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# Forward Focus

## Insurance and wealth management



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## Welcome to the first edition of Forward Focus for the 2011 year

Last year I wrote about the devastating impact the Christchurch earthquake has had. It is with great sadness that I write about another Christchurch earthquake today. With lives lost and destruction caused by the massive after quake last week, there will again be stresses and strains that will arise for both your people in the Christchurch area, their family and friends, and your staff trying to manage the inevitable claims that will arise.

These events only remind us of the importance for insuring our assets and the future of our families and the role the industry plays in everyone's daily lives. It also proves that we can never fully predict what will occur tomorrow.

In this issue we take a look at the impact that technology can have on underwriting.

Technology and social media acceptance in our personal lives has grown exponentially. Businesses are only just starting to pick up on this trend and understand how social media can improve their bottom line.

Regulations will also be a regular feature in the insurance and wealth management space. We expect many of these will be finalised during the year and will endeavour to keep you at the forefront of all developments. In this issue we look at the anti money laundering regulations which are expected to be in place by March/April 2011. We take a closer look at the effects on insurers, including an overview of the impact on different risk products.

We also provide an update on the developments of IFRS 4 and the Foreign Account Tax Compliance Act.

Take care

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# Anti money laundering for insurers

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Since the September 11, 2001 attacks there has been a concerted global push to put legislation in place which detects or prevents money laundering (Anti Money Laundering or AML) activities through financial institutions. NZ has generally been lagging behind the rest of the world in this respect. However, in the next few months regulations will be put in place which seeks to align NZ to the global standards.

## What does AML involve?

The shape of the regulations is already well understood from observing international experience as well as Cabinet papers presented in late 2010. For affected companies it will likely involve the following:

- Developing and maintaining a risk assessment and risk-based AML programme
- Customer identification and identity verification
- Ongoing customer due diligence
- Suspicious transaction reporting
- Record keeping
- Auditing and annual reporting

## Does it impact the insurance industry?

There is a general view that the insurance industry will not be significantly impacted by the regulations. This is because insurance products generally do not have the "deposit and withdrawal" attributes which money launderers seek, and so are considered "low risk". While this view is true of "risk" insurance products (e.g. house insurance, term life insurance), it ignores the fact that there are a variety of investment-style products sold by life insurers predominantly which would fit into this higher risk category. Table 1 outlines Deloitte's view on the likely AML impacts for the industry by product/area.

## What should insurance companies be doing and how can Deloitte help?

Regulations are expected to be in place by March/April 2011, with a 2 year transition period for implementation. Given that the shape of regulations is well understood, affected insurers should be getting ready for implementation right now. Key questions to be answered are:

- How will this fit with existing regulatory programme initiatives. For example:
  - o Prudential insurance regulations – AML is a specific requirement of these regulations;
  - o Financial adviser regulations – advisers will be relied on for compliance with some aspects of AML.
- What are our specific requirements relating to our specific product set?
- What will be the gaps to our existing AML programme?
- Can AML be tailored to fit with the overall customer strategy? Most insurers have strategies to get closer to their customers and AML represents an ideal opportunity to accelerate those plans.

Deloitte has developed a practical and pragmatic approach to designing an AML programme which has already been implemented in several New Zealand financial services companies with great success. We would welcome the opportunity to discuss it with you.

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Area	Impact	Comment
"Risk" insurance. Includes most forms of general insurance (e.g. house, contents) and pure life risk products (term, income protection).	Little to no impact as full exemption.	Some niche products with small investment components may require consideration (e.g. term products with a premium payback feature).
Traditional life insurance investment products e.g. whole-of-life, annuities, investment linked.	Varies  For products closed to new customers there will be full exemption so little to no impact.  Otherwise there will be a partial exemption for "low value" products based on premium thresholds. In these cases identity verification will not need to occur until final payout.	Most companies have closed these product lines to new customers and so will not be impacted. Careful review of product rules required around top-ups and exercising of options to ensure they fall inside the "closed" definition.  Where product lines are still open it may force a review of product economics.
Collective investments e.g. managed fund, unit trusts	High impact	Ability to withdraw funds makes these products high risk for AML and will be a key focus of legislation.
Superannuation schemes e.g. Kiwisaver, Workplace Superannuation	Medium-high impact  There is recognition that these schemes typically involve some form of customer due diligence by either an employer or the IRD and so there will be some exemptions from initial Customer Due Diligence. However ongoing Customer Due Diligence will still be required.  Full exemption for low value superannuation funds where the payout is less than \$1000 per annum.	Superannuation providers will need to review their rules carefully so they apply AML consistent with the legislation.  For some Kiwisaver customers (e.g. Self employed, stay at home parents) there is no employer or IRD involvement and so the full measures will apply.  Another key consideration for reduced measures in this area is the ability of the customer to withdraw funds. Where schemes allow early withdrawal of funds it may impact the nature of the exemptions.
Financial Advisers including Authorised Financial Advisers (AFA's) and advisers of wholesale investment products	High impact  Subject to the core obligations around Customer Due Diligence and Suspicious Transaction Reporting. Exemptions from on-going due diligence.	Effectively advisers will be conducting some AML obligations on behalf of the financial service providers.

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My favourite iPhone application is "Phone Tracker". The application starts with a picture of the Earth and allows you to enter in a mobile phone number, it then zooms in and shows you the current or last recorded location of the mobile. Sounds great and a clever use of data maybe, but at the same time, a little worrying too.

In the same spirit, there are opportunities emerging that use your "e-presence" in business – extracting a picture from what you do, say and show online. Historically, this was more focused on marketing and advertising opportunities (with an occasional recruitment story); now potentially very similar types of data could be extended to underwriting assessments.

Your Facebook activity may say as much about you as an analysis of your bodily fluids.

Developments in underwriting have often been treated warily. In the 1930's new methods, including collection of blood pressure, were considered invasive and contentious at the time. More recently genetic information extending to DNA tests has been adopted very cautiously by the insurance industry.

Data is assuming an ever increasing importance. Our collective ability to marshal data, measure its quality and analyse it to identify and infer meaning is leading to greater monetisation of data and awareness of the value of data to organisations.

Predictive modelling is not new. Driving and accident patterns have affected car insurance pricing and in US, your credit rating affects your premium level. Lifestyle is recognised as a significant factor in coronary disease and depression. What is new is an experiment Deloitte conducted in the US over the last couple of years involving 60,000 insurance policy applications.

The cost of underwriting is high, medical tests and time to assess these by experts is a significant expense factor in pricing. Costs sit anywhere in the range of \$100 to \$1,000 to assess each policy. Expert systems can help here but they ultimately attempt to automate a standard underwriting assessment process. If the findings of the Deloitte study are proven to be correct, then the cost of underwriting in future could lie in the \$5 to \$10 range (for US based large insurers).

## So what did Deloitte do?

Deloitte took 60,000 policies already assessed by a well known insurer using traditional underwriting techniques and categorised into insurance risk – including declined policies. These 60,000 policies were divided into two equal groups. The first 30,000 policies were used to create a data-only predictive model that could potentially reach similar decisions.

The data used to instruct the predictive model came from an original insurance policy application. Added to this was some (US) industry shared information from past applications, and experience with a whole series of consumer-marketing data and information added on top. The consumer data, for example, identified individual-likely hobbies, TV-viewing and reading habits and income. None of the additional medical reports, medical blood and urine test results were available or used.

This predictive model was then run against the second set of 30,000 applications to see how accurately it replicated the original underwriters assessments. It was judged largely successful; the added consumer/marketing data represented about 37% of the predictive ability. The insurers Chief Actuary reported, "The use of third-party data was persuasive across the board in all cases".



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Increasingly, merging online and offline data together can be valuable. Like expert underwriting systems they can speed up the assessment of many standard “clean-skin” cases, leaving others to be more carefully assessed in the traditional way.

There are undoubtedly issues – subscribing to ‘Hang-Gliding Weekly’ doesn’t necessarily mean you actually fly in them. Care will be needed especially in cases that may be seen or believed to have led to an adverse decision, although it also presents an opportunity for more sophisticated pricing and the decision simply now results in a price point within a range.

Deloitte’s methodology was judged sound but it is too early to say how much reliance can be placed on this additional information.

Taking this even further, theoretically online data could be used at an individual level; your Facebook fan pages, online purchases, even the extent of social networking site use could be used directly to assess your life insurance premiums. Interestingly, concerns are emerging that extensive Facebook use late at night is affecting people’s sleep quality and thus health.

Personal transparency may or may not be judged by society to be a good thing. Regardless, it is all public information available electronically which can be analysed and used to enhance policy processes.

The phone tracker application is in fact a very effective joke – shame. “Now, Mr Hett, you want some life insurance? First let’s talk about your loan application”.

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# IFRS 4 Phase II update

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In previous articles of Forward Focus, and in our Insurance Accounting Newsletters<sup>1</sup>, Deloitte has been tracking the progress of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as they attempt to develop the first truly global insurance GAAP reporting standard. The pressure to finalise the standard is now increasing. In June this year the IASB will appoint a new Board and if the standard is not finalised by then it will inevitably slow the progress.

On 30th July 2010 the IASB released an Exposure Draft (ED) for IFRS 4 with a comment period up to 30th November. On January 18th and 19th of this year the IASB and FASB jointly met to consider the 250 plus received responses, and discuss the main issues for deliberation. Although there was continuing support for a new standard there were also some key issues raised. These were:

- The proposed time period for development and implementation of a new standard (linked to the June 2011 IASB rotation) is too short and may lead to a sub-optimal standard;
- For non-life insurance the proposed model is too complex. Some respondents argued that life insurance and non-life insurance are sufficiently different businesses that they warrant development of two different standards;

- The "risk margin". Generally speaking the IASB, life insurers and auditors favour having an explicit "risk margin" which identifies the uncertainty in the calculation of the liability as well as a residual margin to avoid recognition of profit at outset of a contract. The US, Japan and most non-life insurers prefer an approach which combines these margins into a single composite margin;

- Profit and losses are likely to be highly volatile. Although this may be considered more realistic it could result in less relevance, reliability and comparability for users. Several proposals are being considered to address this issue including allowing the residual margin to absorb the volatility. This is very similar to the approach already adopted by NZ life insurers;

- Determining a discount rate. The approach in the ED was "bottom up" (i.e. start with a risk free rate and add an illiquidity premium) and this was considered by many to be difficult to implement. Several "top down" approaches (i.e. start by reference to observable financial instruments) have been proposed and these are being considered;

- The presentation of the financial statements. The ED had proposed a radical approach to presentation which did not show traditional measures such as premiums and claims but instead showed "summarised margins". Most respondents preferred the traditional approach;

- Unbundling. The ED had proposed the unbundling of contracts in specific circumstances however many respondents felt the proposal was unclear.

The Board is still committed to releasing the final standard in June 2011 and will hold several meetings over the next few months in an attempt to meet this target. It does seem increasingly likely that the effective date of the standard will now be 2014 or 2015, rather than the previous stated goal of 2013. This will give insurers some more breathing time for implementation but it remains as important as ever that they stay abreast of the changes. Stay tuned.

<sup>1</sup>See Forward Focus August 2010 and May 2010 and Insurance Accounting Newsletter Issues 16 and 17



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This is a heads up in relation to a tax compliance burden financial institutions around the world will be facing from 1 January 2013. The Foreign Account Tax Compliance Act (FATCA) legislation was enacted in the US early last year, and while it is aimed at preventing tax evasion by US persons that invest back into the US via foreign companies, the rules effectively penalise non-US investors. The rules apply to foreign financial institutions (FFIs) such as New Zealand insurers, banks, superannuation funds and managed funds. FATCA requires all FFIs to enter into an agreement with the Internal Revenue Service (IRS) to provide regular reporting on their investors, including whether any are US persons or could have US investors investing in them. FFIs that do not provide this information will suffer a 30% withholding tax on any income or proceeds received from US sources. The tax applies notwithstanding any double tax agreement (DTA) that may limit the taxing right in the US. FFIs entitled to a DTA relief will need to claim a refund from the IRS.

Income received directly from the US or via another FFI is ultimately caught. While you may not have a direct exposure to the US, your investment into say, another FFI, may then be into the US. For example, take the case of an investment in a global bond fund. The FFI in which you have invested in will be an FFI investing into the US. It will need to comply with the FATCA rules or risk losing 30% of its principal and interest. When it comes to pass that US sourced income, for example, onto another FFI, it will be obliged to withhold 30% unless that FFI has also signed up to be a participating FFI. It is therefore expected that FFIs that do not receive US payments will be pulled into the regime because other FFIs may not want to deal with a non-compliant entity.

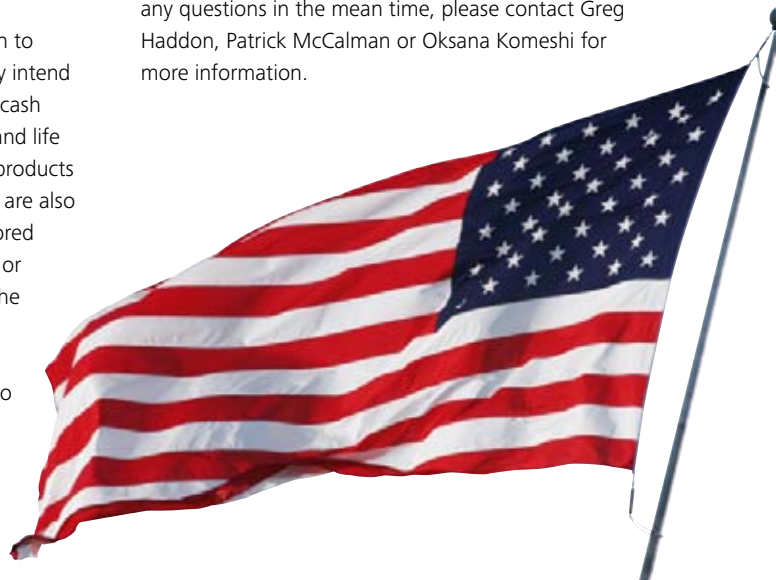
Specific guidance has been released in relation to insurance. The US treasury has confirmed they intend to carve out from the rules contracts with no cash value. This should exempt general insurance and life risk policies, while insurers that issue savings products will need to be FATCA compliant. Exemptions are also expected to apply to foreign employer sponsored retirement plans that have no US participants or beneficiaries, other than those employed by the foreign employer in the country in which the retirement plan was established. It is unclear whether this exemption is intended to apply to multi employer schemes.

Further guidance around the rules is expected.

Guidance is yet to be released on how to go about entering the necessary agreements with the IRS and what the requirements of those agreements will be. In the case of multi-national organisations, we are also waiting to get guidance around whether the agreements cover the global group or whether each institution has to enter into its own agreement.

While these rules will only apply to payments occurring after 1 January 2013, it is important for insurers and fund managers to be aware of and monitor the developments especially if the US investments are held directly. It may be necessary to weigh up whether it is worth becoming a participating FFI versus the costs of not becoming one. Those becoming one will need to prepare themselves for the additional compliance requirements and will be required to ensure that their systems and procedures are capable of handling the additional data. They would need to be able to identify the residency of the customers based on required documentation, classify them into the FATCA categories, and be able to report their financial information to the IRS. They will also be required to withhold US tax on non-compliant accounts. Legal ramifications such as information disclosure waivers and changes to documentation will also need to be considered.

The rules are far from developed. While the core provisions have been passed into law, the regulations that will dictate the implementation are yet to be drafted and not expected until May 2011. We will closely monitor the developments around the rules and the issues surrounding their implementation and will provide updates in future publications. Should you have any questions in the mean time, please contact Greg Haddon, Patrick McCalman or Oksana Komeshi for more information.



We hope you enjoyed the read.

We're always keen to hear your feedback, if you have any suggestions for content or topics you would like us to explore in the newsletter please email us on [nzinfo@deloitte.co.nz](mailto:nzinfo@deloitte.co.nz)

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