Members Health
FUND ALLIANCE

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Dear General Manager, Policy Development

RE: APRA's review of the private health insurance capital framework

1 About Us

Members Health welcomes the opportunity to respond to the regulator's ongoing consultation on its review of the private health capital framework, including the draft capital standards released on 13 December 2021.

As the peak body for 26 not-for-profit (NFP), member owned and community based health insurers, Members Health advocates for a successful private health insurance industry (PHI) which is underpinned by fit-for-purpose policy frameworks and efficient processes.

Our alliance of 26 Members Health funds represents more than 35 per cent of the private health insurance market. APRA data consistently validates the prudential and sound market positioning of our funds: they hold capital above the regulatory minimum required; continue to grow with all age cohorts and importantly, with younger policyholders; offer extremely competitively priced products; return more of the premium dollar back to members as benefits; and lead the industry when it comes to customer satisfaction and retention.

2 Introduction

We note the proposed structure for the PHI framework is largely unchanged from APRA's early discussion paper. Members Health understand that some of the bespoke elements of the sector have been considered in the draft standard, we remain of the view that the framework for PHI should be underpinned by:

- A reduction in the burden on insurers by avoiding unnecessary complexity and provide for standards that are as easy to implement as possible.
- An allowance of sufficient time for insurers to make the necessary adjustment in transitioning to the new standards.
- A design which appropriately recognises the specific nature of PHI insurance risk.
- Minimum capital requirements that are commensurate with the level of risk inherent in the PHI business model, given the short-tail nature of PHI claims and the absence of catastrophic exposures which are experienced in other sectors.

- Evidence and justification for any departures on the previous capital standards.

A core purpose of health insurance is to provide Australians with control and choice around their health care. Regulatory reforms should be optimized and fit for purpose, they should not make private health insurance more complex or more difficult to supervise and regulate.

New standards need to demonstrate that they serve the public interest and do not damage or limit competition and diversity of the PHI market, which would be to the detriment of consumers.

Observations, comments and recommendations in relation to the draft standards are made through the submission, and Members Health's key recommendations to the regulator are summarised in the table below.

Key recommendations

Response to Prudential Standards	
Responding to PHI Insurance Risks	
Recommendation 1	APRA to set the risk charge in the standards commensurate with the potential for such a risk and insurers practical ability to respond to that risk.
The place of management actions	
Recommendation 2	APRA to remove the allowance for management action from the Future Event Risk Charge, in exchange for shortening the horizon of the charge.
Pricing philosophy	
Recommendation 3	Noting pricing risks are already appropriately considered in the ICAAP framework, that APRA remove the requirement for health insurers to have a written, Board approved pricing philosophy.
Investment implications	
Recommendation 4	To better reflect the portion of assets held by insurers over the long term, APRA risk charges should consider risk over a longer horizon.
Asset risk charge	
Recommendation 5	APRA to implement a mechanism to cap investment asset risk charge to recognise where a health fund's investment assets exceed a defined minimum threshold.
ICAAP Transition	
Recommendation 6	APRA to provide further guidance which details the expectations as to what is appropriate for small to medium health insurers in relation to ICAAP.
Other Comments	
Recommendation 7	APRA should minimise unnecessary complexity to the greatest extent possible and remove the notion of the 'general fund'.

Response to proposed reporting standards	
Recommendation 8	APRA should not simultaneously introduce the AASB17 and the new capital standards.
Recommendation 9	APRA to improve its instructions and guidance in relation to the proposed reporting standards and ensure that such standards are appropriately tailored to PHI.
Implementation	
Recommendation 10	Recognising the ongoing operational challenges of the pandemic response, APRA should consider revising the deadline for the introduction of the new standards by at least twelve months to assist the regulator and insurers to better understand and adjust to the final standards.

3 Response to proposed prudential standards

PHI TAILORED DESIGN

APRA's capital standard and the resultant minimum capital requirements must reflect the nature of PHI. Our member feedback consistently notes that APRA's proposal seems conservative, overstating the insurance risks facing the sector.

Members Health acknowledges that PHI shares some characteristics with the life and general insurance industries, in particular risks relating to underpricing where the true underlying exposure is not sufficiently well understood by the insurer. However, in contrast to life and general insurance, PHI claims are very short-tailed by their nature and coupled with the absence of catastrophe exposures means that any underpricing can be identified expeditiously by insurers, allowing for the rapid implementation of a response strategy.

APRA has proposed that the probability of sufficiency requirement apply on a gone concern basis, rather than a going concern basis. Notwithstanding the significant consultation APRA has undertaken to date, there remains considerable confusion in the industry regarding precisely what APRA means by these terms, and when each should be used. It would be helpful to Members Health funds if APRA were to provide definitions and demonstrate which elements of the standard are to be prepared and on which basis.

RESPONDING TO PHI INSURANCE RISK

APRA needs to make clear the evidence it relies upon to support the Future Event Risk Charge, and in particular the horizon to be considered.

APRA has previously noted that the current capital framework does "*not appropriately reflect the risks faced by insurers, and does not adequately allow for consideration of adverse events that could affect their performance, such as extreme adverse events with low probability*". However, neither APRA nor industry experts have been able to provide a consistent, meaningful definition and examples of such events that would impact insurers, beyond government intervention (i.e. sovereign risks). Members Health does not believe that government policy or interventions in the health system

are a matter for minimum prudential capital requirements, and rightly belong in an insurer's target capital assessment (i.e. via ICAAP).

We observe, generally, significant adverse events over the past 20-30 years that have stressed individual insurers have related to rapid policy growth either in response to significant policy changes or entry into new markets when underpriced. These risk factors can be identified, though not always quantified, by insurers (or APRA) in advance. It is not clear that these risk factors are adequately captured in APRA's proposal.

For example, APRA increases the insurance risk charge for insurers that have achieved net growth above 2.5% p.a. in the past three years, however, Members Health contends that not all growth is equally risky. APRA's proposal is not particularly risk sensitive and penalises smaller insurers who have consistently grown above industry average in a controlled manner. As we pointed out in our previous submission, this has implications for contestability in the market, as smaller insurers are more likely to exceed industry average growth when compared to larger insurers. While APRA acknowledged the impact of their proposal on contestability in their response paper and have tweaked the risk charge for growth, we believe the proposal needs to be further changed to reflect the real risk which is growth and underpricing, and not growth alone.

Members Health appreciates that one of the key principles in reforming the PHI Capital Standards is to strengthen the link between the capital requirements and risk, and so 'reward' insurers with stronger, demonstrated risk management capabilities. We find it challenging to understand then why the management actions, allowed under the Future Event Risk Charge, are not able to be introduced until a full 9 months after the significant shocks imposed on insurers under this charge. We believe management actions, if allowed at all, should not be subject to any constraints other than the risk management capabilities of insurers. Insurers have spent significant effort in recent years developing Recovery Plans and lifting their scenario analysis and stress testing capability such that they have a better idea than ever as to how they might respond to adverse events. Assuming insurers will wait for a full nine months before acting in a severely stressed state is unrealistic and does not reward insurers with stronger risk management capability.

Members Health submits that the capital standards should reflect insurance risks relevant to PHI. Unlike the other forms of insurance that APRA regulates, private health insurance:

- Has minimal catastrophe risk;
- Has no specific contract term, and
- Detrimental product changes addressing adverse claiming behaviour can be made with 60 days' notice to affected policyholders.

As a result of these characteristics, we believe that there is limited scope for adverse event stress, and that any risk charge in the standards should be commensurate with the potential for such a risk and insurers practical ability to respond to that risk.

Recommendation 1: APRA to set the risk charge in the standards commensurate with the potential for such a risk and insurers practical ability to respond to that risk.

THE PLACE OF MANAGEMENT ACTIONS

From the outset of APRA's review, Members Health has consistently highlighted the need for the standards to both recognise the specific nature of PHI insurance risk and avoid unnecessary complexity.

As APRA's proposal currently stands, the allowance for management action introduces significant complexity without meaningful gain. The vast majority of our members would support the removal of allowance for management action from the Future Event Risk Charge, in exchange for shortening the horizon of the charge acknowledging the limited scope for adverse events in PHI to go unresponded to.

Recommendation 2: APRA to remove the allowance for management action from the Future Event Risk Charge, in exchange for shortening the horizon of the charge.

PRICING IMPLICATIONS OF APRA's PROPOSAL

The pricing implications of the proposal suggests that further refinement is required to recognise the low prudential risk of PHI and the need for proportionate regulation that mitigates these risks.

While APRA has regularly stated that they expect no change to the total level of industry capital as a result of the capital standards review. However, we would point out that any increase in the minimum capital requirement will cause insurers to review their capital management plans. APRA is aware that many NFP insurers include consideration of the probability of a breach of regulatory capital (or the MCR) as a key pillar in their target capital calculations.

APRA's increase in the MCR is likely to increase the target capital levels adopted by many NFP insurers. This change would come during a time when consumer affordability remains an acute priority, against a political and media landscape which is putting upward pressure on premiums.

The options available to NFP insurers to fund this increase are limited, and are likely to place upward pressure on premium increases.

PRICING PHILOSOPHY

The draft Prudential Standard HPS 110 Capital adequacy contains a requirement for health insurers to have a written, Board approved philosophy. Members Health submits that this requirement be removed for private health insurers, noting that pricing risks are appropriately considered in the ICAAP framework.

Additionally, Members Health notes that such a requirement is absent in the current general and life insurance prudential standards. Recent history indicates that pricing is a much greater risk for general and life insurers than for private health insurers. This is demonstrated by many recent examples of general and life insurers requesting annual price increases of up to (and sometimes in excess of) 100% of annual premiums to rectify historical pricing issues. These pricing increases are significantly greater than the most recent average annual PHI premium increase which was less than 3%. Consequently, Members Health does not consider it appropriate for private health

insurers to be subject to APRA pricing philosophy requirements that are over and above those in the general and life insurance industries.

Recommendation 3: Noting pricing risks are already appropriately considered in the ICAAP framework, that APRA remove the requirement for health insurers to have a written, Board approved pricing philosophy.

INVESTMENT IMPLICATIONS OF APRA's PROPOSAL

Notwithstanding APRA's statement that asset risks are the same regardless of which industry an insurer operates in, we note that NFP insurers have significant assets invested on behalf of their members as part of the member estate. Having conducted the QIS, many of our members commented on the significant increase in asset risk charges arising from the new standard, and in particular the increase in the risk charges on equities when estimated at 30 June 2021.

While the 30 June 2021 ASX200 dividend yield was particularly low and so increased the asset risk charge on equities significantly relative to recent history, we note that the dividend yield was partly depressed because of APRA's directives to APRA regulated institutions in respect to dividend payments. We ask that APRA consider their desired risk charge on equity investments and whether the impact on this particular asset risk charge during the pandemic was as expected. We note that investment in growth assets is foundational to the not for profit PHI proposition, and that the swing in the risk charge on equities in evidence throughout the pandemic will also have implications for target capital levels set by not for profit insurers.

Furthermore, Members Health surveyed our members regarding whether APRA's proposal had significant implications for their investment strategy, and note that approximately half of respondents believed that there would be implications for their asset allocation and the investment returns that are able to be achieved, although the specific work to evaluate the 'cost' of the new standards was still to be completed. There is particular concern about whether the APRA risk charges are necessarily consistent with the long term best interests of policyholders, noting that a portion of the assets held by well capitalised insurers are held for the long term, and the APRA risk charges only consider risk over a one year horizon, which is not consistent with how these funds are invested on their member's behalf.

Recommendation 4: To better reflect the portion of assets held by insurers over the long term, APRA risk charges should consider risk over a longer horizon.

ASSET RISK CHARGE

The Private Health Insurance Industry is unique in that around 35% market share (by policies) is represented by the NFP sector. Higher levels of investment assets and investment income is a key element of many NFP health fund's commercial business models. This allows many NFP health funds the flexibility to offer increased ongoing membership value (e.g. through lower premiums, higher benefits etc) and thereby target lower gross operating margins. The prudential standard unfairly penalises these NFP health funds as investment asset risk charges applies to all investment assets irrespective of the health fund's capital levels that exceed PCR.

Members Health recommends that APRA implement a mechanism to cap investment asset risk charges to recognise where health fund's investment assets exceed a defined minimum threshold.

For example, investments assets in excess of the sum of – 1) insurance liabilities (i.e. outstanding claims liabilities, premium liabilities, and deferred claims liabilities), 2) APRA liability risk charges, 3) APRA future exposure risk charges, and 4) APRA operational risk charges - are not subject to asset risk charges.

Such an approach maintains adequate capital prudence while recognising the diversity of the NFP sector within the PHI industry.

Recommendation 5: APRA to implement a mechanism to cap investment asset risk charge to recognise where a health fund's investment assets exceed a defined minimum threshold.

ICAAP TRANSITION

Members Health funds are broadly supportive of the introduction of ICAAP, although there is an acknowledgement that there will be uplift required from insurers in transition. In introducing ICAAP to PHI, APRA makes statements to the effect that ICAAP should be "appropriate to the size and complexity of the organisation". Noting that PHI is mono-line short tail business, and that the NFP segment of the market is characterised by a large number of small insurers it would be very helpful if APRA could provide further guidance as to the expectations of what is appropriate for small to medium health insurers.

Recommendation 6: APRA to provide further guidance which details the expectations as to what is appropriate for small to medium health insurers in relation to ICAAP.

OTHER COMMENTS

Members Health suggests that unnecessary complexity will only add to the financial impost of the standards and APRA should ensure these are minimised to the greatest extent possible. It is our view that the notion of the 'general fund' adds to the overall complexity of the prudential and reporting standards for a minimal gain in many cases.

Recommendation 7: APRA should minimise unnecessary complexity to the greatest extent possible and remove the notion of the 'general fund'.

4 Response to proposed reporting standards

APRA's earlier consultations suggested that the regulator would undertake to align reporting requirements with those of AASB 17. Under the proposal we understand that insurers will be asked to undertake liability valuation on two separate bases for AASB17 and APRA prudential reporting. Such duplication hinders engagement with insurers and their Boards. At this time we ask that APRA consider divorcing the introduction of AASB17 and the new capital standards, allowing insurers more time to make the transition to the new standards. The proposed simultaneous introduction of AASB17 and the new Capital Standard was made under the assumption that this

minimised the systems and reporting burden on insurers. It is unclear at this time whether any such synergy exists.

With respect to the proposed reporting standards, our members have been challenged by the unclear instructions and guidance offered. In particular there is a lack of clarity around the inter-relationships between the reporting forms and common elements across multiple forms. Members have commented on the total absence of any reconciliation checks, the challenge in working across unlinked workbooks, and the fact that HRS 300 does not appear to have been tailored to PHI in any way at all with significant redundant cells included.

Recommendation 8: APRA should not simultaneously introduce the AASB17 and the new capital standards.

Recommendation 9: APRA to improve its instructions and guidance in relation to the proposed reporting standards and ensure that such standards are appropriately tailored to PHI.

5 Implementation

While there has been no confirmed set date for the introduction of the new standards, Members Health understand that APRA will ask insurers to implement the new standards by the beginning of 2023.

Members Health funds acknowledge that APRA's consultation on the draft standards have been conducted during an operationally challenging period as both funds and the regulator navigate their responses to the COVID-19 pandemic.

Uncertainty as to the impact of the COVID-19 virus on health insurance operations will continue until it becomes endemic. The present situation is that the COVID-19 pandemic remains a major ongoing issue and is continuing to present significant operational challenges for health insurers. These challenges include managing staff absenteeism and isolation due to illness, remote working, alongside recruitment challenges in a tight labour market where international and domestic travel is yet to return to normalcy. These and a range of other pandemic issues and uncertainties continue to impact on the capacity of health funds to effectively implement new standards.

Notwithstanding these challenges, the consultation itself has included several draft iterations on various report standards for example, with clarifying remarks culminating in an announcement in late February to change the guidance on the treatment of the DCL. Feedback from Members Health funds has been that the draft reporting standards have been rushed and that there would be significant value in APRA considering the user-friendliness of the forms and the provision of appropriate guidance.

Having regard to these issues, and the operational challenges that funds are facing, Members Health strongly suggests that APRA appropriately schedule the introduction of the new standards by 12 months to assist insurers to better understand and adjust to the final standards.

Recommendation 10: Recognising the ongoing operational challenges of the pandemic response, APRA should consider revising the deadline for the introduction of the new standards by 12 months to assist the regulator and insurers to better understand and adjust to the final standards.

6 Conclusion

Members Health recognises APRA's ongoing engagement with the industry on this important matter. We continue to encourage the regulator to carefully consider the issues and suggestions raised in our submissions. We ask that APRA ensure that it adheres to the following overarching principles to ensure that when the new standards are introduced they:

- Are optimised to reflect the unique and bespoke nature of private health insurance;
- Reflect the low short term prudential risk of PHI;
- Reduce unnecessary regulatory imposts;
- Avoid making PHI more complex, harder to supervise and regulate, and;
- Do not dilute consumer competition and choice.

We look forward to continuing to participate in this process and invite any further queries relating to our submission.

Yours sincerely,

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CEO, Members Health Fund Alliance