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TO: ALL PRIVATE HEALTH INSURERS

APPLICATION OF THE CAPITAL FRAMEWORK FOR COVID-19 RELATED DISRUPTIONS

This letter sets out APRA's interpretation of what is necessary for insurers to be consistent with *Prudential Standard HPS 110 Capital Adequacy* (HPS 110) and *Reporting Standard HRS 602.0 Financial and Capital Data* (HRS 602.0).

Restrictions on medical services introduced in March 2020 in response to COVID-19 have affected the pattern of claims by private health insurance policyholders. As some treatments were unable to proceed, insurers will typically have experienced a fall in benefit expenditure in the June quarter. However, in many instances policyholders affected by the restrictions will defer rather than forgo treatment, resulting in a delay in when they claim benefits from their health insurance policy.

In light of uncertainty regarding the appropriate treatment and the potential for inconsistent approaches across industry to COVID-19 related disruptions to claims, APRA is providing interpretive guidance to insurers on the treatment of the liability for deferred claims for capital and prudential reporting. APRA's guidance is intended to protect the interests of policyholders by making sure that insurers have adequate capital to meet all legitimate claims from policyholders, including those which have been disrupted due to COVID-19. Providing clarity on this specific issue should also enable greater focus by insurers and their Boards on how they deliver value for policyholders over the longer-term.

If an insurer is unable to demonstrate, with an explanation acceptable to APRA, that its application of HPS 110 and HRS 602.0 is consistent with the contents of this letter, APRA may ask the insurer to resubmit its returns and may also consider taking further action such as applying a capital adequacy supervisory adjustment to that insurer.

Background

APRA wrote to all insurers on 14 May 2020 outlining its view on prudent considerations related to uncertainty around the impact of COVID-19 related restrictions on medical services. That letter outlined APRA's view that insurers may experience a catch-up period in claims as the resumption of medical services expands.

The Australian Securities and Investments Commission (ASIC) has also issued an FAQ[1] that provides guidance on the accounting treatment by private health insurers for a backlog of procedures. APRA supports the ASIC FAQ, and insurers should use this guidance to prepare their financial statements.

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[1] https://asic.gov.au/regulatory-resources/financial-reporting-and-audit/covid-19-implications-for-financial-reporting-and-audit-frequently-asked-questions-faqs/#q6

APRA has engaged extensively with industry and professional bodies to seek their views on issues related to the expected backlog of claims. Recent data provided to APRA indicates that, at an industry level, benefit expenditure has begun to rebound toward pre-COVID levels. However, APRA's engagement has revealed that insurers remain uncertain on the appropriate method to report and quantify the backlog of claims for regulatory reporting and the Capital Adequacy Requirement. Such uncertainty has the potential to lead to inconsistent approaches between insurers. APRA is also concerned that a number of optimistic assumptions being taken by insurers could result in an imprudent Capital Adequacy Requirement.

This letter sets out APRA's interpretation of the appropriate treatment of COVID-19 related disruptions so as to overcome uncertainty in reporting to APRA and ensure that insurers' Capital Adequacy Requirement remains prudent.

Reporting the liability for deferred claims in APRA returns and determining the Capital Adequacy Requirement

ASIC's FAQ outlines that private health insurers should recognise a claims liability in relation to the backlog of procedures. Consistent with ASIC's guidance, APRA expects regulatory returns will include a specific liability for the backlog of procedures that did not occur due to COVID-19 ('deferred claims liability').

- The deferred claims liability is to be reported as an 'Other insurance liability' (field BSL20766 in *Reporting Form HRF 602.7*).
- Insurers should not include the backlog of claims in the calculation of the liability adequacy test or the stressed net margin estimate.

As outlined in ASIC's FAQ, in determining the value of the deferred claims liability, insurers should typically have regard to the pattern of claims in prior periods compared to the pattern of claims in the current year.

Reflecting a prudent approach, APRA expects insurers to value the deferred claims liability at no less than the percentages of '*claims that did not occur'* set out in Table 1. For the 30 June 2020 returns, the *claims that did not occur* should be calculated with regard to the claims that were expected to occur during March to June 2020 but did not eventuate. Insurers may use the benefits projected during the 2020 premium round or another projection to calculate this amount. Insurers may choose to adjust the *claims that did not occur* for changes in membership and/or product mix.

Table 1: Determining the value of the deferred claims liability

Deferred claims liability	*Percentage of claims that did not occur*	
	Hospital treatment	*General treatment*
APRA regulatory reporting (BSL20766 & BSL20789 of HRF 602.7)	100%	85%
Capital Adequacy Requirement at the 98^{th} percentile (BSL20790 of HRF 602.7)	105%	100%

APRA has determined the percentages in Table 1 based on numerous discussions with industry stakeholders and providers across the health insurance system, as well as a recent survey of health actuaries undertaken by the Actuaries Institute.

Insurers that report benefits materially different to those forecast during the 2020 premium round will be asked to demonstrate the deviation is prudent and complies with this guidance.

Releasing the deferred claims liability

The deferred claims liability is expected to be released or unwound as deferred claims materialise and claims are paid. Insurers should have regard to the same factors that were used to calculate the deferred claims liability in its unwinding. That is, unwinding should have regard to claim payments in the 2021 financial year above those ordinarily expected based on experience in prior periods.

APRA's engagement with industry experts has revealed a general view that a catch-up in claims is likely to be completed by 30 June 2021. Insurers are expected to have fully released the deferred claims liability by 30 June 2021. Should there be further disruption to medical services arising from COVID-19, this date should be reviewed.

In accordance with the requirements of *Prudential Standard CPS 320 Actuarial and Related Matters* (CPS 320), APRA expects the insurer's Appointed Actuary to calculate the value of the deferred claims liability and provide advice on the release of the deferred claims liability. An insurer must notify APRA if it does not accept the advice of the Appointed Actuary in a material respect.

Other implications of COVID-19

In addition to the backlog of claims, COVID-19 gives rise to other risks that should be considered in the 30 June 2020 regulatory returns. These include: appropriateness of risk margins for outstanding claims, calculation of the stressed net margin estimate, potential changes in membership and product mix, adequacy of premium revenue and other implications of COVID-19 on benefit payments – especially relating to mental health.

Insurers are expected to consider these matters specifically, and Appointed Actuaries are expected to include information on these matters in their 2020 Financial Condition Reports. The Actuaries Institute has detailed these matters in a briefing note on year-end accounts[2].

Audit requirements

Information provided to APRA by an insurer is expected to meet certain audit requirements, as set out in *Prudential Standard HPS 310 Audit and Related Matters* (HPS 310) and HRS 602.0. In circumstances where an insurer cannot meet the audit requirements, as the treatment of the deferred claims liability outlined in this guidance deviates from the statutory accounts, the insurer should contact the responsible supervisor.

[2] https://actuaries.logicaldoc.cloud/download-ticket?ticketId=8e67f269-f337-47e0-93d8-7b885cb77811

Sustainability and affordability challenges

Uncertainty around economic conditions and household income impacts from COVID-19 may affect the policyholder mix over the medium-term. Policyholders who expect to make lower claims may be more likely to reduce or cease cover which could exacerbate the underlying challenges of sustainability and affordability in the private health insurance industry over the medium to longer term.

As such, it is important that insurers continue working on plans to robustly manage these challenges in line with the expectations set out in APRA's letter of 3 June 2019. APRA will continue to engage with insurers on their progress in responding to these expectations. APRA will request formal detail on progress in early 2021 and expects to see that insurers have made significant progress, including in scenario analysis and how COVID-19 may have intensified the underlying challenges.

This letter should be shared with all board members, the Appointed Actuary and the Appointed Auditor of the insurer.

If you have any questions on matters raised in this letter, please contact your APRA supervisor.

Yours sincerely

Geoff Summerhayes
Executive Board Member