

Victorian Government

Prudential Insurance Standard

for

Victorian Government Insurance Agencies

January 2009

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Foreword

The Victorian Government has significant assets and liabilities in insurance schemes managed by Government agencies.

It is critical that these insurance schemes are managed prudentially to ensure the viability of the schemes, assets are available to fund liabilities and that the schemes do not adversely impact on the state government's finances.

The *Prudential Insurance Standard for Victorian Government Insurance Agencies* establishes a policy framework for public sector insurance agencies that integrates with and builds on existing government wide policies, to provide for the prudential management of the state insurance schemes.

TIM HOLDING MP

Minister for Finance, WorkCover
and the Transport Accident Commission

1 Introduction

The Victorian Government has established a framework of legislation, policy and guidelines for public sector agencies to prudentially supervise agencies and ensure agencies:

- Implement and maintain appropriate financial management practices
- Achieve a consistent standard of accountability and financial reporting
- Implement appropriate risk management practices
- Maintain appropriate governance frameworks

Key components of this *Prudential Supervision Framework* include:

- Audit Act
- Financial Management Act
- Public Administration Act
- Standing Directions of the Minister for Finance
- Victorian Government Risk Management Framework
- Victorian Government Procurement Policy
- Guidelines for the Appointment and Remuneration of Part-time Non-executive Directors
- Government Business Enterprise Guidelines
- State Services Authority Good Practice Guide for Victorian Public Sector Entities.

The Victorian public sector insurance agencies are significant insurance operations with substantial assets and liabilities and generate substantial premium annually to fund the liabilities. These liabilities are predominantly claims liabilities to be paid out over many years into the future. Due to the nature of the liabilities there is significant uncertainty in their value. It is therefore critical that these insurance agencies are prudentially managed to:

- Ensure the assets held are sufficient to fund the liabilities
- Safeguard the interests of policyholders and claimants
- Minimise the risk of any adverse impact on the State's financial position and on consumers.

This *Prudential Insurance Standard* for insurance agencies establishes clear expectations for the Boards and managements of the agencies, and for the DTF in its role as the prudential supervisor. It adds requirements that are specific to the insurance businesses and makes clear the primary responsibility of the agency Board for complying with the framework.

2 Coverage and Application

This *Prudential Insurance Standard* applies to Victorian public sector insurance agencies. These specifically include:

- WorkCover
- Transport Accident Commission
- Victorian Managed Insurance Authority

The *Prudential Insurance Standard* is structured to complement the existing requirements and together form a comprehensive *Prudential Supervision Framework*. The standard identifies the relevant existing legislation and policies and enhances and extends those policies to meet the needs of the insurance agencies.

3 Accountability

3.1 Boards

The Board of Directors of each public sector insurance agency are accountable for ensuring the appropriate application of this *Prudential Insurance Standard* within their agency. Boards are required to take reasonable steps to satisfy themselves that the policy has been properly implemented.

3.2 Attestation of Compliance

Boards and Chief Executives of public sector insurance agencies to whom this policy applies, are required to provide an attestation to the Department of Treasury and Finance that the agencies have appropriate governance, risk management and prudential management arrangements in place consistent with this policy and with the Board's expectations.

Compliance with this requirement is documented in Directions of the Minister for Finance under each agency's governing legislation. A sample attestation is provided in the Attachment to this policy.

3.3 Prompt Disclosure of Significant Events

The Board of Directors have an obligation to ensure that significant events relating to the prudential management of the agency, including event that may materially affect the application of the *Prudential Insurance Standard* to the agency, are brought to the attention of DTF on a timely basis.

3.4 Roles and Responsibilities

Board of Directors

The Board of Directors are ultimately accountable for ensuring compliance with this *Prudential Insurance Standard* and are required to:

- Ensure the establishment of appropriate policies and procedures to give effect to this *Prudential Insurance Standard*
- Assign management responsibilities for implementation of the *Prudential Insurance Standard*
- Appoint an external Actuary. The external Actuary is to have access to the Board and have 'whistle blowing' powers to the Board with a reserve power to the Department of Treasury and Finance. These whistle blowing powers should be expressly detailed in the engagement letter or contract appointing the Actuary.
- Verify compliance with the *Prudential Insurance Standard*
- Attest compliance with the *Prudential Insurance Standard* (including relevant guidance material attached to this standard), to the Department of Treasury and Finance.

CEO and Management

The Chief Executive and their management team are responsible for implementing the *Prudential Insurance Standard*, other Victorian government financial policies and other relevant Board policies.

The Department of Treasury and Finance (DTF)

In its primary role of managing the Victorian government's finances, DTF is concerned that the state's insurance schemes are prudentially managed and do not adversely impact on the state's finances. As such DTF will liaise with and advise public sector insurance agencies to assist with an effective and consistent implementation of the *Prudential Supervision Framework*. However DTF's advisory role in no way diminishes or reduces the primary responsibility of agency Boards to ensure effective implementation and ongoing compliance with the *Prudential Supervision Framework*.

DTF is responsible for the development and maintenance of this standard but is not expected to undertake intrusive supervision to ensure compliance with the standard or the broader framework. However, DTF has the reserve power and authority to undertake or require such further investigations and enquiries as it considers appropriate. If requested, an agency is to provide DTF with a copy of any of its policies or other documents referred to in the *Prudential Insurance Standard*.

The Victorian Auditor General's Office (VAGO)

The external audit of each agency by VAGO under the Audit Act is an important element of the prudential supervision framework. VAGO's role is limited to that under the Audit Act and it is not required to supervise compliance with this framework.

4 Prudential Insurance Management

Each agency shall develop and implement financial policies in accordance with this standard, dealing with:

- Liability reserving
- Capital management
- Pricing
- Investment of assets
- Reinsurance
- Actuarial review.

Each agency shall review its financial policies at least once every five years. These policies should complement existing Victorian whole of government policies (as outlined in section 1) which together form the *Prudential Supervision Framework*.

4.1 Liability Reserving

Insurance liabilities of statutory insurance agencies are to be established based on actuarial advice, are to be discounted at a risk-free rate and include a risk margin that provides a 75 per cent probability of sufficiency.

4.2 Capital Management

Insurance agencies are required to develop and implement a Capital Policy approved by the Board of the agency in accordance with this *Prudential Insurance Standard*. Each agency shall review its Capital Policy at least once every five years. Each insurance agency must act in accordance with its Capital Policy.

The Capital Policy shall specify how the capital of the agency is to be measured and how its funding ratio is to be expressed. The Capital Policy shall establish a target funding range, with a preferred funding level that is unbiased in preference towards the top or bottom of the range. The policy should clearly state that being outside the range at a particular time is not of itself significant.

The target funding ratio range and preferred level shall be determined in accordance with the Government's risk preference as advised by the Minister. This risk preference shall be expressed in terms of probabilities that the agency's reported funding ratio will move below 100 per cent within the next operating year.

The Capital Policy of the agency should discuss at which levels of reported funding ratio the agency's Board and management would consider taking corrective actions and the possible nature and timing of those corrective actions. The time within which any corrective actions are expected to return the funding ratio to within the range may be longer than one operating year, but the reasons why a particular timeframe has been chosen must be stated in the policy.

The target funding range and the preferred funding level are to signal the agency's long term funding ratio aspirations, and serve as a point of reference when considering corrective actions and for developing the agency's Pricing Policy.

The Capital Policy shall include consideration of the payment of dividends and of tax-equivalent payments to the extent they are relevant to the agency.

4.3 Pricing

Insurance agencies are required to develop and implement a Pricing Policy approved by the Board of the agency in accordance with this *Prudential Insurance Standard*. Each agency shall review its Pricing Policy at least once every five years. Each insurance agency must act in accordance with its Pricing Policy.

The Pricing Policy shall specify how each agency determines its break-even premium and how any margin above or below that level is expressed. The investment return to be assumed in determining the break-even premium should be that expected according to the agency's investment objective. The implications of failing to achieve this return are also to be considered as part of the policy. Each agency's Pricing Policy must be consistent with achieving or maintaining the agency's target funding ratio level and demonstrate that any target or projected rate of return on capital adopted by the agency and/or margin in premium is consistent with the target funding ratio.

Financial reports and projections and premium recommendations of each agency shall include discussion of their relationship to the Capital and Pricing Policies of the agency, and DTF shall assess these reports, projections and recommendations in accordance with this policy framework and the agency's policy.

4.4 Investment of Assets

At the time of drafting this standard, it is government policy that all investment of assets of the insurance agencies will be undertaken by the Victorian Funds Management Corporation (VFMC).

While this remains government policy, the Board of the insurance agency is not responsible for prudential management or supervision of the investments. The management responsibility rests with the Board of VFMC and the prudential supervision responsibility rests with DTF.

Each insurance agency has a responsibility to determine investment objectives for the VFMC and to review the contractual and service level agreements between the agency and VFMC. An agency's investment objectives are to be established by the agency's Board having regard to the agency's Capital Policy as based on the Government's risk preferences.

While actual investment outcomes are the responsibility of VFMC, the insurance agencies have an interest in this as investment performance affects their financial results and business plans. Therefore, the insurance agencies are responsible for periodically reviewing investment performance against their investment objectives as well as discussing with VFMC, on an ongoing basis, the strategic asset allocation and the implications for achieving their business objectives. If the Board of an insurance agency has material reservations in this respect which it is unable to resolve with the VFMC, then it should raise these with DTF.

4.5 Reinsurance

Reinsurance is a key tool to be considered for managing risk in an insurance operation. The use of reinsurance as a risk mitigant should be considered by each agency from time to time. The Board should develop a reinsurance policy having regard to the premium implications as well as the impact on the State's Balance Sheet and Operating Statements. This reinsurance policy should be specifically included for review in the financial sustainability review detailed below under 'Additional Actuarial Roles'. In considering an approach to reinsurance an agency must consider the likelihood and potential impact of catastrophic events. An agency's approach to reinsurance must be endorsed by the agency's Board.

The nature of the VMIA business is such that reinsurance is an important component of its prudent financial management and is expected to be a significant component of its activities. For VMIA the importance of reinsurance is such that the Board should consider the APRA Prudential Standard GPS 230 as a benchmark for its own activities. This does not imply that it must follow GPS 230 literally, but it should document the nature of and reasons for any differences in its approach.

4.6 Actuarial Review

Appropriate use of actuarial skills is an important element of the sound management of an insurance business. The *Prudential Insurance Standard* sets out expectations for the ways in which the insurance agencies will utilise actuarial review, particularly as it relates to prudential management. It is not the intention to create an inflexible set of rules about actuarial review, and so the standard is expressed in terms of principles. Each agency is expected to conduct its affairs in a way that reflects these principles and reflects the particular needs and circumstances of the agency at the time.

A copy of any, or all, of the actuarial reports completed under this standard must be provided to DTF upon request.

Appointment of Actuaries

Each agency shall engage an external actuarial firm to undertake valuation of its insurance liabilities (and other work as considered appropriate and consistent with this standard).

The actuarial consultant must:

- Be a firm with proven capacity and capability to undertake the scope of work
- Nominate a designated principal with sufficient experience and reputation to deliver credible advice and who meets "fit and proper" and independence tests
- Be appointed from time to time in accordance with the Victorian Government Procurement Policy.

Liability Valuation

A liability valuation must be obtained at least once each year, to coincide with preparation of the annual report. Each agency should also consider the need for actuarial valuations to coincide with significant decisions, for example pricing.

These are minimum requirements - agencies are not restricted from employing actuaries in-house, undertaking other work in-house or completing valuations more frequently than the minimum specified.

An agency may appoint more than one external actuary for different tasks provided there is no 'actuary shopping' and no gaps in the coverage of the agency's insurance liabilities.

The relevant actuary should be independent of the agency and the Victorian government, applying normal professional standards of independence. The actuary need not be independent of other contractors or service providers to the agency such as internal audit providers. The critical test is whether the actuary is in a position to give objective advice.

Additional Actuarial Roles

In addition to the liability valuation there are important actuarial roles in premium setting, costing of scheme changes and broader issues of financial sustainability.

The principle of this standard is that the Board should obtain and consider actuarial advice when relevant, although the responsibility for some decisions rest with the Board and for other decisions with the government.

The Board of the agency should obtain and consider actuarial advice in the following situations, if they are regarded as material to the prudential management of the insurance business:

- Premium setting/review – significant decisions about premium rates (which should be no less frequent than annual)
- Scheme changes – major changes to benefits and entitlements, whether by legislative change or some other force such as legal decisions or changes in other jurisdictions
- Financial sustainability – every three to five years the Board should obtain actuarial advice on financial sustainability of the scheme having regard to its financial policies, scheme trends and external forces.

The financial sustainability review is broadly equivalent to the financial condition report required by APRA for authorised insurers, but is required less frequently and has a somewhat different focus. It is expected that it will be linked with the agency's own review of its financial policies in accordance with this standard. To the extent that the agency is reviewing its policies under this *Prudential Insurance Standard* from time to time it should also consider the relevance of actuarial advice on those policies.

Peer Review or Second Opinion

This standard does not establish specific requirements for an annual peer review or second opinion on actuarial liability valuations or other advice. The standards above are considered sufficient for sound prudential supervision.

Nevertheless, it remains true that (as with any management function) there is benefit in a fresh look on occasions, and there may be times when the management or Board of an agency would value a second opinion on some issue. In addition such reviews can assist as

a risk mitigation strategy and can be considered as part of an agency's risk management policy.

The Board of each agency should determine the need, frequency and scope of peer reviews having regard to the circumstances of the agency. These circumstances may include: funding levels, current/emerging trends and issues, internal capacity, length of tenure of the current actuary. Boards should note that some form of peer review of the most important issues every three to five years reflects good practice.

Each agency should be aware of the needs of VAGO in respect of audit review of critical actuarial advice. This standard requests the agencies and VAGO to co-operate in considering and engaging actuarial second opinions to achieve best value for the government of Victoria.

Attachment

Prudential Insurance Standard – Board Attestation

**TO THE DEPARTMENT OF TREASURY AND FINANCE
ATTESTATION BY THE BOARD OF DIRECTORS OF [agency]
TO THE PRUDENTIAL INSURANCE STANDARD**

[This attestation of compliance with the Prudential Insurance Standard should be completed as part of the annual reporting cycle and submitted to the Department of Treasury and Finance. It is to be completed by the Chair of the Board and the CEO for and on behalf of the Board.]

The Board of Directors of *[the agency]* certify that:

for the year ended 30 June *[year]*, with the exception of matters stated in Schedule 1,

[Name of the agency] has established and maintained appropriate prudential policies consistent with the Victorian Government's *Prudential Insurance Standard* and that the agency has complied with its policies and the *Prudential Insurance Standard*. The Board verifies this assurance and that compliance with the standard has been subject to critical review within the last twelve months.

Schedule 1

[indicate nil where there are no matters to be reported]

Signed for and on behalf of the Board

Chair of the Board

Chief Executive Officer

Dated: