanently" incapacitated and could return to work. Noting, return to work in scenario 1 is the best position for the client and for the rest of the insurance pool members.

We also note a potential concern with 'own occ' TPD with the transition to, perceptively, less generous IDII products from October 2021. Caution needs to be demonstrated and prudent risk profiling performed by risk technicians across both the underwriting and claims streams to protect where possible the risk of larger covers being written under the (own occ / suited E.T.E) TPD product offering to try and compensate for IDII product changes (particularly after the 2yr benefit period).

11.4 Product Option to Combine Temporary and Permanent Disability Insurance

One solution to the problem of overlapping IDII and personal TPD insurance which could be beneficial to both the customer and Insurer would be to combine these into one product. This would provide some certainty around income being replaced under the IDII cover until a more informed decision can be made about the permanency of the disability. For customers, this could provide relief while the permanence of the medical condition can be established properly.

11.4.1 Recommendation

A possible way a combined product could work would be after a period of 1 or 2 years of IDII payments being made, if the condition is then established to be permanent, IDII would cease and the lump sum amount could be paid. The payment of the lump sum benefit could either be made in full at the point IDII payments cease or paid in instalments over a 3-5 year period. However, it is acknowledged that this involves the creation of a new product which falls outside the scope of this document.

11.5 Underwriting Options to Reduce Potential Over-insurance

10.5.1 Offset Options

Offset 1 (reduce personal TPD cover for IDII amounts held)

Assume the personal TPD Lump Sum amount has been calculated based on the multiples of income approach.

Reduce the TPD amount by the IDII amount for the term of the IDII cover.

Allow an additional amount of TPD for a catastrophic event under a "severe disability"/ADL category (so not to be junk insurance but to have a practical need and be priced accordingly).

Example 1: *Customer age 45 – electrician – Income $100,000* *IDII (@ 70% replacement ratio) = $5,833.33 per month ($70,000 pa) – to age 65* *TPD based on multiple = $2,000,000 ($100,000 x 20)* *Reduce the TPD cover by $5,833.33 x 12 months x 20 years = $1,400,000* *Allow TPD cover of $600,000 ($2,000,000 less IDII amount which if TPD would be paid to age 65 of $1,400,000)* *Allow "severe disability" TPD of $1,000,000 in addition to this to cater for additional costs incurred in the event of a catastrophic event (@significantly reduced premiums)* *Claim* *Knee injury, can no longer squat or kneel which are requirements of the occupation and assumed to meet the TPD definition* *Customer receives:* *TPD of $600,000* *IP $5,833.33 per month for 20 years = $1,400,000* *Total = $2,000,000 which is 100% replacement of income up to retirement*	*Example 2:* *Customer age 45 – builder – Income $100,000* *IDII (@ 70% replacement ratio) = $5,833.33 per month ($70,000 pa) – to age 65* *TPD based on multiple = $2,000,000 ($100,000 x 20)* *Reduce the TPD cover by $5,833.33 x 12 months x 20 years = $1,400,000* *Allow TPD cover of $600,000* *Allow "severe disability" TPD of up to $1,000,000 (@significantly reduced premiums)* *Claim* *MVA resulting in brain injury & irreversible paraplegia* *Customer receives:* *TPD of $600,000* *TPD of $1,000,000 for "severe disability"* *IP $5,833.33 per month for 15 years = $1,400,000* *Total = $3,000,000 which is 100% replacement of income up to retirement*

(but not a "windfall" of $3,400,000 which would be paid on the current approach)	*plus an additional amount for home modifications and equipment*

Offset 2

An alternative approach could be to say you can insure up to 110% of your earned income multiplied by the years left to retirement (age 65) over both personal TPD and IDII benefits combined. The reason for the uplift to 110% being to cover the possible extra costs associated with being unable to work such as home modification, health care costs, impact on spouse income etc.

Example 1: *Customer age 45 – electrician – Income $100,000* *IDII (**to age 65**) at **70%** RR = $5,833 x 12 x 20 = $1,400,000.* *Allowable maximum over both IDII & TPD = $2,200,000 income replacement (110% x $100k x 20, to age 65)* *Allow TPD cover of up to $800,000 (total of $2,200,000 – $1,400,000 total IDII payable if TPD)*	*Example 2:* *Customer age 45 – builder – Income $100,000* *IDII (**5 year benefit period**) at **60%** RR = $5,000 x 12 x 5 = $300,000.* *Allowable maximum over both IDII & TPD = $2,200,000 income replacement (110% x $100k x 20, to age 65)* *Allow TPD cover of up to $1,900,000 (total of $2,200,000 – $300,000 total IDII payable if TPD)*

It might be that at underwriting stage, if the applicant exceeds the maximum available, they are offered the choice of which product (IDII or personal TPD) they want to reduce. Another consideration would be to use a factor of less than 110% for older ages to allow for lump sum needs reducing over time as expenses decrease when mortgages are paid down and children become independent.

11.5.2 Reduce multiples applied for (Own Occ / Suited E.T.E) TPD back to more commonly accepted global levels

Multiples currently applied to determine the level of TPD cover available to an applicant have been pushed considerably higher over time in a competitive Australian market resulting in, multiples commonly applied to (Own Occ / Suited E.T.E) TPD cover being 20-25 x income as opposed to globally accepted levels of up to a maximum 15 x income.

A return to more commonly accepted global multiples to derive (Own Occ / Suited E.T.E) TPD cover levels will reduce this risk.

Suggested multiples of Income for (Own Occ / Suited E.T.E)

Age band	Income multiple
Up to age 40	up to 15x

Age 41-50	5 - 14x
Age 51-60	2 - 12x

Insurers wishing to provide additional TPD cover above and beyond those provided under (Own Occ / Suited E.T.E) levels could do so under a severe/catastrophic definition TPD basis as already outlined in this paper.

For example:

Applicant aged 45:

Multiple of 10 x income used (from table above) to derive (Own Occ/Suited E.T.E) TPD cover

Further Catastrophic TPD cover could be offered of up to 10x Income.

i.e. age 45-applicant has 20 years to retirement age (65)

Therefore, a further 10 x income (for the remaining 10yrs to age 65) could be used to offer Catastrophic TPD cover.

11.5.3 Recommendations for Managing Concurrent IDII and Personal TPD Policies

11.5.3.1

A reasonable solution would be to limit combinations of IDII and personal TPD cover to a maximum 110% of an insured's earned income, multiplied by the number of years left until retirement (suggest age 65) over both personal TPD/IDII benefits. Where higher levels of TPD cover are deemed necessary using this offset approach, these could be considered using a catastrophic definition based TPD product.

If the applicant exceeds the maximum available at application time, they could be offered the choice of which product (IDII or personal TPD) they would prefer to reduce, as this may be different depending on the customer’s unique circumstances and longer-term needs.

11.5.3.2

Alternatively, a return to more commonly accepted global multiples (of up to 15 x income maximum) to derive (Own Occ/Suited Education Training & Experience) TPD cover levels could be implemented as outlined in 7.5.2 above. Again, where higher levels of TPD cover are deemed necessary, these could be considered using a catastrophic definition based TPD product.

Either of the two approaches above will serve to provide financial assistance for extra costs associated with being unable to work; such as home modification, health care costs and impact on spouse income, whilst also providing a reasonable ongoing income stream during disability.

11.6 Recommendation regarding TPD definition (out of scope of this project)

This working group would like to highlight that this combination IDII/personal TPD risk could be mitigated to some extent with an amendment to the TPD definition. We believe it is important that TPD definitions be addressed by the industry to see the product provide cover as it is priced and intended; i.e. to only pay TPD claims when an individual is both *Totally* **and** *Permanently* disabled and is determined to never be unable to work again.

12. Conclusion

It is clear from the above findings that life insurance underwriters and claims professionals need to consider the better practice approaches outlined in this report in the five key areas identified to have the biggest impact on the issue of IDII sustainability from a financial underwriting and claims perspective. The industry was invited to provide feedback as part of ALUCA's consultation period from September 2021 to November 2021 to the recommended better practice approaches to the five areas outlined in this paper.

The feedback was overwhelmingly supportive of the recommendations outlined. There was agreement that the next steps around execution and implementation of these better practices are really important to achieve industry sustainability. It is important that the industry drives and adopts these recommended better practices to achieve this.

Finally, as life insurance professionals, we need to be adequately trained and qualified to perform our tasks and present ourselves in this light. We need to ensure that our actions not only conform with legislation and regulation but also meet community standards and expectations.

13. Appendices

13.1 Appendix 1 – Definition of 'Insurable Income' in this Document

Insurable Income means the life insured's total remuneration and includes salary, wages, director's fees, allowances, packaged fringe benefits, regular (consistent in size and frequency having regard to the past 3 years) commissions, bonuses and overtime payments and pre-tax superannuation contributions.

If the life insured is Self-Employed, 'insurable income' also includes the life insured's share of the net profit and/or net loss of the business, whether the income is paid to them or not. Income from the life insured's business is calculated after the deduction of expenses necessarily incurred or normally required in producing that income but before the deduction of tax.

Where the business income, expenses, profits or losses are accounted for in multiple business entities and/or structures, we will have to consider all these entities in determining the life insured's 'insurable income'.

Where income is split with or paid to a family member who is not involved in the generation of that income, we will allocate that income (minus remuneration expenses commensurate with the role of the family member) to the insured.

Insurable income does not include passive investment earnings, such as rental earnings or interest received.

Self-Employed means the Insured Person directly or indirectly owns all or part of the business in which their work is performed, including where the business operates under a company structure (ignoring shares in publicly listed companies).

13.2 Appendix 2 – Ongoing Business Income (OBI) offset examples

Method	Pros	Cons
OBI offset included in policy terms (offset at time of claim) using an Income Replacement Ratio (IRR) method of offset (i.e. adjust the benefit amount payable such that the benefit amount and the amount of OBI combined do not exceed 60% or 70% of pre-disability income)	• Maintains the intended IRR • Some benefit amount would be likely to be paid • Once OBI ceases then full benefit payable • If insured for all business income including OBI then no possible longer-term underinsurance issue	Paying premiums on an amount that will not initially be received (until OBI ceases)
OBI offset included in policy terms (offset at time of claim) using a direct offset method (i.e. every $1 of OBI is offset)	• Once OBI ceases then full benefit payable • If insured for all business income including OBI then no possible longer-term underinsurance issue	• Overall IRR could be less than intended (but not less than the IRR they took out cover for e.g. if took out cover for 20%, they would always get at least a 20% in [benefits + OBI]) • Paying premiums on an amount that will not initially be received (until OBI ceases)
Actuaries Institute Taskforce Reference Product proposed method	Paying premiums on an amount more likely to match the amount that will be received so less customer surprise, providing OBI at claim matches OBI at time of underwriting	• Hard to estimate the amount of ongoing business income which could continue at the time of underwriting • May result in a longer-term under-insurance issue once the business interest is sold and OBI ceases. However, this issue is somewhat mitigated if the business owner then receives money from the sale of the business which can be used as a substitute income stream • The introduction of passive investment income into the calculation adds further operational complexity and further obligations for the insurer to explain why passive investment income impacts the ability to insure their 'insurable income' at usually allowable IRR %

Offsetting a proportion of the ongoing business income (i.e. 75% consistent with the Partial Disability calculations)	Less of an offset than the above approaches could give this approach a competitive advantage	• The intended IRR is exceeded • Less sustainable product
OBI offset included in Policy terms (offset at time of claim) <u>but also</u> reduced from the benefit insured at the time of underwriting		Double offset. Nil benefit may be calculated at time of claim
Insure only replacement wage cost and not the ongoing business income with no OBI offset at time of claim	Opportunity to be a different product such as a 'key person business expense policy' covering the business owner's replacement wage cost	Overall replacement ratio can exceed 60/70%. *See yellow highlighted calculation below*

Scenario 1: pre-disability income = application income

				Actuaries Institute (AI) method (example 2)		
Insurable income at application (ie profit + add backs)	A	200,000	per annum		200,000	per annum
Ongoing income **estimated** at application @ 25%	B	50,000	estimated for 9 months		50,000	per annum
Insured benefit at application @60%	C = (A x 60%)/12	10,000	per month	J = [A x 60% - B]/12	5,833	per month
Waiting period		60	days			
Pre-disability income at claim (per annum)	D	200,000	per annum			
Pre-disability income at claim (per month)	E = D ÷ 12	16,667	per month			
Replacement ratio @60%	F = E x 60%	10,000	per month	F = E x 60% - H	5,833	per month
Maximum monthly benefit payable	G = lesser of C or F	10,000	per month	G = lesser of J or F	5,833	per month

Insurable Benefit Example

	Example 1	Example 2	Example 3	Example 4
Personal Income	$150,000	$150,000	$150,000	$100,000
Unaffected Business Income	$0	$50,000	$50,000	$0
Passive income	$0	$0	$100,000	$250,000
Total Income	$150,000	$200,000	$300,000	$350,000
IRR Scale on Total Income	$90,000	$120,000	$168,000	$188,000
Less UBI, Less PI	$0	-$50,000	-$150,000	-$250,000
Insurable Benefit p.a.	$90,000	$70,000	$18,000	$0
Insurable Benefit p.m.	*$7,500*	*$5,833*	*$1,500*	*$0*
Effective IRR	*60%*	*47%*	*12%*	*0%*

			Post claim period											
			Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12
Pre-disability income	D		16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667
60% of pre-disability earnings	F		10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Actual ongoing income @ 25%	H	as per monthly P&L	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	0	0	0
Replacement ratio offset method (offset at claim)			Waiting period											
Benefit payable	F - H capped at G		0	0	5,833	5,833	5,833	5,833	5,833	5,833	5,833	10,000	10,000	10,000
Ongoing business income			4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	0	0	0
Total income			4,167	4,167	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Replacement ratio			*25%*	*25%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*
Direct offset method (offset at claim)														
Benefit payable	G - H		0	0	5,833	5,833	5,833	5,833	5,833	5,833	5,833	10,000	10,000	10,000
Ongoing business income			4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	0	0	0
Total income			4,167	4,167	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Replacement ratio			*25%*	*25%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*
Actuaries Institute method (lower of offset at application & offset at claim) - Example 2														
Benefit payable	G = lesser of J or F		0	0	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833
Ongoing business income			4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	0	0	0
Total income			4,167	4,167	10,000	10,000	10,000	10,000	10,000	10,000	10,000	5,833	5,833	5,833
Replacement ratio			*25%*	*25%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*35%*	*35%*	*35%*
Offset 75% of OBI similar to partial disability (offset at claim)			Waiting period											
Benefit payable	G - 75% of H		0	0	6,875	6,875	6,875	6,875	6,875	6,875	6,875	10,000	10,000	10,000
Ongoing business income			4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	0	0	0
Total income			4,167	4,167	11,042	11,042	11,042	11,042	11,042	11,042	11,042	10,000	10,000	10,000
Replacement ratio			*25%*	*25%*	*66%*	*66%*	*66%*	*66%*	*66%*	*66%*	*66%*	*60%*	*60%*	*60%*
					@ 66% IRR the intended 60% has been exceeded									
Remove OBI at time of underwriting plus offset clause built-in to Policy														
Insure only the $150K personal income = $150,000 x 60%/12 = 7,500 pm														
Benefit payable	$7,500 - OI ($50K pa)		0	0	3,333	3,333	3,333	3,333	3,333	3,333	3,333	7,500	7,500	7,500
Ongoing business income			4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	4,167	0	0
Total income			4,167	4,167	7,500	7,500	7,500	7,500	7,500	7,500	7,500	11,667	7,500	7,500
Replacement ratio			*25%*	*25%*	*45%*	*45%*	*45%*	*45%*	*45%*	*45%*	*45%*	*70%*	*45%*	*45%*
										Illustration of not applying the offset at time of claim (60% IRR exceeded)				

Scenario 2: pre-disability income = application income but OBI higher than estimated

					Actuaries Institute (AI) method (example 2)										
Insurable income at application (ie profit + add backs)	A	200,000	per annum				200,000	per annum							
Ongoing income **estimated** at application @ 25%	B	50,000	estimated for 9 months				50,000	per annum							
Insured benefit at application @60%	C = (A x 60%)/12	10,000	per month		J = [A x 60% - B]/12		5,833	per month							
Waiting period		60	days												
Pre-disability income at claim (includes unknown amt of OBI)	D	200,000	per annum												
Pre-disability income at claim	E = D ÷ 12	16,667	per month												
Replacement ratio @60%	F = E x 60%	10,000	per month		F = E x 60% - H		2,000	per month							
Maximum monthly benefit payable	G = lesser of C or F	10,000	per month		G = lesser of J or F		5,833	per month							
				Post claim period											
				Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12
Pre-disability income	D			16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667	16,667
60% of pre-disability earnings	F			10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Actual ongoing income @ $8,000 pm for 9 months	H	as per monthly P&L		8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000			
Replacement ratio offset method (offset at claim)				Waiting period											
Benefit payable	F - H capped at G			0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	10,000	10,000	10,000
Ongoing business income				8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000			
Total income				8,000	8,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Replacement ratio				*48%*	*48%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*
Direct offset method (offset at claim)															
Benefit payable	G - H			0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	10,000	10,000	10,000
Ongoing business income				8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	0	0	0
Total income				8,000	8,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Replacement ratio				*48%*	*48%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*
Actuaries Institute method															
Benefit payable	G = lesser of J or F			0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	5,833	5,833	5,833
Ongoing business income				8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	0	0	0
Total income				8,000	8,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	5,833	5,833	5,833
Replacement ratio				*48%*	*48%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*35%*	*35%*	*35%*

Assume OBI is actually $96,000 =$8,000 pm at time of claim. This amount is only estimated at time of UW and is an unknown component of PDE. Ie can only be actually know in the post claim period

Scenario 3: pre-disability income > application income and OBI lower % than assumed

Insurable income at application (ie profit + add backs	A	200,000	per annum
Ongoing income estimated at application @ 25%	B	50,000	estimated for 9 months
Insured benefit at application @60%	C = (A x 60%)/12	10,000	per month
Waiting period		60	days
Pre-disability income at claim	D	220,000	per annum
Pre-disability income at claim	E = D ÷ 12	18,333	per month
Replacement ratio @60%	F = E x 60%	11,000	per month
Maximum monthly benefit payable	G = lesser of C or F	10,000	per month

Actuaries Institute method (example 2)		
A	200,000	per annum
B	50,000	per annum
J = [A x 60% - B]/12	5,833	per month
D	220,000	per annum
E = D ÷ 12	18,333	per month
F = E x 60% - **H**	8,250	per month
G = lesser of J or F	5,833	per month

Insurable Benefit Example	Example 1	Example 2	Example 3	Example 4
Personal Income	$150,000	$150,000	$150,000	$100,000
Unaffected Business Income	$0	$50,000	$50,000	$0
Passive income	$0	$0	$100,000	$250,000
Total Income	$150,000	$200,000	$300,000	$350,000
IRR Scale on Total Income	$90,000	$120,000	$168,000	$188,000
Less UBI, Less PI	$0	-$50,000	-$150,000	-$250,000
Insurable Benefit p.a.	$90,000	$70,000	$18,000	$0
Insurable Benefit p.m.	*$7,500*	*$5,833*	*$1,500*	*$0*
Effective IRR	*60%*	*47%*	*12%*	*0%*

			Post claim period											
			Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12
Pre-disability income	D		18,333	18,333	18,333	18,333	18,333	18,333	18,333	18,333	18,333	18,333	18,333	18,333
60% of pre-disability earnings	F		11,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000
Actual ongoing income @ 15%	**H**	as per monthly P&L	2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	0	0	0
Replacement ratio offset method (offset at claim)			Waiting period											
Benefit payable	F - H capped at G		0	0	8,250	8,250	8,250	8,250	8,250	8,250	8,250	10,000	10,000	10,000
Ongoing business income			2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	0	0	0
Total income			2,750	2,750	11,000	11,000	11,000	11,000	11,000	11,000	11,000	10,000	10,000	10,000
Replacement ratio			*15%*	*15%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*60%*	*55%*	*55%*	*55%*
Direct offset method (offset at claim)														
Benefit payable	G - H		0	0	7,250	7,250	7,250	7,250	7,250	7,250	7,250	10,000	10,000	10,000
Ongoing business income			2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	0	0	0
Total income			2,750	2,750	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Replacement ratio			*15%*	*15%*	*55%*	*55%*	*55%*	*55%*	*55%*	*55%*	*55%*	*55%*	*55%*	*55%*
Actuaries Institute method	Example 2													
Benefit payable	G = lesser of J or F		0	0	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833
Ongoing business income			2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	2,750	0	0	0
Total income			2,750	2,750	8,583	8,583	8,583	8,583	8,583	8,583	8,583	5,833	5,833	5,833
Replacement ratio			*15%*	*15%*	*47%*	*47%*	*47%*	*47%*	*47%*	*47%*	*47%*	*32%*	*32%*	*32%*

13.3 Appendix 3 –Comprehensive Risk Profiling Checklist

A calculator has been designed to assist an insurer with understanding the mitigants they have in place to profile someone financially. It also looks to offer some assistance in identifying any potential gaps an insurer may have in their question sets, philosophies, products or an absence of alignment across product, underwriting and claims.

It is not intended to dictate every question area that should be addressed, but rather assist in mapping overall risk. This risk should then be considered more broadly by the insurer in the context of their product, other mitigants, their corporate objectives, the target market, operational costs and their overall risk appetite. It should assist in the holistic overview of internal financial profiling philosophies across the business and enable an insurer to build their unique story around why they operate as they do, from a financial profiling perspective. It stands to act as a tool to assist insurers to make conscious decisions about their position when asked to communicate potential risk to their senior management, Boards and regulators.

LINK to the Financial Check-list

ALUCA members portal – Research & Papers

13.4 Appendix 4 – Instant asset write-off and its treatment in income calculation (the ideal methodology)

		Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Revenue	a	100,000	120,000	40,000	30,000	25,000
Less: expenses						
Operating expense		40,000	50,000	30,000	10,000	7,000
Instant asset write-off		40,000	0	0	20,000	0
Total expenses	b	80,000	50,000	30,000	30,000	7,000
Net profit	c = a - b	20,000	70,000	10,000	0	18,000
Adjustment:						
Add-back: cost of asset written off		40,000	0	0	20,000	0
Less: depreciation expense	(note 1)	(10,000)	(10,000)	(10,000)	(15,000)	(5,000)
Total adjustment	d	30,000	(10,000)	(10,000)	5,000	(5,000)
Total income	e = c + d	50,000	60,000	0	5,000	13,000

Note 1: It is assumed useful life of assets written of is 4 years, hence depreciation expense 25% of asset cost on straight line basis. Between year 1 to year 3, depreciation expense is $ 10,000 (25% of $40,000). In year 4 depreciation expense is $ 15,000 (25% of $ 40,000 asset acquired in year 1 + 25% of 20,000 asset acquired in year 4). In year 5, as asset acquired in year 1 has been fully depreciated, depreciation expense of $ 5,000 recognised (25% of $ 20,000 asset acquired in year 4)

Note 2: Assumed Year 1 and Year 2 is pre-disability period, Year 3 to Year 5 – post disability period

13.5 Appendix 5 – Income splitting arrangement scenarios and better practice guides

Spouse has a support role

	Current		**Better practice guide**	
Role of the spouse	**Remuneration paid to spouse**	**% of profits allocated to spouse (or percentage ownership of spouse)**	**Wages**	**Profit share**
None	Any	Any (0% to 100%)	Add back all wages and superannuation paid to the spouse from the business	Attribute 100% to the income-producing client (0% to the spouse even where they might own 100% of the business)
Minimal admin role – 5 hours per week	Any	Any		
Part-time admin role – 20 hours per week	Paid on an hourly basis at market rate e.g. $ 30 per hour = $ 31,200 pa or a similar amount in this order	Any	No adjustment required	Attribute 100% to the income-producing client
	Any amount other than above e.g. $ 100,000 pa	Any	Add back wage amount paid to spouse greater than around $31,200 (e.g. for wages paid of $100,000 add back $68,800)	
	None	Any	Deduct around $ 31,200 from profits to allow for replacement cost of spouse’s role	
Full-time admin role – 37.5 hours per week	Paid on an hourly basis at market rate e.g. $ 30 per hour = $ 58,500 pa or a similar amount in this order	Any	No adjustment required	

Spouse has an active role

	Current		Better practice guide	
Role of the spouse	**Remuneration paid to spouse**	**% of profits allocated to spouse (or percentage ownership of spouse)**	**Wages**	**Profit share**
Part-time income producing role – e.g. 20 hours per week (i.e. professional, sales, technical, labourer) and client has a full-time income producing role	None	Any (0% to 100%)	No add-back required	In this example, as the client is working twice as many hours as the spouse, then attribute 67% of the business income to the client regardless of the actual ownership percentage
	Any e.g. $ 100,000 pa	Any	Add back the wage amount paid to the spouse and the wage amount paid to the client before taking the ownership interest	Attribute 67% including all add backs and wage add backs to the client
Full-time income producing role e.g. 35+ hours per week and client has a full-time income producing role	None	Any	No add-back required	Attribute 50% to the client
	Any e.g. $ 100,000 pa	Any	Add back the wage amount paid to the spouse and the wage amount paid to the client before taking the ownership interest	Attribute 50% to the client
Full-time income producing role – e.g. 35+ hours per week (and client has an administration role)	None	Any	Calculate client's 'insurable income' based on the market rate wage amount for role and average number of hours worked. Ensure the business has enough profitability to cover the wage	Attribute 0% to the client

13.6 Appendix 6 – JobKeeper subsidy – accounting treatment

- JobKeeper payments are paid as normal wages to employee and unlikely to be reflected in employee payslips, income summaries or tax returns
- JobKeeper payments can be received in respect of arms' length employee, business owners and/or non-working spouse and can be reflected in the P&L on a gross or net basis (see below table)
- JobKeeper payments received by owners, non-working spouse and cash flow boost payments will need to be adjusted to calculate net income.

Self-employed jobkeeper example

Profit & Loss account

Income		**Gross**	**Net**	**Remarks**
Fee received		578,840	578,840	
Government grants - jobkeeper		54,000	0	
Government grants - cash flow boost		15,000	15,000	
Total income	a	647,840	593,840	
Expenses				
Salaries and wages - employees		262,563	226,563	
Salaries and wages - owner		80,000	71,000	
Salaries and wages - non-working spouse		40,000	31,000	
All other expenses		145,523	145,523	
Total expenses	b	528,086	474,086	
Profit/(loss) before tax	*c = a - b*	***119,754***	***119,754***	
Suggested add-backs relating to Jobkeeper subsidy & cash flow boost payments				
Less: Adjustment				
Government grants - cash flow boost		-15,000	-15,000	
Government grants - owner		-9,000	0	Removed as it related to a discretionary payment
Government grants - non-working spouse		-9,000	0	Removed as it related to a discretionary payment
Add: Adjustment				
Salary & wages - owner		80,000	71,000	Discretionary payment and does not depend on jobkeeper subsidy
Salaries and wages - non-working spouse		40,000	31,000	Discretionary payment and does not depend on jobkeeper subsidy
Total adjustments	*d*	*87,000*	*87,000*	
Net adjusted income	**e = c + d**	**206,754**	**206,754**	
Note:				
Government grants - employees			36000	
Government grants - owner			9000	
Government grants - non-working spouse			9000	