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TO: ALL LIFE INSURERS AND FRIENDLY SOCIETIES

FINAL INDIVIDUAL DISABILITY INCOME INSURANCE SUSTAINABILITY MEASURES

This letter sets out APRA's finalised position on the sustainability measures for individual disability income insurance (IDII), introduced in APRA's letter of 2 December 2019. This important step provides certainty for life insurers and friendly societies (life companies) to make the necessary changes to their products and practices to improve IDII sustainability, which is in the interest of both life companies and policyholders.

The progress of each life company in meeting APRA's expectations will be taken into account in adjusting that life company's IDII capital charge.[1] [2] Life companies are expected to review and update their product offerings and associated practices with a focus on long-term sustainability, while ensuring that products still meet the needs of consumers. APRA's final IDII sustainability measures are provided in **Attachments A and B**.

The release of the final measures and the introduction of the IDII capital charge have been delayed owing to COVID-19. While the challenges from COVID-19 remain, IDII is a significant concern and is likely to be the product most vulnerable to the ongoing impact of the pandemic. APRA and industry cannot afford further delays in taking decisive action.

Sustainability measures

APRA's IDII sustainability measures have three components.

- Consequence management: Each life company was informed of the amount of its IDII capital charge in December 2019. As a result of COVID-19, implementation of these charges was deferred and will now become effective on 1 October 2020. IDII capital charges will remain in place for each life company until it demonstrates sufficient and sustained progress against APRA's expectations. Failure to meet APRA's expectations could also result in the IDII capital charge being increased, or in APRA issuing directions or amending a life company's licence conditions.

- Managing riskier product features: APRA sought feedback on specific design details of the measures communicated in the December 2019 letter. Feedback received was incorporated into the final measures, contained in **Attachment A**.

- Data: Data remains a key enabler of the actions necessary to improve IDII sustainability. APRA is therefore pleased to observe the release of updated IDII industry experience tables earlier this year. APRA will shortly release its own IDII data collection, which should further enhance its and industry's understanding of IDII performance. **Attachment B**

[1] Sustainability measures set out in this letter, as well as expectations shared in APRA's 2 May 2019 industry letter.
[2] This will be in the form of a supervisory adjustment included in the Prudential Capital Requirement (PCR), consistent with paragraph 44 of *Prudential Standard LPS 110 Capital Adequacy* (LPS 110).

contains APRA's expectations around data, including minor amendments to clarify some of the detail in the December 2019 letter.

Approach

As indicated in the December 2019 letter, APRA's product measures are aimed at addressing two broad areas of risk. These are product design features which are not consistent with the principle of indemnity and the effect of the long time horizons of current policy contract terms and benefit periods. Over recent years, these features have contributed to significant financial losses for life companies, posing a threat to the viability of this product and the protection it offers the Australian community.

APRA's measures are intended to operate as boundaries within which life companies can still offer a range of products to meet consumer needs. There are many facets to product design which APRA's measures do not directly address, but still require careful consideration when developing sustainable IDII products. It is important to consider product design holistically and to ensure controls are commensurate with the riskier product features. More broadly, APRA expects that life companies design and manage IDII products with the objective of:

- meeting the needs of consumers, with clear and objective criteria for claims eligibility;
- providing policyholders with certainty of coverage and premium stability; and
- being financially viable over the long term. While cross subsidies between products may exist, this must be underpinned by a clear understanding of stand-alone profitability.

Life companies also need to observe other conduct requirements, such as impending unfair contract terms provisions, as well as design and distribution obligations, overseen by ASIC.

In conclusion

APRA will continue to engage and work with industry stakeholders to further support sustainable practices. APRA is working closely with ASIC to consider the implications of the IDII sustainability measures for the conduct of life companies and other market participants. During the coming months, APRA and ASIC plan to convene joint engagements with life companies and other industry participants to discuss these matters.

While APRA's sustainability measures are targeted at specific areas of risk and current weak practices in IDII, APRA expects that life companies also apply the underlying principles to other insurance products, where appropriate. This must happen to ensure the ongoing sustainability and availability of life insurance to the Australian community.

With the finalisation of these measures, APRA's focus will shift towards monitoring the progress of life companies in meeting APRA's expectations. The onus is now on individual life companies, and the industry collectively, to move IDII to a sustainable state and thereby deliver better outcomes for policyholders.

Yours sincerely

Geoff Summerhayes
Executive Board Member

ATTACHMENT A: MANAGING RISKIER PRODUCT FEATURES

APRA's measures are aimed at addressing issues in product design that violate the principle of indemnity or contribute to heightened risk owing to the uncertainty arising from long time horizons. It is important to consider product designs holistically. Riskier design features should be mitigated by effective controls, with due consideration of the cumulative impact of multiple product features that may contribute to uncertainty.

APRA's measures cannot, and are not intended to, address every eventuality or exception. APRA expects that life companies design and manage products in a way that is consistent with the broad intent of APRA's sustainability measures, taking account of responsible risk management practices, while remaining fair to policyholders. To provide further clarity, APRA has provided additional considerations and guidance in respect of the measures contained in this attachment.

APRA's IDII sustainability measures apply to products designed to address the income needs of policyholders in the event of temporary or permanent incapacity. Where insurance products provide regular benefits, but these benefits are not designed to solely address income needs (e.g. products that cover business expenses or loan repayments), it is not APRA's expectation for these products to comply with this full package of IDII measures. Life companies are however expected to consider and apply the principles underpinning APRA's sustainability measures to all insurance products, as appropriate.

The measures contained in this attachment are primarily targeted at direct writers. To the extent that reinsurance companies have an opportunity to provide input into the design, development, pricing and management of IDII products, APRA expects such input to be consistent with the IDII sustainability measures contained in this attachment.

APRA will closely monitor the practices of life companies and take these into account in the ongoing review of each company's IDII capital charge.

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.

ATTACHMENT B: DATA

APRA expects that all life companies improve the quality, quantity and timeliness of their data. Along with industry consistent definitions, this will enable life companies to efficiently contribute to industry experience studies, conduct their own annual internal experience studies and set more appropriate pricing and valuation assumptions. APRA considers timely access to quality data to be a key enabler of effective risk management and sustainable industry practices.

1. APRA data collection on IDII

APRA will shortly be releasing a targeted IDII data collection, aimed at:

- providing further insight into the drivers of IDII results;
- informing APRA's ongoing monitoring of life companies' progress in meeting APRA's expectations and feeding into the review of each life company's IDII capital charge; and
- supporting a general uplift in industry's IDII data capabilities.

APRA Data Measure 1: APRA IDII Data Collection

1.1 APRA expects that life companies provide quality data in their timely submissions to APRA's data collection on IDII.

APRA intends to publish aggregate industry level information and insights as soon as the credibility and reliability of the data has been established.

2. Industry and entity experience studies

It is in the interest of all life companies that industry studies are performed regularly and in a timely manner. APRA expects that life companies individually, and collectively as an industry, take responsibility for performing industry experience studies and releasing updated industry tables when appropriate.

APRA expects that life companies perform regular internal experience studies and set their valuation and pricing assumptions with due consideration of both their own and industry experience.

APRA Data Measure 2: Industry and Entity Experience Studies

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

2.1 contribute to industry experience studies with quality data in a timely manner, enabling the release of results at least every 18 months;

2.2 conduct internal experience investigations at least annually and update valuation and pricing assumptions where appropriate; and

2.3 set assumptions using the most recent industry table (or industry experience study when a new industry table is not produced) with a release date not older than 18 months at the time assumptions are set. Deviations between a life company's assumptions and the most recent industry study and/or table should be clearly understood and justified.