AIA AUSTRALIA INCOME PROTECTION CORE TECHNICAL AND POSITIONING

October 2021

HEALTHIER, LONGER, BETTER LIVES

aia.com.au

AIA Australia – Income Protection that protects and supports your clients

We have designed our Income Protection cover to give your clients financial protection when they need it most. This cover helps your clients – who are working Australians – by protecting them in the event of disability, severe illness or loss of income. no matter which stage of life they are in, AIAA is committed to protecting your clients financially and rewarding them for getting healthier through our science-backed wellness program, AIA Vitality.

To support you as an adviser in our AIAA community, we are continually innovating and enhancing our product range.

This is to ensure that we create benefits that are suitable for insurance industry standards and meet the long-term objectives of your clients' needs.

Requirements from the Australian Prudential Regulation Authority (APRA) and the Actuaries Institute have resulted in AIAA developing our new Income Protection product: Income Protection CORE. The APRA requirements become an industry standard in October 2021, and we've taken a leadership approach by being one of the first insurers to launch a new product based on these principles.

We have carefully designed this product to align with APRA and the Actuaries Institutes's objective to deliver more stable premiums in the Income Protection market. Because of this, your clients will now have greater ability to tailor their income protection based on their personal needs and budget.

It's important to note that there are currently ongoing industry discussions around how best to introduce and implement the new 5 year contract term as defined under APRA's requirements. For this reason, the releases in 2021 of Income Protection CORE will not include this.

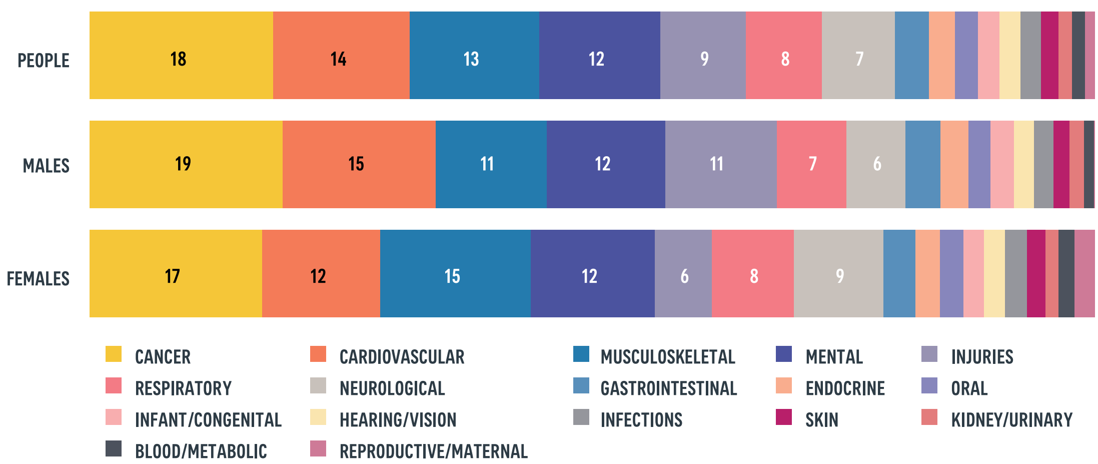
In this brochure, we'll guide you through an overview of the pre October 2021 Income Protection, and walk you through the benefits of Income Protection CORE, designed on a standard guaranteed renewable basis.

Here's why Income Protection is important

- This type of cover provides an income when someone becomes disabled and unable to work, and;
- Helps a business continue to operate if the key person can no longer perform their role solely due to an injury or sickness.

AIAA's Priority Protection Income Protection CORE pays monthly benefits if a client is unable to perform any work (and classified by us as Totally Disabled) or is able to work but in a limited capacity (classified by us as Partially Disabled) due to an injury or sickness as defined in the insurance policy. When a client loses their income in this way, there are significant impacts on their lifestyle and finances. Through our cover, we help protect the greatest asset a working Australian has; themselves and the ability to earn income.

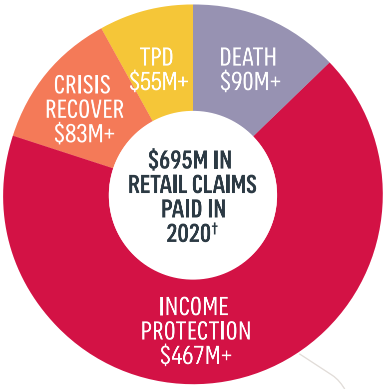
If injury or sickness occurs, Income Protection CORE is there to provide your clients with a replacement of their lost income – allowing them to continue paying their bills and debts such as mortgage repayments. The core purpose of Income Protection CORE is to pay month-by-month support to a client and help with their regular repayments and monthly living expenses. This provides a financial safety net during difficult times.



All of these diseases could render a client unable to work and produce a living, resulting in significant income loss to the household.

https://www.aihw.gov.au/getmedia/c076f42f-61ea-4348-9c0a-d996353e838f/aihw-bod-22.pdf.aspx?inline=true

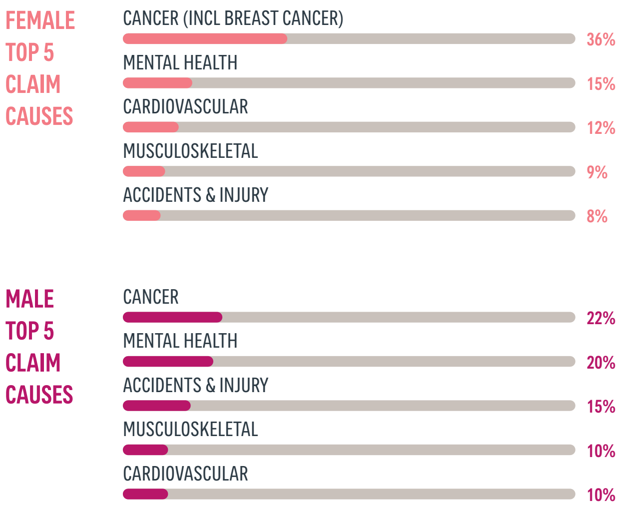
AIA 2020 CLAIMS PAID IN THE ADVISER CHANNEL



INCOME PROTECTION

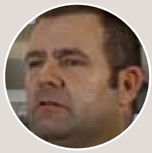
- YOUNGEST CLAIMANT 17
- AVERAGE 49
- OLDEST CLAIMANT 88

† Total retail (IFA) claims figure



Top 5 claim causes by percentage of payment amounts ($).

AIA Australia customers reflect on their claims experience



WATCH THIS VIDEO

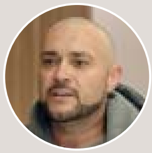
"Couldn't ask for a better insurance company."

Adam
Income Protection claim

WATCH THIS VIDEO

"Peace of mind to know that there was money coming in."

Richard
Income Protection claim with Rehabilitation plan



WATCH THIS VIDEO

"Since working with the Rehab consultant, life's been great."

Phil
Rehabilitation plan

WATCH THIS VIDEO

"Receiving the payment took that financial burden away."

Nadun
Income Protection and Crisis Recovery claim

Income Protection complements an insurance package that often includes Life Cover, Crisis Recovery and Total and Permanent Disablement (TPD) Cover. This financial safety provides peace of mind and gives your clients a sense of security during a difficult period. The funds received from the monthly benefit paid helps cover the essential costs. Income Protection can also help with your client's rehabilitation and getting them back to a sustained return to work.

This multidisciplinary approach to insurance (combining Life, Crisis, and TPD) supports recovery from injury, illness or disablement, and helps to ensure that your clients stay comprehensively financially protected.

When talking about illness and injury to clients, it is helpful to understand what specific illness and injuries are prevalent within certain age categories. The tables below summarise the leading burdens of disease in both males and females across age. Burden of disease is considered the best method to measure the impact of different diseases or injuries in a population.

These burden of disease analyses combine living with poor health (non-fatal burdens of disease) with dying prematurely (fatal burdens).

In the most recent Australian data, the leading disease groups causing the most burden include cancer, cardiovascular diseases, musculoskeletal conditions, mental and substance use disorders, and injuries. These account for two-thirds (65%) of the total burden, many of which will impact your client's ability to earn an income.

LEADING CAUSES OF TOTAL BURDEN (DALY '000; PROPORTION %) FOR FEMALES, BY AGE GROUP, 2015

	AGE GROUP (YEARS)								
Rank	Under 5	5–14	15–24	25–44	45–54	55–64	65–74	75–84	85+
1st	Pre-term/lbw complications (7.0; 12.3%)	Asthma (7.0; 12.4%)	Anxiety disorders (14.5; 11.3%)	Anxiety disorders (36.3; 9.5%)	Back pain and problems (18.2; 6.7%)	Osteoarthritis (20.6; 6.3%)	COPD (23.0; 6.4%)	Dementia (33.6; 9.7%)	Dementia (59.7; 20.0%)
2nd	Birth trauma/ asphyxia (6.2; 10.9%)	Anxiety disorders (6.1; 10.8%)	Depressive disorders (11.4; 8.9%)	Back pain and problems (30.4; 7.9%)	Anxiety disorders (17.1; 6.2%)	Lung cancer (18.3; 5.6%)	Osteoarthritis (20.7; 5.8%)	Coronary heart disease (29.8; 8.6%)	Coronary heart disease (40.0; 13.4%)
3rd	Cardiovascular defects (2.5; 4.3%)	Depressive disorders (4.7; 8.3%)	Asthma (9.2; 7.1%)	Depressive disorders (30.1; 7.8%)	Breast cancer (15.5; 5.6%)	Breast cancer (18.2; 5.5%)	Lung cancer (20.6; 5.8%)	COPD (25.2; 7.3%)	Stroke (24.2; 8.1%)
4th	SIDS (2.3; 4.1%)	Dental caries (2.9; 5.2%)	Back pain and problems (7.7; 6.0%)	Asthma (19.1; 5.0%)	Depressive disorders (14.1; 5.1%)	Back pain and problems (17.8; 5.4%)	Coronary heart disease (20.3; 5.7%)	Stroke (19.1; 5.5%)	COPD (14.2; 4.8%)
5th	Asthma (2.0; 3.6%)	Conduct disorder (2.8; 4.9%)	Suicide/self-inflicted injuries (7.6; 6.0%)	Suicide/self-inflicted injuries (13.8; 3.6%)	Osteoarthritis (11.1; 4.0%)	COPD (13.3; 4.0%)	Breast cancer (15.1; 4.2%)	Lung cancer (12.2; 3.5%)	Falls (11.8; 4.0%)
6th	Lower respiratory infections (1.3; 2.3%)	Acne (2.5; 4.5%)	Bipolar affective disorder (5.9; 4.6%)	Bipolar affective disorder (11.1; 2.9%)	COPD (10.5; 3.8%)	Coronary heart disease (12.2; 3.7%)	Rheumatoid arthritis (14.9; 4.2%)	Osteoarthritis (11.6; 3.3%)	Atrial fibrillation (8.3; 2.8%)
7th	Neonatal infections (1.0; 1.8%)	Back pain and problems (2.2; 4.0%)	Polycystic ovarian syndrome (5.3; 4.1%)	Polycystic ovarian syndrome (10.2; 2.6%)	Asthma (9.4; 3.4%)	Rheumatoid arthritis (11.3; 3.4%)	Back pain and problems (13.3; 3.7%)	Hearing loss (10.0; 2.9%)	Hearing loss (7.4; 2.5%)
8th	Dermatitis and eczema (0.9; 1.7%)	Epilepsy (1.8; 3.3%)	Alcohol use disorders (5.0; 3.9%)	Poisoning (10.0; 2.6%)	Lung cancer (8.5; 3.1%)	Anxiety disorders (11.0; 3.3%)	Dementia (12.6; 3.5%)	Rheumatoid arthritis (9.9; 2.9%)	Chronic kidney disease (7.2; 2.4%)
9th	Brain malformations (0.9; 1.6%)	Dermatitis and eczema (1.8; 3.2%)	RTI/motor vehicle occupant (4.2; 3.3%)	Migraine (9.5; 2.5%)	Rheumatoid arthritis (6.9; 2.5%)	Depressive disorders (9.7; 2.9%)	Type 2 diabetes (11.0; 3.1%)	Bowel cancer (9.4; 2.7%)	Lower respiratory infections (6.8; 2.3%)
10th	Neural tube defects (0.9; 1.6%)	Eating disorders (1.1; 1.9%)	Acne (4.0; 3.1%)	Eating disorders (9.0; 2.4%)	Suicide/self-inflicted injuries (6.8; 2.5%)	Type 2 diabetes (9.4; 2.8%)	Stroke (9.9; 2.8%)	Type 2 diabetes (9.1; 2.6%)	Non-rheumatic valvular disease (5.3; 1.8%)

Note: Disease rankings exclude 'other' residual conditions from each disease group; for example, 'other musculoskeletal conditions'.

LEADING CAUSES OF TOTAL BURDEN (DALY '000; PROPORTION %) FOR MALES, BY AGE GROUP, 2015

	AGE GROUP (YEARS)								
Rank	Under 5	5–14	15–24	25–44	45–54	55–64	65–74	75–84	85+
1st	Pre-term/lbw complications (10.3; 14.6%)	Asthma (9.2; 13.7%)	Suicide/self-inflicted injuries (19.7; 12.8%)	Suicide/self-inflicted injuries (47.7; 10.3%)	Coronary heart disease (28.5; 8.9%)	Coronary heart disease (43.7; 10.6%)	Coronary heart disease (53.0; 11.4%)	Coronary heart disease (47.8; 12.7%)	Coronary heart disease (30.7; 15.8%)
2nd	Birth trauma/ asphyxia (6.3; 9.0%)	Anxiety disorders (7.0; 10.5%)	Alcohol use disorders (11.1; 7.2%)	Back pain and problems (29.2; 6.3%)	Back pain and problems (18.9; 5.9%)	Lung cancer (23.7; 5.8%)	COPD (32.8; 7.0%)	COPD (27.0; 7.2%)	Dementia (25.5; 13.1%)
3rd	SIDS (3.9; 5.5%)	Conduct disorder (4.6; 6.9%)	RTI/motor vehicle occupant (8.7; 5.7%)	Alcohol use disorders (27.8; 6.0%)	Suicide/self-inflicted injuries (18.4; 5.8%)	Back pain and problems (18.2; 4.4%)	Lung cancer (31.7; 6.8%)	Dementia (25.4; 6.8%)	Stroke (12.8; 6.6%)
4th	Cardiovascular defects (3.7; 5.2%)	Depressive disorders (4.1; 6.1%)	Depressive disorders (8.3; 5.4%)	Poisoning (27.2; 5.9%)	Anxiety disorders (11.7; 3.7%)	Type 2 diabetes (15.5; 3.8%)	Type 2 diabetes (17.2; 3.7%)	Lung cancer (19.3; 5.1%)	COPD (11.1; 5.7%)
5th	Asthma (2.6; 3.8%)	Autism spectrum disorders (3.6; 5.3%)	Back pain and problems (7.8; 5.1%)	Depressive disorders (25.9; 5.6%)	Depressive disorders (10.4; 3.3%)	COPD (15.5; 3.8%)	Prostate cancer (16.2; 3.5%)	Stroke (18.4; 4.9%)	Prostate cancer (8.9; 4.6%)
6th	Lower respiratory infections (1.6; 2.2%)	Dental caries (3.1; 4.6%)	Asthma (7.2; 4.7%)	Anxiety disorders (22.8; 4.9%)	Chronic liver disease (10.3; 3.2%)	Chronic liver disease (14.0; 3.4%)	Bowel cancer (15.3; 3.3%)	Prostate cancer (16.2; 4.3%)	Falls (6.1; 3.1%)
7th	Drowning (1.2; 1.8%)	Back pain and problems (2.0; 3.0%)	Anxiety disorders (7.1; 4.6%)	Drug use disorders (15.2; 3.3%)	Poisoning (9.5; 3.0%)	Bowel cancer (12.6; 3.1%)	Stroke (14.2; 3.0%)	Bowel cancer (11.3; 3.0%)	Chronic kidney disease (5.0; 2.6%)
8th	Epilepsy (1.1; 1.5%)	Epilepsy (2.0; 2.9%)	Drug use disorders (5.6; 3.7%)	Asthma (14.4; 3.1%)	Lung cancer (9.3; 2.9%)	Osteoarthritis (11.4; 2.8%)	Back pain and problems (13.6; 2.9%)	Type 2 diabetes (10.7; 2.8%)	Lung cancer (4.7; 2.4%)
9th	Urogenital malformations (1.0; 1.4%)	Attention deficit hyperactivity disorder (2.0; 2.9%)	Acne (4.5; 2.9%)	Coronary heart disease (12.7; 2.8%)	Alcohol use disorders (8.3; 2.6%)	Rheumatoid arthritis (10.6; 2.6%)	Dementia (13.3; 2.9%)	Hearing loss (10.3; 2.7%)	Atrial fibrillation (4.3; 2.2%)
10th	Dermatitis and eczema (1.0; 1.4%)	Acne (1.9; 2.8%)	Bipolar affective disorder (4.3; 2.8%)	Schizophrenia (12.4; 2.7%)	Type 2 diabetes (7.5; 2.4%)	Liver cancer (9.3; 2.3%)	Rheumatoid arthritis (11.0; 2.4%)	Chronic kidney disease (8.3; 2.2%)	Lower respiratory infections (4.2; 2.2%)

Note: Disease rankings exclude 'other' residual conditions from each disease group; for example, 'other musculoskeletal conditions'.

Combining innovation with industry requirements

At AIA Australia we are proud to be market leaders within the life insurance industry. What's important to us is to protect our clients' financial security and support them when they need us most. A key part of this commitment is to maintain a strong insurance industry that delivers products that are sustainable for both the insurer and its customers.

The APRA requirements are an industry standard from October 2021, and we've taken a leadership approach by being one of the first insurers to launch a new product based on these principles.

We have carefully designed this product to align with APRA and the Actuaries Institutes's objective to deliver more stable premiums in the Income Protection market. Because of this, your clients will now have greater ability to tailor their income protection based on their personal needs and budget.

These APRA requirements also saw the end of Agreed Value benefits being recommended to new clients from 31 March 2020; and significant changes to the current Income Protection products in market were mandated by 1 July 2021 (phase two), with a final position issued in relation to Income Protection on 30 September 2020 which extended phase 2 to 1 October 2021. An additional extension for the 5 year rule was applied, deferring it until October 2022.

- Read APRA's Initial Intervention announcement article
- Read APRA's Finalised Disability Income Insurance Sustainability Measures
- Read Individual Disability Income Insurance Sustainability Guide
- Read Actuaries Institute Taskforce Finds Broad Changes needed to Sustain Disability Income Insurance Market

Key APRA and Actuaries Institute requirements that could affect you and your clients:

APRA Requirements	Impact to Income Protection on 1 October 2021
Income at risk (removal of agreed value and endorsed agreed on 31 March 2020)	• Changes to the assessment of income at the time of claim: - Predominately stable incomes should be based on annual earnings at the time of claim, not older than 12 months - Variable Income be based on average earnings over a time-appropriate period for the occupation and reflective of future earnings lost as a result of the disability. See additional guidelines in the appendix of this document
Income Replacement Ratio	• Capping the limits of income replacement to a maximum of: - 90% of earnings in the first six months of claim - Not exceeding 70% of earnings thereafter • Adjustments to claims escalation benefits to ensure that indexation claim payments are suitable • Return-to-work initiatives focused on rehabilitation can be made in addition to the income replacement limits • Superannuation contributions can be excluded from the limits and are to be paid to the nominated super fund and not to the claimant See additional guidelines in the appendix of this document

APRA Requirements	**Impact to Income Protection on 1 October 2021**
Policy Contract Terms Note: the 5 year contract terms have been delayed until 1 October 2022	• Policy Contract terms will not exceed 5 years • Policy Contracts may, at 5 years, be re-underwritten occupationally, financially and for dangerous past times, for a new contract with another 5-year term that is then available from the life company, however no medical underwriting is required • If terms and conditions are changed for the IP product, these must be endorsed with approval of the insurer's board after advice from the appointed actuary who considers sustainability and fairness to the customer See additional guidelines in the appendix of this document
Benefit Periods	Life Companies are expected to: - Have effective controls in place, including benefit design features to manage the risk of long-term claims particularly those with long benefit periods - Set internal benchmarks for new Income Protection products that reflect insurers' risk appetite and the effectiveness of their controls See additional guidelines in the appendix 1 of this document
Actuaries Institute Requirements	
Product Design	• Income definition and replacement ratio incentivise return to work/wellness • Disability definitions are clear and support the customer when they are unable to return to work • The occupation definition and replacement ratios encourage the customer to minimise the loss • Product terms and conditions keep up with environmental changes • Products communicate to promote alignment between insurer and customer See additional guidelines in the appendix 2 of this document
Underwriting Practices	• Financial underwriting ensure that benefits cover insurable interests and promote loss minimisation • Insured events updated to keep up with the customer's changing circumstance (alignment with APRA's requirements on the 5 year financial underwriting) See additional guidelines in the appendix 2 of this document
Claims	• Claims team has the capacity and skills to access the claims definition • Claims team actively plans, encourages and implements return to work/wellness with claimants See additional guidelines in the appendix 2 of this document
Pricing for Uncertainty	• Pricing assumptions put a cost on uncertainty for at least 5 years • The pricing philosophy addresses key question of equity • Annual sustainability assessment/ actuarial control cycle See additional guidelines in the appendix 2 of this document

Refer to appendix 1 or 2 for additional material and extracts from APRA and Actuaries Institute requirements.

How does this change your advice?

Many of these requirements will have an impact on your recommendations and how you talk to your clients about Income Protection from 1 October 2021. With this in mind, here are some considerations on ways that you can support your clients:

APRA Guided Change	**Considerations**
Income at Risk	• Ensure that you have reviewed a client's income over several years to determine if the income is stable or variable. • Ask the client to provide you with their tax returns over the last 3–5 years to support your recommendation. • Ensure that you frequently review your clients' coverage amount with a conversation or structured review or process. • Emphasise in your SOA/ROA the importance of the clients notifying you of any significant changes to their salary or employment.

APRA Guided Change	Considerations
Income Replacement Ratios	• Consider how you are currently recommending Income Protection and review your insurance philosophy to manage the reduction in the percentages covered. • Utilise other benefits to protect the Income Protection claim payment. You can only attempt to do this as there is no certainty other benefits will execute at the time of claim or during the claim. However, utilising a stepping stone approach to the cover could be a consideration. By using Crisis, Crisis Extension and TPD to do the heavy lifting for covering debt, freeing up capacity of the claimable Income Protection amount.
Policy Contact Terms Note: the 5 year contract terms have been delayed until 1 October 2022	• Insurers will work tirelessly to create simplified processes for your clients. Dependent on the nature of the final 5 year design, this might include; - Early notifications of the 5-year anniversary. - Digital programs to deliver requirements to your clients for simplified acceptance should there be no additional changes to the specific circumstances such as occupation. - Changes to the product terms and conditions with regular product updates. • Educate your client of the 5-year responsibility, strongly encourage if they have not sought advice from you within the 5 -years that a structured review is conducted at this time. • Potentially consider building a process within your Client Record Management (CRM) system to execute a reminder of the 5-year anniversary obligations. • Seek council on regular product updates from your Client Development Manager or Associate. • Regularly review your insurance philosophy to ensure it is still aligned with the product constructs that are offered in market every year.
Benefit Periods	• Ensure that you have the most current PDS of the insurers who you regularly utilise with your clients. • Seek Client Development support to understand regular product updates.
Actuaries Institute	
Product Design	• Discussions with your client about the return to work programs that your client's policy supports. • Products that have been designed in alignment of The Actuaries Institute guidance will hold a suitability score. This score can be an additional anchor within your recommendation. The higher the sustainability score, the great the chance of stable premiums. • Rehabilitation supports a wide range or return to work programs, adding additional value to the client during the claims process. • Ensure that your client understands total disability and partial disability definitions. Note with your client that after 24 months on claim the 'own' occupation definition will alter to 'education, training and experience' definition. Check the client's prior education to understand how this definition could potentially impact them. • At the time of review, always check the client's occupation hasn't changed, and advise them appropriately where there has been an alteration to their occupation. • Ensure that you have the most current PDS of the insurers who you regularly utilise with your clients. • Seek AIA Client Development Manager support to understand regular product updates.
Underwriting Practices	• Within your Fact Find take into consideration all income streams, whether via personal exertion or passive, ensuring the client is not over insured. • Insurers will work with you and your client to ensure your client can easily apply for their cover at 5 years. • Educate your client of the 5-year responsibility, strongly encourage if they have not sought advice from you within the 5 years that a structured review is conducted at this time. • Potentially consider building a process within your Client Record Management (CRM) system to execute a reminder of the 5-year anniversary obligations. • Seek counsel on regular product updates from your AIA Client Development Manager or Associate.
Claims	• Form strong working relationships with your client's claims officer to ensure that you and your client are regularly up to date with the claim and the requirements need to manage the claim. • Talk with your client about rehabilitation programs and support them with a return to work strategy, when needed. Work can play a critical function in mental health and in an individual's wellbeing.

APRA Guided Change	Considerations
Pricing for Uncertainty	• Pricing assumptions are not a guarantee that premiums will remain unchanged. It will be important to discuss pricing fluctuation within initial conversation and work to find an appropriate product that manages long term affordability. • Using a stepping stone strategic approach may reduce the reliance on Income Protection. • Taking sick leave, private health and other self-funding mechanisms to extend the waiting period could be a consideration. • Note within your SOA that annual Sustainability assessment may result in pricing changes that haven't been projected into your quote.

With the above new requirements in mind, Income Protection CORE has been carefully designed as part of our suite of products to help improve the future viability of Income Protection in Australia and deliver more stable and more affordable premiums for your clients.

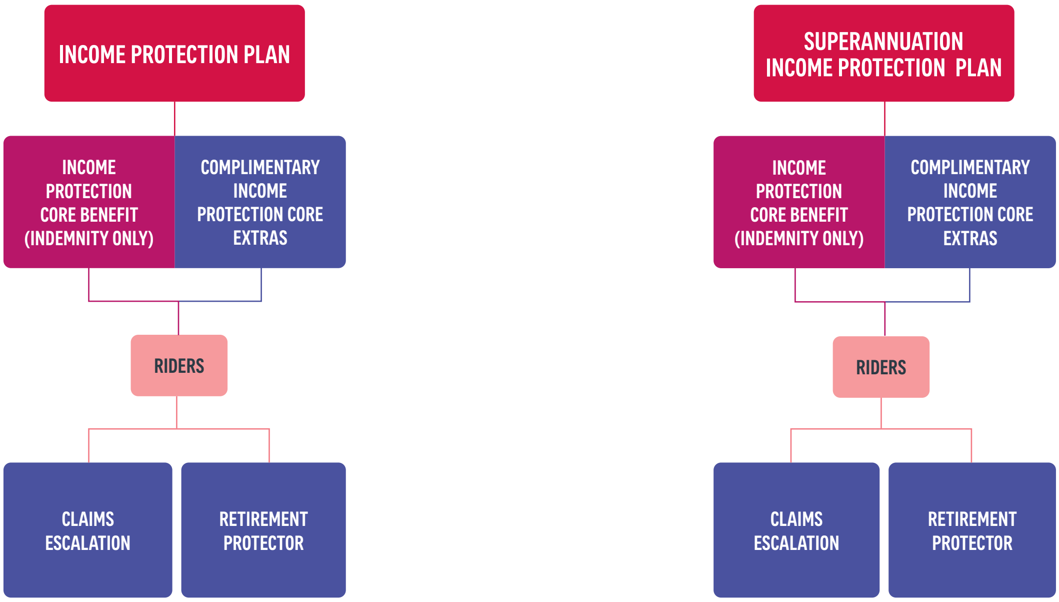
Through this cover, your clients will now have greater ability to tailor their Income Protection to their personal needs and budget.

What is Income Protection CORE?

Income Protection CORE is about getting back to basics and focusing on what Income Protection cover was designed to do. It provides a monthly replacement income that is calculated based on your client's current income should they become totally or partially disabled and unable to work to their usual capacity. With built in benefits and services, Income Protection CORE can also help get your client back to meaningful and sustained work, either in their own role or to a different role.

Income Protection CORE responds to APRA and the Actuaries Institutes's new Income Protection requirements which require certain changes to the products we can offer.

AIA INCOME PROTECTION PLANS



How is Income Protection CORE different to previous Income Protection covers?

Like previous Income Protection covers, Income Protection CORE provides a monthly benefit if your clients become Totally or Partially Disabled – however, there are some significant differences that are important to understand.

Please note this is only a summary of the key differences between these products. For full details please refer to the Product Disclosure Statement (PDS).

Summary of key differences:

	Income Protection* *Not open for New Business	**Income Protection CORE**
Cover Basis	Indemnity, Extended Indemnity	Indemnity only
Income Replacement Ratio	Up to 75% of Pre-disablement Income.	Up to 70% of Pre-disablement Income for 24 months of benefit period, then 60% for remainder of benefit period.
Policy Term	Guaranteed renewable until the Expiry Date.	Guaranteed renewable until Expiry Date
Expiry Date	Choice of Policy anniversary prior to your 65th birthday or 70th birthday. Note: Depending on your occupation category	Policy anniversary prior to your 65th birthday
Waiting Period	14, 30, 60, 90 days and 1 and 2 years.	30, 60, 90 days and 2 years
Benefit Period	2 years, 5 years, to age 65*, to age 70*, 2 year Benefit to age 70* * To policy anniversary before age 65/70	2 years, 5 years, to age 65* * To policy anniversary before age 65
Occupation Categories	A1, A2, M, A3, A4, B1, B2, C1, C2, D, E	A1, A2, M, A3, A4, B1, B2, C1, C2, D
Disability Definition	Unable to perform one or more essential income-producing duties of the usual occupation for more than 10 hours p/w. Total Disablement – Multi Definition also available under Extended Indemnity.	Unable to perform the Material and Substantial Duties of your Own Occupation for initial 24-month Benefit Period and a Suited Occupation thereafter.
Total Disability Benefit	√	√
Partial Disability Benefit	√	√ Must be earning income of less than 80% of Pre-Disablement Income. After 2 years capability based on maximum of 40 hours or 80% of pre-disability hours.
Definition of income	Can include employer superannuation contributions for employees.	Excludes employer superannuation contributions for employees.
Pre-disablement income	12 consecutive months or latest financial year preceding disablement. Under Extended Indemnity option, highest averageof monthly Income in any consecutive 12-month period in the three years immediately prior to disablement.	12 consecutive months or latest financial year preceding disablement. (Can be extended to 24 months where there is a >25% reduction in income year on year)
Benefit Offsets	Fewer offsets.	Broader list of offsets.
Benefit Indexation	√ Higher of CPI increase and 3%	√ Increase limited to the CPI increase.
Guaranteed Insurability/Salary Increase Benefit	√	√
Recurrent Benefit	√	√

	Income Protection* *Not open for New Business	Income Protection CORE
Waiver of Premium	√	√
Rehabilitation Benefit	√	√
Death and Terminal Illness	√	×
Needlestick Benefit (Occupation Category M only)	√	√
Cosmetic or Elective Surgery benefit	√	×
Involuntary unemployment Waiver of Premium	√	√
Accident Only Options	√	×
Optional Benefits	Access to a range of additional benefits through the advantage and Plus options.	No additional optional benefits.
Rider Benefits	Range of rider benefits including Day 1 Accident, Income Protection Lump Sum, Carers allowance, Retirement Optimiser or Business Expenses.	Claim Escalation and Retirement Protector.
Superannuation Option	√ Benefits not permitted under Super legislation available via a separate Super Extras policy.	√ Benefits not permitted under Super legislation provided to all insureds via a separate Complimentary Income Protection CORE Extras policy.

Please note this is only a summary of the key differences between these products. For full details please refer to the Product Disclosure Statement or talk to your Client Development Manager or associate.

Here's an example of Income Protection CORE in action

At 51, Sam is an accountant who has been with her firm for 7 years.

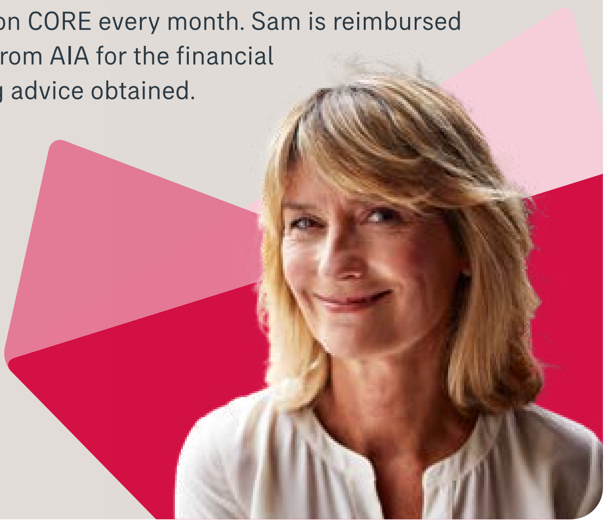
You see that she needs income protection, however she has Death cover of $1,200,000, Crisis Recovery of $600,000 and TPD of $800,000. You see this as an opportunity to look at a simple Income Protection product that will work in combination with her current cover, not in isolation.

Income Protection CORE will cover her for 70% of her income, which has been consistent over 7 years. You arrange Income Protection cover which insures her for $5,833 per month.

By working in combination, Income Protection CORE supports Sam when she's diagnosed with MS and is unable to continue with work, her pre-disablement income has been consistent allowing her PDI to equal the monthly benefit coverage of $5,833. At the same time Sam receives her Crisis Recovery payment of $600,000, allowing her to pay down debt, freeing up her income protection payment for medical and monthly payment needs.

Unfortunately, Sam's MS hasn't been stabilised and her illness is progressing, Sam has been on claim with AIA Income Protection CORE for 24 months. At this time Income Protection CORE will reduce to 60% of her income to $5,000 per month, however Sam also has TPD cover and is now aware that she's totally and permanently disabled (TPD) and unlikely to return to any work. She submitted a TPD claim and AIA determined that Sam meets the TPD definition and is paid $800,000.

Sam seeks advice on how to utilise this money to deliver an income stream for her family and herself, giving her greater flexibility around the payment of Income Protection CORE every month. Sam is reimbursed $3,000 from AIA for the financial planning advice obtained.



Choosing between salary continuance (inside a group super policy) or self owned Income Protection

As an adviser, you play an integral role in helping your clients recognise the importance of income protection and help them to manage their cash flow and any potential risks. However, for many clients the decision to hold income protection insurance comes down to affordability.

But what should your clients consider when deciding on how to structure their income protection cover? When thinking more broadly than Income Protection CORE and whether insurance should be held inside or outside of superannuation, it is important to note that some of the key features remain the same, such as:

- Premiums are generally tax deductible under both ownership structures
- The after-tax cost of the premiums is generally the same for the client under both structures, and
- Upon claim, monthly benefit payments are taxed at the client's marginal tax rate under both structures as payments are considered 'ordinary income'.

Superannuation-owned income protection

Most superannuation funds offer insurance for their members. There are many benefits of this ownership structure however, clients must also be aware of the potential pitfalls. The points below are the potential advantages and disadvantages to consider when it comes to owning income protection through superannuation.

Advantages

- Premiums can be funded from employer contributions, member contributions or by using their existing superannuation fund balance, which may assist clients in managing their cash flow and affordability of premiums.
- Clients can benefit from income tax savings by claiming a tax deduction for personal contributions or by contributing via a salary sacrifice arrangement using their pre-tax salary which may provide cost savings on premiums.
- For clients who have cover in an insurance-only superannuation fund, they may be entitled to an upfront 15% premium rebate on rollovers made to the fund to pay for their premiums. The 15% rebate represents the tax concession the fund trustee receives from claiming a tax deduction on premiums paid, which is passed back to members.
- The trustee of the superannuation fund will generally withhold PAYG tax on benefit payments before the monthly benefit is paid to the client.

Disadvantages

- In addition to meeting the insurance policy definition of incapacity, the client must also meet the temporary incapacity condition of release under superannuation law before the trustee can pay the Income Protection benefit to the client (i.e. client must cease employment due to illness or injury to meet eligibility requirements). Based on this, there is a risk the benefits may not be received if and when the insurable event occurs.
- Payments may be delayed as benefits must generally be paid by the insurer to the trustee first.
- Premiums can erode retirement savings if clients don't make extra contributions to negate premium cost.
- Contributions made to fund premiums count towards the contribution caps.
- Additional fees may be payable when funding premiums by way of rollover from another complying superannuation fund.

Income protection outside of superannuation

Owning income protection outside of superannuation can provide clients with more product features and flexibility when compared with owning insurance inside superannuation. Below are some of the main advantages and disadvantages when it comes to having a personally owned income protection policy.

Advantages

- Premiums are generally tax deductible for the client if they are both the life insured and the policy owner.
- Can provide protection even if the life insured is not employed at the time of incapacity.
- Policies are customisable and available under different ownership structures (e.g. may be used for business purposes, such as covering business expenses in the event of illness or injury).
- Can elect for cover to increase the monthly benefit in line with inflation to ensure cover keeps up with the rising cost of living beyond their current income.
- May be able to exchange ongoing payments for a lump sum benefit.

Disadvantages

- If the income protection policy provides for benefits of an income and capital nature, the ATO's view is that only that part of the premium attributable to the income benefit is deductible.[1]
- Pre-existing medical conditions and lifestyle factors such as smoking may impact the cost of premiums (whereas taking insurance via a group insurance policy held inside superannuation may have automatic acceptance).
- As PAYG tax is generally not withheld from benefit payments, clients must remember to declare the income replacement component in their income tax return.

When it comes to weighing up the option of having a linked policy, the same pros and cons of having insurance inside versus outside superannuation apply. For example, clients can tailor what cover is inside and outside of superannuation and not compromise their level of cover. This is because a linked policy outside of superannuation gives clients access to enhanced cover and optional benefits that are not available inside superannuation.

However, there are some extra factors that clients should consider when it comes to linked policies, such as:

- The client cannot choose which policy they are paid under upon claim time. If an income protection claim is made, it will firstly be assessed under the superannuation policy.
- The insured monthly benefit amount under both income protection policies must be the same at all times.
- The total benefit payable under both policies cannot exceed the total insured monthly benefit under the superannuation income protection plan.
- If the insured monthly benefit is reduced under either the superannuation policy or the linked benefit under the ordinary policy, the same reduction may apply to the other policy.

1 https://www.ATO.gov.au/individuals/income-and-deductions/deductions-you-can-claim/other-deductions/income-protection-insurance/

Comparison of policies owned inside versus outside of superannuation

The table below provides a summary of the key differences between the two ownership structures:

	Inside Superannuation (Group environment)	Outside Superannuation (Retail environment)
Type of Policy	**Indemnity**	**Indemnity**[1]
Underwriting	Group policies: assessed for eligibility at the time of claim. No underwriting if cover is within the Automatic Acceptance Limits (AAL). Linked Retail policies: underwritten at the time of application.	Underwritten at the time of application.
Maximum Cease Age	Group policies: generally, TA65 but some offering TA67 and 70. Linked Retail policies: to age 65.	To age 65.
Waiting Periods	Group policies: may be limited to have waiting periods of 30 or 60 days. Linked Retail policies: can have waiting periods ranging from 14 days to 2 years.	Policies can have waiting periods ranging from 14 days to 2 years.
Benefit Period	Group policies: mainly 2 year but many available with to age 65 . Linked Retail policies: 2 year, 5 year, to age 65.	Options are generally available from 2 to 5 year benefit periods or to age 65. Some policies may also have to age 70 or more.
Pre-Disability Income (PDI)	Group policies: generally, 12 month look back with some shorter. Linked Retail policies: last 12 month of income from personal exertion. A broader PDI definition may apply if income is deemed volatile.	Last 12 month of income from personal exertion. A broader PDI definition may apply if income is deemed volatile.
Definition of Disability	Group policies: one duty widely available. Linked Retail policies: material and substantial.	Material and substantial.
Partial Disability	Group policies: vast majority include. Linked Retail policies: ceases when income exceeds 80% of PDI.	Ceases when income exceeds 80% of PDI.
Occupation Definition	Group policies: mostly flat Own/Usual Occupation. Note many limit benefit period to 2/5years but a number of schemes are still offering. Linked Retail policies: own first 2 years then Suited thereafter.	Own first 2 years then Suited thereafter.
Offsets	Group policies: broad offset provision. Linked Retail policies: broad offset provision.	Broad offset provision.
Rehabilitation Obligations	Group policies: rehabilitation not always mandatory. Linked Retail policies: no current obligations in product.	No current obligations in product.
Can Cover Super Contributions	Group policies: Mostly available. Linked Retail policies: yes.	Yes.
Claims	Claim must meet requirements set by the insurer and the trustee of the superannuation fund must determine that a condition of release has been met.	Claim is commenced directly with the insurer.

	Inside Superannuation (Group environment)	Outside Superannuation (Retail environment)
Type of Policy	**Indemnity**	**Indemnity**[1]
Deductibility of Premiums	Generally, tax deductible to the superannuation fund. Clients may be eligible to claim a tax deduction for personal contributions or salary sacrifice contributions made to their superannuation fund.	Generally, tax deductible for the portion of the premium attributed to benefits that replace income[2].
PAYG tax withheld	PAYG tax is withheld by the trustee of the superannuation fund before monthly benefit is paid to client.	No PAYG tax is generally withheld when benefit is paid to the policy owner, however income replacement component of payment must be declared on client's annual tax return and taxed at their marginal rate.
Remuneration	Group policies: no remuneration Linked Retail policies: commission or fee based	Commission or fee based

1 Agreed value policy available if purchased before 31 March 2020.
2. The ATO has provided guidance stating that the portion of the premium attributed to benefits that are capital in nature are not deductible https://www.ato.gov.au/individuals/income-and-deductions/deductions-you-can-claim/other-deductions/income-protection-insurance/

Considerations for you and your clients

Making the right choice when purchasing income protection insurance will depend on the different requirements of each client. For example, clients who have sufficient cash flow may be better suited to having income protection outside superannuation whereas clients with cash flow sensitivities such as small business owners or young families with tight finances, might have no choice but to insure their incomes inside superannuation not withstanding the impact of premium erosion on their underlying superannuation retirement savings.

As this is a complex area for clients to navigate alone, it is important for advisers to explain to their clients the advantages and disadvantages of insurance policy ownership and the benefit of regularly reviewing their insurance needs. Unlike personal lump sum cover, premiums for income protection are generally tax deductible which may alleviate any cash flow sensitivities prevailing at a given time.

Explaining Income Protection CORE as an adviser

Through in-depth consultation with both advisers and licensees, Income Protection CORE was designed so AIAA could meet the APRA and Actuaries Institute requirements, ensure financial losses are protected, and manage affordability; while balancing your 'best interest duty' obligations as an adviser.

AIAA has identified three key areas where Income Protection CORE can create a positive outcome for clients:

1 Addressing long-term affordability concerns
2 Stepping Stone Insurance Strategy
3 Post 2021 – Retention Strategy and Premium Rate Minimisation

1. Addressing long-term affordability concerns

Once an adviser conducts the 'Fact Find' with a client and has identified a need for Income Protection within a full insurance program, e.g. Life, Crisis, TPD with Income Protection, or in isolation; the adviser will prepare the recommendation for the Statement of Advice (SOA).

As part of your 'Best Interest' duty you are obligated to ensure that the client can not only afford the cover today and into the short term; however you must consider the long-term affordability of Income Protection.

If you have a client that has objections with the initial premium, then placing them into Income Protection may result in increased premiums and a risk that you've not meet the obligations of ensuring your client can manage the premiums in the future.

Should you recognise there is a long-term affordability issue, the consideration of Income Protection CORE is valid and allows you to still meet the client's coverage needs and manage costs. The Actuaries Institute sustainability rating can support you addressing affordability concerns, as the higher the rating from The Actuaries Institute score increases, the expectation is the policy has been built to manage long term stability in premium movement.

Bear in mind that income protection cover could be one of several funding mechanisms capable of being deployed in the event of a temporary illness. Knowing what these alternative funding solutions could comprise of may influence the manner in which IP Core is structured, which in turn may garner premium cost efficiencies for clients going forward.

For example, the client may already have, or be in a position to be able to accumulate, meaningful cash reserves, or emergency funds, that could top-up a monthly insured benefit to meet day-to-day cash flow requirements and ad-hoc medical costs immediately following the injury or onset of illness. The income stream produced by this pool of capital, which is effectively a return of the client's own cash, could work in tandem with the monthly insured benefit to normalise cash flow while the client remains off work.

Likewise, some clients may have accumulated significant leave balances that could replace 100% of employment income for days, weeks or indeed even months. This could provide a crucial source of income whilst off work and allow for an extended waiting period.

Interplay with Private Health Insurance

Private health insurance also has an important role to play in the event of temporary illness or injury. Ordinarily, Medicare will pay 75% of the Medicare Benefits Schedule (MBS) fee for treatment of private patients in hospital. If private health cover exists and qualifying criteria has been met, the private health insurer will then pay the remaining 25% (if eligible for benefits for those items under the private health insurance policy).

Clients with taxable income in excess of the prevailing surcharge level are likely to have private health cover in place, not least due to the threat of being slugged with the Medical Levy Surcharge. Having Private Health Insurance in place affords your clients choice of specialists to see and quicker access to treatment. While financial advisers are not expected to be experts when it comes to the world of private health insurance, at the very minimum it may be prudent to refer such clients for a review of their existing private health insurance arrangements. At your direction, an Insurance Specialist from AIA Health can arrange to contact your client for a comprehensive review, with a referral fee payable to you for any subsequent AIA Health policy taken out by the client. Please contact your local AIA Client Development Manager for more information.

Considerations when taking this approach:

The client needs to be aware that when they utilise Income Protection CORE that there are limitations with the Income Protection CORE product with regard to coverage limits and the calculations of pre-disablement income. There are also limitations with the definitions while on claim.

Without the usage of Life, Crisis and TPD, the client is exposed to lower sum insured, which could result in their immediate financial needs not being fully insurable.

Ensure that the client makes contact with you yearly to ascertain if the sums insured are still warranted and that there are no changes to their health, financials, past-times or occupation.

Within annual reviews, be aware of the client's health for the year before to ascertain if there have been any claimable events. At review, walk the client through the claims scenarios so there is a reaffirmed understanding the Income Protection CORE and your insurance strategy that has been implemented.

When reviewing a clients current income protection policy:

When presenting the SOA, the client must understand why you recommended Income Protection CORE instead of Income Protection, and it is extremely important to reaffirm that they have affordability issues which resulted in an APRA-styled contract being recommended as this product does have limitations.

The Actuaries Institute sustainability score can be taken into consideration within your supporting discussions with clients or within the SOA, as evidence when presenting this approach.

We believe that placing the table below within the SOA – and highlighting the product selection – will support a higher level of understanding of the product differences.

Summary of key differences:

	Income Protection* *Not open for New Business	**Income Protection CORE**
Cover Basis	Indemnity, Extended Indemnity	Indemnity only
Income Replacement Ratio	Up to 75% of Pre-disablement Income.	Up to 70% of Pre-disablement Income for 24 months of benefit period, then 60% for remainder of benefit period.
Policy Term	Guaranteed renewable until the Expiry Date.	Guaranteed renewable until Expiry Date
Expiry Date	Choice of Policy anniversary prior to your 65th birthday or 70th birthday. Note: Depending on your occupation category	Policy anniversary prior to your 65th birthday
Waiting Period	14, 30, 60, 90 days and 1 and 2 years.	30, 60, 90 days and 2 years
Benefit Period	2 years, 5 years, to age 65*, to age 70*, 2 year Benefit to age 70* * To policy anniversary before age 65/70	2 years, 5 years, to age 65* * To policy anniversary before age 65
Occupation Categories	A1, A2, M, A3, A4, B1, B2, C1, C2, D, E	A1, A2, M, A3, A4, B1, B2, C1, C2, D
Disability Definition	Unable to perform one or more essential income-producing duties of the usual occupation for more than 10 hours p/w. Total Disablement – Multi Definition also available under Extended Indemnity.	Unable to perform the Material and Substantial Duties of your Own Occupation for initial 24-month Benefit Period and a Suited Occupation thereafter.
Total Disability Benefit	√	√
Partial Disability Benefit	√	√ Must be earning income of less than 80% of Pre-Disablement Income. After 2 years capability based on maximum of 40 hours or 80% of pre-disability hours.
Definition of income	Can include employer superannuation contributions for employees.	Excludes employer superannuation contributions for employees.
Pre-disablement income	12 consecutive months or latest financial year preceding disablement. Under Extended Indemnity option, highest averageof monthly Income in any consecutive 12-month period in the three years immediately prior to disablement.	12 consecutive months or latest financial year preceding disablement. (Can be extended to 24 months where there is a >25% reduction in income year on year)
Benefit Offsets	Fewer offsets.	Broader list of offsets.
Benefit Indexation	√ Higher of CPI increase and 3%	√ Increase limited to the CPI increase.
Guaranteed Insurability/Salary Increase Benefit	√	√
Recurrent Benefit	√	√
Waiver of Premium	√	√
Rehabilitation Benefit	√	√
Death and Terminal Illness	√	×
Needlestick Benefit (Occupation Category M only)	√	√
Cosmetic or Elective Surgery benefit	√	×

	Income Protection* *Not open for New Business	**Income Protection CORE**
Involuntary unemployment Waiver of Premium	√	√
Accident Only Options	√	×
Optional Benefits	Access to a range of additional benefits through the advantage and Plus options.	No additional optional benefits.
Rider Benefits	Range of rider benefits including Day 1 Accident, Income Protection Lump Sum, Carers allowance, Retirement Optimiser or Business Expenses.	Claim Escalation and Retirement Protector.
Superannuation Option	√ Benefits not permitted under Super legislation available via a separate Super Extras policy.	√ Benefits not permitted under Super legislation provided to all insureds via a separate Complimentary Income Protection CORE Extras policy.

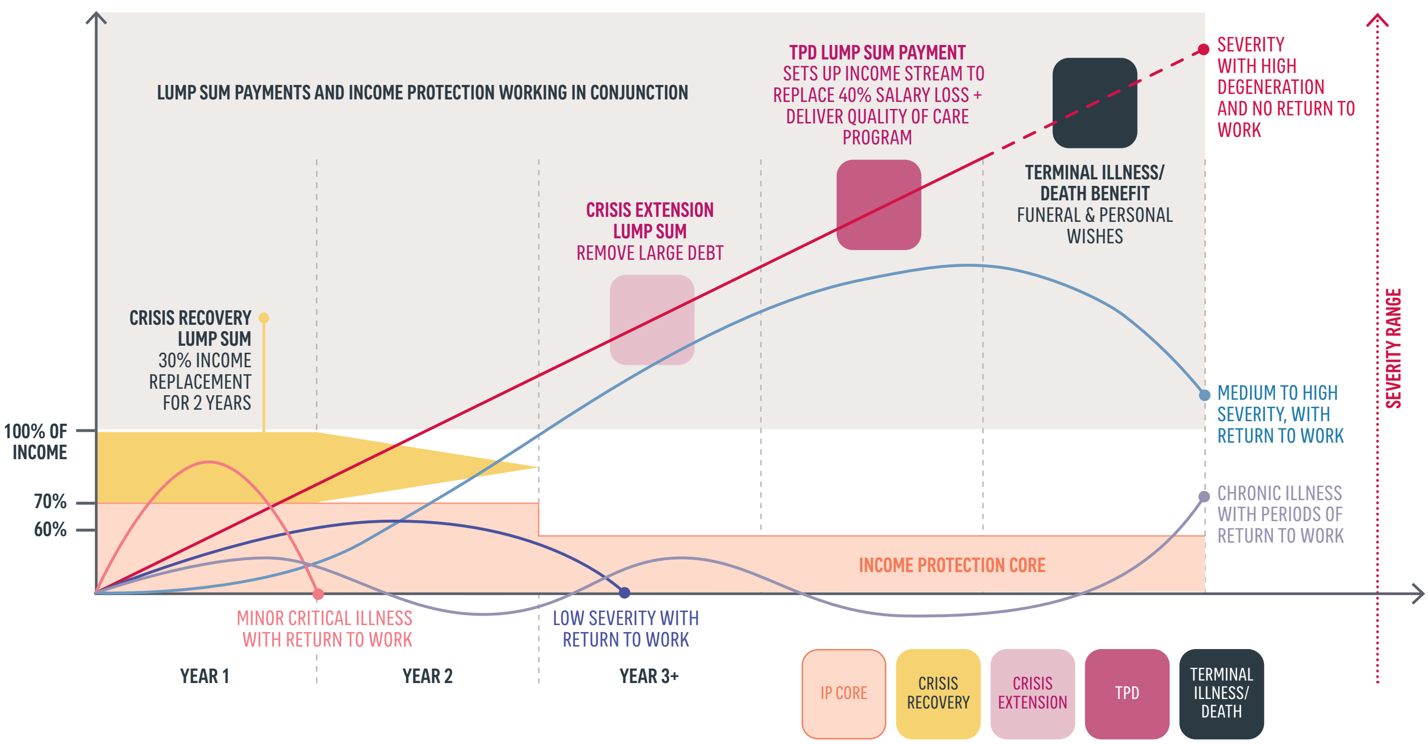
Please note this is only a summary of the key differences between these products. For full details please refer to the Product Disclosure Statement or talk to your Client Development Manager or Associate.

2. Stepping stone insurance strategy

Insurance strategies can never been designed to ensure that a client is fully protected against unknown risk. As an adviser the best you and an insurance solution can offer is if something significant occurs through illness, injury or disablement that you've reduced the financial risk exposure, and that the cover delivers the claim to them when they need it to manage short-term and long-term financial requirements. You are never able to give a client absolute certainty of payment and protection of loss.

To manage a client's risk the utilisation of all benefits in a stepping stone strategy can manage premiums, and also show the client how each product works as part of a combined insurance strategy.

FIGURE 3: STEPPING STONE STRATEGY



Income Protection CORE complements this particular strategy by only covering 70% PDI in the first 2 years and 60% thereafter for the benefit period. By using Crisis Recovery, Crisis Extension, TPD and Life cover in combination it allows the premiums to be managed through all benefits and if the client returns to work, they will still have additional insurance in place to protect them for future issues. If they deteriorate, other claim payments from complementary cover kicks in.

This allows the Income Protection CORE to work at replacing required income and enables the other benefits to do the heavy lifting of helping cover debt and creating future earnings lost, while maximising premium efficiencies.

Considerations when taking this approach:

The client needs to be aware that when they utilise Income Protection CORE within a stepping stone strategy, that the progression of their illness may mean that only some of their benefits become payable rather than together with Crisis Recovery and/or TPD. The Crisis Recovery and/or TPD Cover benefits may become payable later after their condition has further deteriorated.

When using Crisis Extension within this strategy it will operate separately from Crisis Recovery, which will trigger for illnesses that pose lower financial stress. When a serious illness occurs, exposing them to higher and significant financial risk, both benefits (Crisis Extension and Crisis Recovery) will operate concurrently.

The client needs to clearly understand if Income Protection CORE triggers without any additional benefit offering a claimable amount that there is a shortfall that will need to be covered through a self-funded program, or the client will need to consider a reduction in household expenditure.

Ensure that the client makes contact with you yearly to ascertain if the sums insured are still warranted and that there are no changes to their health, financials, past-times or occupation.

Within annual reviews, be aware of the client's health for the year before to ascertain if there have been any claimable events. at review, walk the client through the claims scenarios so there is a reaffirmed understanding the Income Protection CORE and your insurance strategy that has been implemented.

When presenting the SOA, the client must understand that Income Protection CORE covers a loss in salary and that Crisis Recovery and Crisis Extension are for specific illnesses. TPD is for a total and permanent disablement.

When reviewing a clients current income protection policy:

We believe that placing the table on pages 17–18 within the SOA – and highlighting the product selection – will support a higher level of understanding of the product differences between Income Protection and Income Protection CORE.

When presenting the SOA, the client must understand why you recommended Income Protection CORE instead of Income Protection, and it is extremely important to reaffirm that they have affordability issues which resulted in an APRA-styled contract being recommended as this product does have limitations.

EXAMPLE

INCOME CORE DESIGNED TO REPLACE BETWEEN 70-60% OF YOUR EARNED INCOME

PAYS EVERYDAY EXPENSES, BILLS AND MORTGAGE REPAYMENTS

CRISIS RECOVERY (IF CLAIMABLE) DESIGNED TO REPLACE BETWEEN 30–40% OF YOUR EARNED INCOME

ENABLES YOU TO CONTINUE TO HAVE APPROX. 100% OF INCOME FOR UP TO 2 YEARS

CRISIS EXTENSION (IF CLAIMABLE) DESIGNED TO ENSURE A LUMP SUM PAYMENT

ENABLES YOU TO REMOVE MORTGAGE DEBT AND MANAGE EDUCATION, HOLIDAY AND MANAGE MEDICAL COSTS

TPD (IF CLAIMABLE) DESIGNED TO ENSURE A LUMP SUM PAYMENT

ENABLES YOU TO CREATE AN INCOME STREAM, MANAGE QUALITY OF CARE PROGRAM AND SUPPLEMENT INCOME PROTECTION FOR EVERYDAY EXPENSES

3. Post 2021 – Retention Strategy and Rate Minimisation

Retention strategy

AIAA understands that retention plays a significant role in an adviser's business. The current climate has made this particularly challenging to ensure your clients retain insurance cover. When trying to discuss retention strategy with clients, advisers are often forced to compromise benefits or coverage amounts. By utilising the long-term affordability strategy on page 15 you are better able to ensure that during these challenging times, additional support can be offered to your clients.

Income Protection CORE can be utilised through a 'cancel and replace' strategy on the client's existing Income Protection cover.

For details on the cancel and replace process reference the Adviser Guide – Section E Policy Services Procedures (alterations to Policies).

Advisers will be required to do this via a Cancel & replace Form as long as the following criteria is met:

- Total sum insured remains the same, however note only 70% of pre-disablement income instead of 75% will be covered.
- No claims have been paid: the insured has not been paid an Income Protection claim.
- There are no loadings or exclusions.
- They are still gainfully employed under the same occupation.
- No new past times have been taken up since the start of this policy.

Considerations when taking this approach:

When creating a retention strategy, take extreme care and consideration with 'cancel and replace'. Avoid accidentally cancelling any benefits (such as agreed value income protection) and double-check the policy and benefit construct of any policy that is being cancelled. We encourage you to inform AIAA of the specific benefits that are being cancelled and replaced. Do not request full cancellation if the client is planning to keep benefits active within the old policy.

Any policy that is under two years may hold LIF responsibility on remuneration that could be subject to clawback.

When exercising a retention strategy, clients may be subject to underwriting if additional risks are being held by AIAA (or reassurance) upon the change.

Clients will need to be aware of the change in products within the ROA (or SOA if required by your Licensee).

The client needs to be aware that when they utilise Income Protection CORE that there are limitations with the Income Protection CORE product with regard to coverage limits and the calculations of Pre-disablement income. There are also limitations with the definitions while on claim.

Ensure that the client makes contact with you yearly to ascertain if the sums insured are still warranted and that there are no changes to their financials, past-times or occupation.

Within annual reviews, be aware of the client's health for the year before to ascertain if there have been any claimable events. At review, walk the client through the claims scenarios so there is a reaffirmed understanding the Income Protection CORE and your insurance strategy that has been implemented.

When presenting the SOA, the client must understand why you recommended Income Protection CORE instead of Income Protection, and it is extremely important to reaffirm that they have affordability issues which resulted in an APRA-styled contract being recommended as this product does have limitations.

We believe that placing the table on pages 17–18 within the SOA – and highlighting the product selection – will support a higher level of understanding of the product differences between Income Protection and Income Protection CORE.

Premium Rate Minimisation:

As the industry continues to review premiums rates, APRA and The Actuaries Institute indicated their concerns with regards to the sustainability of the Income Protection that was in market. At AIAA, we review Income Protection, and every attempt is made to keep premium affordable.

Income Protection CORE will help clients to minimise or even circumnavigate any changes in the current policy's premiums. By referring to the long-term affordability strategy and retention strategy options discussed above, advisers will able to offer solutions to clients on any changes in premium that were not factored into the original recommendation.

Considerations when taking this approach:

When creating a premium rate minimisation strategy, take extreme care and consideration on the alteration in which you are about to implement either with an adjustment of cover from Crisis Recovery to Crisis Extension or with 'cancel and replace'. Do not accidentally cancel or reduce definitions that held broader definitions without consultation with the client, e.g. prostate cancer. Double-check the policy and benefit construct of any policy that is being altered or cancelled.

We encourage you to inform AIAA of the specific benefits that are being cancelled and replaced. Do not request full cancellation if the client is planning to keep benefits active within the old policy.

Any policy that is under two years may hold LIF responsibility on remuneration that could be subject to claw back.

When exercising a retention strategy, clients may be subject to underwriting if additional risks are being held by AIAA (or reassurance) upon the change.

Clients will need to be aware of the change in products within the ROA (or SOA if required by your Licensee).

The client needs to be aware that when they utilise Income Protection CORE that there are limitations with the Income Protection CORE product with regard to coverage limits and the calculations of Pre-disablement income. There are also limitations with the definitions while on claim.

When presenting the SOA, the client must understand why you recommended Income Protection CORE instead of Income Protection, and it is extremely important to reaffirm that they have affordability issues which resulted in an APRA-styled contract being recommended as this product does have limitations. The 'Summary of the key difference' table shown above outlines this.

We believe that placing the table, shown on pages 17–18 of this document and within the AIA adviser SOA document – and highlighting the product selection – will support a higher level of understanding of the product differences between Income Protection and Income Protection CORE.

Appendix 1

APRA Additional guidance – Extracts from the APRA website

1. Income at risk

APRA considers it imperative that claim payments should be consistent with the principle of indemnity, thereby avoiding moral hazard as far as possible. In the December 2019 letter, APRA asked for feedback on the appropriateness of using a 12 month period to determine the income at risk, as well as the protections to be considered for policyholders whose income fluctuates due to reasons such as unpaid parental leave or contract work. Feedback received:

- indicated that there are several occupations and/or industries where income can be volatile and where using the most recent 12 month period may not result in a reasonable definition for income at risk; and
- suggested a variety of ways to deal with the specific circumstances where there may be income fluctuations, for example, as a result of unpaid parental leave.

APRA remains of the view that annual earnings in the 12 months prior to the time of claim event is suitable in calculating income at risk where the insured's pattern of expected income is likely to be stable. However, APRA recognises that income may vary considerably from one year to the next for certain segments of the workforce. Where income is subject to such variability, APRA considers it appropriate for the income at risk to be based on the average earnings over periods longer than the 12 month period prior to the time of claim event.

APRA IDII Product Measure 1: Income at Risk

To address the issues related to income at risk:

1.1 with effect from 31 March 2020, APRA expects life companies to have discontinued writing IDII contracts where insurance benefits are not based on income at the time of claim, including agreed value (and endorsed agreed value) contracts;

1.2 with effect from 1 October 2021, APRA expects that, for policyholders with a predominantly stable income, the income at risk for new IDII contracts should be based on annual earnings at the time of the claim event, not older than 12 months; and

1.3 with effect from 1 October 2021, APRA expects that, for policyholders with an income that is variable, the income at risk be based on average annual earnings over a period of time appropriate for the occupation of the policyholder and reflective of future earnings lost as a result of the disability.

Additional considerations and guidance:

a) APRA believes that income at risk should be based on income earned through personal exertion. There are views it could be beneficial for industry to adopt a standard definition for income at risk. APRA views this as something for the industry to consider further.

b) APRA acknowledges that, in the absence of income at risk, there may still be a legitimate need for cover. In these limited circumstances, APRA expects that products and cover levels be defined with due consideration of the principles outlined earlier.

c) Where appropriate, the time periods in this measure could also be defined to correspond with Australian tax years.

2. Income replacement ratio

Current IDII products have features and ancillary benefits that can result in income replacement ratios exceeding 100 per cent. It is widely accepted that returning to health, and potentially to work, where possible, is in the interest of both the individual claimant and the community at large. Excessive income replacement ratios may reduce incentives to return to work, thereby potentially impeding better health outcomes and increasing claim durations.

To assist with the finalisation of this measure, APRA asked for feedback on a number of specific items, including the appropriateness of setting at six months an initial period that allows for higher income replacement ratios, the appropriateness of applying a limit of 75 per cent after the initial six months, as well as the appropriateness of a $30,000 monthly benefit limit. The feedback received can be summarised as follows.

- an initial period of six months during which benefits are allowed to be higher was supported by most respondents;
- generally, there was support for a benefit limit of 75 per cent after the first six months. But there were also calls for the long term benefit limit to be lowered to bring about step change;
- There were a number of submissions challenging the appropriateness of permitting a higher benefit limit during the initial six months. This feedback was underpinned by the view that return to work strategies focused on the period immediately after the claim event are generally most effective; and
- respondents generally questioned the benefit of placing a simple dollar limit on monthly benefits, also considering that most life companies already apply some form of tapered benefit limit.

In deciding on appropriate income replacement limits, APRA weighed up:

- the need of the claimant to make adjustments and/or deal with additional expenses at the onset of the claim;
- not impacting adversely on strategies aimed at supporting the claimant to return to work; and
- setting limits that do not unnecessarily inhibit the ability of life companies to develop a range of appropriate and innovative products.

APRA acknowledges the value of benefits that support rehabilitation and/or, where appropriate, retraining of a claimant to facilitate a return to employment. Provided such benefits are targeted to support areas of rehabilitation and retraining, and are paid directly to third party providers, they need not be constrained by income replacement limits.

APRA also acknowledges the value and importance of defining IDII benefits that allow for the continuation of superannuation contributions during the claim period. Benefits related to these contributions should however not result in an increase in the income replacement ratio, and should always be paid directly to a superannuation fund.

Finally, whilst it could be appropriate to allow for increases in the benefit payments during the claim period, APRA considers it appropriate for there to be limits to these increases to ensure that the principle of indemnity is maintained throughout the claim duration.

APRA IDII Product Measure 2: Income Replacement Ratio

With effect from 1 October 2021, APRA expects that, for all new IDII policies issued by life companies:

2.1 insurance benefits, taking account of all benefits paid under the IDII product, do not exceed 90 per cent of earnings at time of claim for the first six months of the claim and do not exceed 70 per cent of earnings thereafter;

2.2 indexation of benefit payments (before income offsets are taken into account) to the claimant throughout the claim duration should be limited to a suitable inflation index;

2.3 payments to third parties to support return to work initiatives focused on rehabilitation and retraining (to the extent that it is possible under current legislation) may be made in addition to the above income replacement limits; and

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.

Additional considerations and guidance:

a) The income replacement ratios referred to in APRA's measure are set as boundaries within which life companies should design and manage their IDII products. Benefit levels should be set with consideration of other design features and built-in controls. APRA expects that the risk associated with higher income replacement limits, i.e. a reduced incentive to return to health and potentially work, be mitigated by other design features and/or controls.

b) Benefits and payments in respect of return to health and work initiatives should:

- be designed to improve the probability of the claimant returning to health and work;
- be paid directly to third parties, or where not possible, paid to claimants on a reimbursement basis; and
- not exceed the cost of the service provided.

c) While APRA deems it appropriate that dollar limits be applied to the insurance benefits of high earning policyholders, a single fixed limit may not be appropriate in all circumstances. APRA notes that there is already a practice in the Australian market of applying a tapered approach to limit the benefit level of high income earners and views this approach to be appropriate.

d) APRA notes there are views that a standard definition for disability could contribute to the sustainability of IDII. Standardised disability definitions could contribute to making products more comparable for consumers, but could also reduce life companies' ability to innovate. APRA deems this to be a matter for industry to give further consideration to.

3. Policy contract term

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 wants to ensure that there is an appropriate mechanism 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 should moderate the extent of premium increases that may otherwise be needed.

APRA sought feedback on the appropriateness of using a five-year period for its policy contract term measure. Overall, the feedback received confirmed that a five-year period was considered to be an appropriate duration. APRA also asked for feedback on whether there were alternative approaches that would achieve the objective of not having fixed terms and conditions for extended periods of time. While very little was received in terms of viable alternatives, submissions noted that the measure could have unintended consequences for policyholders, most notably the lack of certainty on the terms of coverage over the long term.

Submissions also highlighted a number of practical considerations, including the potential impact on the advice process, the persistency of policies over the longer term, implications for advisor commissions and level premium contracts, as well as the potential implications of pending legislation on unfair contract terms. It is APRA's view that these matters are best dealt with by the industry, particularly those related to the management of distribution channels. Conduct related implications of the measure will however be considered in the planned joint engagements between APRA, ASIC, life companies and other industry participants.

APRA remains of the view that this measure is an important component of the package of IDII sustainability measures. Without such a mechanism, there will not be a change to current practices that lock in terms and conditions for extended periods, leaving premium as the only lever to address sustainability issues.

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).

Additional considerations and guidance:

a) Notwithstanding the above measure, it remains of paramount importance that products are designed and developed with a view to providing policyholders with stability and transparency in respect of both coverage and price.

b) The advice provided by the Appointed Actuary, analysing the changes in IDII products, should cover:
- details of the change and the impact on premiums;
- reasons for the change and why the previous terms and conditions are no longer considered appropriate; and
- evidence demonstrating that the ongoing sustainability of the IDII product, as well as fairness to existing policyholders with a renewal option (if applicable), have been considered and addressed appropriately.

References to changes in IDII products extend to the introduction of new IDII products, or new options under existing IDII products.

The preceding information should also be captured in the life company's annual FCR.

c) APRA's measure on Policy Contract Term is not intended to curtail the ability of life 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 life 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.

4. Benefit period

Currently, the majority of IDII policies have long benefit periods, typically to retirement age. APRA understands that there may be a legitimate need for products of this nature, and acknowledges that there is nothing inherently wrong with this product feature. However, if the risks associated with long benefit periods are not managed appropriately, they can detract from claimants' motivation to return to work and have an adverse impact on claim duration. Long benefit periods may also exacerbate the impact of other problems in product design and controls.

APRA IDII Product Measure 4: Benefit Period

With effect from 1 October 2021, APRA expects that life companies:

4.1 have effective controls in place to manage the risks associated with long benefit periods, including specific product design features; and

4.2 set internal benchmarks for new IDII products with long benefit periods which reflect their risk appetite and the effectiveness of their controls.

Additional considerations and guidance:

a) Internal benchmarks should reflect the proportion of business with long benefit periods that life companies are comfortable to offer, given their risk appetite. APRA expects that the level of this benchmark reflect the strength of life companies' controls and specifically the design features offered in conjunction with long benefit periods.

b) Product design features that could mitigate the risks associated with long benefit periods include applying a stricter disability definition, or having lower benefit levels when claims exceed a given period.

c) While this measure focuses specifically on the risks associated with long benefit periods, the riskiness of IDII products should be considered holistically, as should the controls to manage and mitigate these risks. As a minimum, life companies are encouraged to give specific consideration to the following design features:
   - disability definition;
   - benefit period;
   - level of income replacement, including the tapering of benefit levels for different levels of income and/or with longer claim duration; and
   - requirements or incentives for claimants to follow medical advice, participate in rehabilitation and/or retraining activities.

   APRA expects that, where a particular design feature increases risk and uncertainty, other design features should provide some risk mitigation. Where multiple riskier product features are offered, APRA expects additional and/or stronger controls.

   This measure expects that life companies set internal benchmarks around long benefit periods. Going beyond this, better practice would be to extend this to all key product design features, taking into account the combined effect of different features and effectiveness of controls.

d) Given that long benefit periods are usually offered to policyholders with a need for long term protection, life companies are encouraged to also give consideration to other products aimed at providing long term disability protection. APRA deems it appropriate for life companies to continuously review their product offerings holistically with the intention to meet policyholder needs, but also to ensure that products are designed and managed in a sustainable manner.

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12 May 2021

TO: ALL LIFE INSURERS AND FRIENDLY SOCIETIES

INDIVIDUAL DISABILITY INCOME INSURANCE: DEFERRAL OF IMPLEMENTATION OF THE POLICY CONTRACT TERM MEASURE

APRA communicated the finalised sustainability measures for individual disability income insurance (IDII) in September 2020.[1] In particular, the policy contract term measure was introduced with the intention of creating a mechanism for life insurers and friendly societies (life companies) to update their IDII products, taking into account changes in the operating environment.

APRA's updated position

APRA, along with ASIC, has been actively engaging with the FSC and other industry stakeholders on the implementation of the policy contract term measure. It has become clear that the industry is unlikely to be able to develop viable solutions for implementing the measure by APRA's previously communicated deadline of 1 October 2021. APRA is aware that life companies have considered various options, but to date have not settled on solutions that satisfy both the legal and operational constraints and without unintended adverse consequences for consumers.

APRA acknowledges the challenges associated with implementing the policy contract term measure, as well as the industry's efforts to date in working to formulate viable solutions. Nevertheless, APRA views this measure as an important mechanism to manage the risks associated with long contract terms. Without the policy contract term measure, it is unlikely there will be a change to the current practice that effectively locks in terms and conditions for extended periods of time, leaving premium changes as the primary (or only) lever to deal with the impact of external changes on IDII sustainability.

To provide life companies more time to implement the policy contract term measure, APRA has decided to postpone the implementation of the measure to **1 October 2022**. APRA expects life companies to intensify their efforts to explore and develop workable solutions to meet the intention of APRA's policy contract term measure and to proactively keep APRA informed of progress.

Ongoing areas of focus

With the deferral of the policy contract term measure, APRA notes the following.

- While a viable solution to operationalise the policy contract term measure is being developed, it is important that life companies have appropriate mitigants to manage the risks associated with extended contract terms. This includes critically reviewing all product features in accordance with APRA's remaining sustainability measures and other frameworks, such as the Actuaries Institute Disability Insurance Taskforce's Sustainability Guide and Reference Product. Life companies must ensure that their IDII products remain within the risk appetite set by their boards.

[1] Finalised sustainability measures – 30 September 2020

- Notwithstanding the deferral of the policy contract term measure, life companies are encouraged to challenge the status quo in formulating viable solutions to operationalise this measure in a timely manner, with due consideration to legislative requirements and consumers' needs.

- Demonstrated actions taken by the life companies to mitigate the risks associated with extended policy contract terms, and ultimately, the effective and timely implementation of the policy contract term measure, will contribute positively towards future revisions of the IDII capital charge.

In conclusion

APRA's product measures are intended to operate as boundaries, aimed at addressing fundamental risks associated with IDII. It is important to note that all of APRA's other IDII product measures, as communicated in APRA's 30 September 2020 letter, will still take effect on 1 October 2021.

APRA will continue to engage and work with industry stakeholders and ASIC to support the implementation of the policy contract term measure and sustainable practices more broadly. Ultimately, however, it is the responsibility of life companies to proactively manage the risks associated with the design of their IDII products to ensure ongoing sustainability.

Yours sincerely

Brandon Khoo
Executive Director

Appendix 2

Actuaries Institute Guidance – Extracts from Document B – Individual Disability Income Insurance Sustainability Guide

4 Reference Product and associated benchmark operations

This section details the main elements of the Reference Product and benchmark operations. These elements are not intended to cover every possible aspect of an insurer's product and organisation. The focus is on the most material outcomes that are expected to lead to a relatively sustainable industry. In developing an insurer's own approach to sustainability, it is envisaged that the rationale for any variations to this benchmark are discussed, documented and agreed (see section 5).

The reference/benchmark aims to deliver on the principles of insurable interest and customer loss minimisation. It is not intended to achieve the 'ultimate' in sustainability; rather deliver more consistent outcomes for both the customer and insurer in a range of potential future social, regulatory and economic scenarios. It is recognised that many of the components interact and similarly sustainable outcomes may be achieved with a different combination of factors. The insurer's Target State and actual go-to-market product and service offerings may be more or less conservative than the benchmark.

The following sections complement rather than substitute for an insurer's team of insurance practitioners applying best practice in their fields.

4.1 Product design

The Reference Product has been designed to meet insurability principles. The following sections detail the outcomes / themes that are central to sustainability and cross references the Reference Product document in the footnotes.

4.1.1 Income definition and replacement ratio incentivise return to work / wellness[6]

The combination of income definition and replacement ratio (including offsets and ancillary benefits) is intended to ensure that the product covers an insurable interest of the customer and incentivises return to work / wellness. The Reference Product provides benefits on an indemnity basis only.

4.1.2 Eligibility for benefits is clear and supports the customer when they are unable to work[7]

The total disability definition in the Reference Product aims to be clear and provide support for the consumer where there is a significant incapacity to work. Partial disability benefits are structured to promote return to work and not encourage remaining on claim. To this end, waiting periods are also limited.

4.1.3 The occupation definitions and replacement ratios encourage the customer to minimise the insured loss[8]

The Reference Product design is intended to ensure that claimants are aligned with the insurer on the insurance principle of loss minimisation. The replacement ratio is higher in the first six months and the

6 Reference Product sections 1.3.2, 1.3.5, 1.3.6, 1.3.7, 1.3.8, 1.3.15
7 Reference Product sections 1.3.1, 1.3.3, 1.3.4
8 Reference Product sections 1.3.1, 1.3.2, 1.3.10

occupation definition moves from own occupation to an education, training or experience definition at two years. A maximum benefit period of 'to age 60' is intended to reduce the incentive to utilise benefits to support early retirement.

4.1.4 Product terms and conditions keep up with environmental changes[9]

Under the Reference Product the insurer retains rights to alter substantive terms and conditions at least every five years to ensure that changes in environmental and other factors can be reflected in product design. Factors may include social inflation (e.g. societal expectations, attitude to mental health, lawyer involvement), regulatory change, medical advances, change in the structure of the economy (e.g. casualisation of the workforce) and shifting economic conditions (e.g. high to low inflation environment).

It is noted that implementing this feature may be challenging under the current legislative framework but it is a material risk management feature that should be discussed. If implemented then the right to change product terms should not be used to experiment with unsustainable terms that are likely to be subsequently withdrawn.

4.1.5 Products communicated to promote alignment between insurer and customers

Under the Reference Product, the intention is that customer expectations of the product should be aligned with those of the insurer. This is intended to support the long term expectations and needs of the community. To achieve this, the benchmark practice is to:

- Describe the product using language that is understandable by customers. Examples of poor use of language are: (i) calling the product 'income protection' when the insurer expects return to work to be a key focus, (ii) complex disability definitions that make it difficult for customers to understand when and what they can claim and (iii) use of the term 'level premium' may be inferred by customers to mean that the dollar premiums will always remain unchanged.
- Clearly and regularly communicate about the uncertainty and claims experience variations of the product so that customers are less surprised by premium rate increases. In support of this, under the benchmark practices the insurer would provide key elements of its pricing philosophy (see 4.4.2) to rating houses for inclusion in their product ratings.
- Support publication by the industry of claims statistics on components of benefits such as key types of disability definitions, claims causes and ancillary benefits.

4.2 Underwriting practices

The Reference Product requires supporting underwriting and claims practices to promote sustainable outcomes including return to work where appropriate. Underwriting and claims practices must combine with product design to:

- limit claims to the insurable interest of the customer; and
- operate to encourage the consumer to return to health and minimise loss of their income.

9 Reference Product sections 1.3.13

4.2.1 Financial underwriting ensures that benefits do not exceed insurable interests and promote loss minimisation[10]

Under the benchmark practices, the intention is that the combined value of the customer's Unaffected Business Income, Passive Income, lump sum living benefits and disability income benefits incentivise return to work. Benefit periods that are too long may encourage the use of an insurance claim as an early retirement strategy. The Reference Product has a maximum benefit period of 'to age 60'.

4.2.2 Insured events updated to keep up with the customer's changing circumstances[11]

Under the benchmark practices, the customer is asked annually to confirm their financial information details to ensure that cover continues to deliver on their insurable interest and they are charged the correct premium. This includes the customer's occupation, pastimes and income level.

4.3 Claims practices

The insurer should ensure that its claims practices cover matters identified in SPG250, LPG240 and LICOP. Documentation should highlight how these claims practices support the product's design, intended customer experience and approach to pricing.

4.3.1 Claims team has the capacity and skills to assess the claims definitions

Under the benchmark practices, the claims team has a sufficiently skilled and experienced team with sufficient capacity to assess claimants against the claims definitions. Claims assessors must retain ownership of the decision regarding payment of a claim and (i) request only factual medical information from GPs and (ii) use assessments from occupational physicians, occupational therapists and other specialist practitioners in assessing function and capacity to work.

4.3.2 Claims team actively plans, encourages and implements return to work / wellness with claimants[12]

Under the benchmark practices, during the first 18 months of each claim it is important that the claimant receives regular communication on return to wellness / work expectations at least every six weeks following acceptance of the claim. Communication should include the agreed recovery management plan (where appropriate) and future changes in benefits under the product terms and conditions.

4.4 Pricing for uncertainty

Uncertainty is particularly high in IDII products because of product optionality[13] and other factors including:

- in a rapidly changing environment, historic data may be inadequate to estimate the future claims cost;

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10 Reference Product sections 1.3.5, 1.3.10
11 Reference Product sections 1.3.12
12 Reference Product sections 1.3.1, 1.3.14
13 Product optionality means the extent to which definitions permit flexibility in behaviour and includes: multi-tier total disability definitions, partial disability benefit and other features that may result in the customer valuing benefits differently under various future lifestyle, economic and environmental conditions.

- limited understanding of customer behaviour and social factors impacting on claims cost; and
- the high potential for social inflation / environmental changes / black swan events to increase costs (including social, medical, economic and regulatory factors).

Sustainability requires that insurers proactively seek to understand and reduce uncertainty through product terms and underwriting and claims practices. Given the high levels of uncertainty inherent in the product, past claims experience may have limitations when considering what product terms, underwriting and claims practices are sustainable. These are important considerations in pricing becoming sustainable. The primary focus of the Guide is to achieve that outcome.

Insurers should acknowledge uncertainty and not default to being optimistic about (i.e. underestimate) the cost of uncertainty. Pricing assumptions / margins should allow for that cost. If insurers are routinely optimistic about uncertainty, then competition results in the ongoing / iterative relaxation of product terms and insurers increasing premium rates in future. An argument can be mounted that no consumer detriment occurs because there is a free market and customers can move to a superior and/or cheaper product. This argument has limitations for IDII products because consumers face high frictional costs[14] that the insurer should consider in their pricing decisions. The customer also has a right to understand how the price of their product may change over time.

4.4.1 Pricing assumptions put a cost on uncertainty for at least five years

Under benchmark practice, careful consideration of uncertainty over at least the first five years from inception of policies is required. It is intended that it is <u>more likely than not</u> that allowing for uncertainty over this period: (i) the premium rate schedule will remain unchanged and (ii) the insurer will meet its minimum profit metrics[15]. This does not imply that that premium rates should be guaranteed.

Uncertainty should be allowed for explicitly in best estimate assumptions or separately in risk margins. Under benchmark practice, the starting point in setting best estimate assumptions should be the industry table and a credibility approach used to overlay the insurer's own historic experience (and/or alternate rating factors).

In recognition that assumptions are typically built up from historic experience, a number of additional factors should be considered in respect of the allowance for uncertainty in best estimate assumptions or risk margins. Product optionality is one factor where the option cost and/or interaction with future environmental factors may increase cost above what has historically been observed. If there is reasonable empirical data or research to explain why suspected uncertainty will not have a cost then under benchmark practice the cost of that uncertainty can be reduced. Equally, evidence may indicate that a cost for uncertainty is required in best estimate assumptions. Section 4.5 details benchmark practices to reduce uncertainty over time.

Under benchmark practice, the uncertainty factors to consider include:

i. continuation of adverse historic trends in experience (unless credibly explained as one-off by factors such as changes in the insurer's operations, social inflation / community attitudes, regulatory expectations or industry and legal practices);

ii. mis-estimation of the mean by assuming that the insurer's own favourable and credible experience compared with the industry will persist into the future. The total claims

14 Frictional costs for consumers include: (i) the significant cost to understand and transact, (ii) actual inability to transact because of changes in their health and the insurer's medical underwriting, (iii) the risk of cover being lost in transition between insurers and (iv) fear of making a mistake because of the complexity of the product.

15 The insurer should determine the methodology and metric(s) that it wishes to use to assess profitability and profit margins (i.e. the Guide neither defines a technical approach nor whether uncertainty should be included).

cost arising from combinations of best estimate assumptions that are more favourable than the lesser of (i) the insurer's credibility weighted experience and (ii) the industry experience may not be sustainable;

iii. to the extent not reflected in the underlying experience, the average cost of cyclical effects such as the impact of the economic cycle should be costed; in particular unemployment and underemployment;

iv. the potential that duration based termination assumptions are optimistic because: (i) the insurer assumes that credible insurer experience at short durations implies credible experience at longer durations or (ii) the shape of the industry table has been altered without evidence that there is not an unaccounted for opposite effect at another duration; and

v. any expectations that customers would reasonably have.

It is recognised that it may take insurers some time to better understand uncertainty and reduce the cost of uncertainty in pricing.

4.4.2 The pricing philosophy addresses key questions of equity

Under benchmark practice, the pricing philosophy articulates how the insurer proposes to address factors that impact on the product's cost over time. Factors include how the insurer:

i. addresses cross subsidies between the early policy years and later periods so that pricing allows for factors including the spread of acquisition costs and known policy duration effects on claims costs;

ii. deals with profitability issues that may arise from uncertainty crystallising and impacting on the disabled lives reserve;

iii. allows for uncertainty in its pricing including the practices detailed in section 4.4.1 and how pricing of uncertainty differs between short and long duration benefits;

iv. exercises its repricing rights if uncertainty crystallises and in particular how it proposes to balance: (i) allowance for uncertainty in upfront pricing, (ii) frictional costs that customers may face if prices increase and (iii) how it will manage its profit metrics; and

v. ensures that pricing for each individual product line[16] is not loss making at least on a marginal cost basis.

4.5 Data, experience investigations and research

IDII products are inherently complex. To reduce uncertainty and understand risk it is necessary for each insurer to collect data, analyse that data and collaborate on industry research.

4.5.1 Data is collected to cost all benefits, options and key drivers of claims cost

Under benchmark practice, data is collected so that a granular understanding of the product's cost is available. This includes:

- demographic information that is relevant to pricing;
- all the choices made by the customer when purchasing a policy, including features that

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