29 March 2022

Australian Prudential Regulation Authority (APRA)
General Manager, Policy Development
Policy and Advice Division
Level 12, 1 Martin Place
Sydney NSW 2000

Dear Sir/Madam

Submission to APRA: Review of Private Health Insurance Capital Framework

The Actuaries Institute ('the Institute') welcomes the opportunity to respond to APRA's detailed proposals concerning its review of the private health insurance ('PHI') capital framework released on 13 December 2021.

Our response was coordinated by a working group ('the group') re-convened by the Institute to consider APRA's draft prudential capital standards. We would like to acknowledge APRA for the thinking and significant effort that has already gone into developing the prudential standards, including considering and adopting a number of recommendations from our previous submissions in July 2020 and May 2019. This submission draws on those previous submissions and is intended to provide additional considerations for APRA. As such, considerations already raised in the previous submission are generally not repeated in this submission.

As APRA has outlined its detailed rationale behind the proposed standards in the Response Paper, this submission paper focuses on areas where we believe further clarification would be beneficial and/or where there are potential inconsistencies between APRA's objectives in reviewing the PHI capital framework and the draft standards.

We hope that these additional views will be helpful to APRA in finalising the standards.

1. Overview and summary of recommendations

The Institute supports adopting the Life and General Insurance Capital (LAGIC) structure for the capital standards in PHI and the introduction of the Internal Capital Adequacy Assessment Process (ICAAP) to encourage better management of risks and capital in a consistent manner. These two mechanisms should ideally work and support each other to protect policyholders.

PHI has unique features which have required APRA to modify the proposed LAGIC approach for this industry. This is evident by the proposed standards, which differ in some respects from the approach currently in place for general and life insurers.

The tailoring of the approach for PHI includes the way in which 'gone concern' has been interpreted in the PHI context. It can also be seen by how management actions have been interpreted to reflect the regulations in PHI and the unique nature of its risks.

Overall, whilst we support the effort to tailor the capital standards to better suit PHI, it is not always clear how the underlying concept for gone concern is, or is not, applied and whether its application has influenced APRA's thinking on management actions.

Hence, in arriving at our list of recommendations, it can be seen that our suggestions largely stem from uncertainty about APRA's approach for applying gone concern. As a result of the approach to management actions, we also highlight some potential implications for the consistency between ICAAP and capital management practices. There are also implications for how gone concern is interpreted.

In particular, where a gone concern basis has been applied to the current balance sheet through capital base reductions and an Insurance Liability Risk Charge (ILRC) and not applied to future premiums (i.e. a 'going concern' basis) through the Future Exposure Risk (FER)Charge, this leads to an element of double count of similar risks in the standards as some risks are subject to capital charges in each of the capital base reductions, ILRC and FER.

The following recommendations (and the implications that we think should be avoided) are as follows for APRA's consideration.

1. **Investment and other income be allowed to offset the FER.** This would be consistent with going concern, which is the basis for FER and the gone concern basis for the Asset Risk Charge.
2. **Tax benefits to offset the FER.** This would be consistent with going concern, which is the basis for FER.
3. **Deferred Claims Liability (DCL) or other similar insurance liabilities at 99.5th percentile under Other Insurance Liabilities Risk Charge be allowed for in the FER.** Again, this would be consistent with going concern basis under FER as DCL is nil on a gone concern basis.
4. **Tax asset reductions on the gone concern basis are applied consistently with either the ILRC or FER**. For example, the deferred tax asset arising from the DCL is currently not counted towards the capital base under a gone concern basis. However, the DCL would be zero on a gone concern basis. This would effectively lead to a double charge for the DCL, i.e. writing off the tax asset and incurring a capital charge for a 99.5% DCL event under a going concern basis.
5. **An allowance or 'offset' be included in the FER for overlaps with other insurance risk charges**. Premium liabilities and DCL have capital risk charges in the Premiums Liability Risk Charge and Other Insurance Liabilities Risk Charge respectively. However, as premium liabilities and DCL are expected to run off over the next 12 months, there are effectively additional risk charges applied to the next 12 months of earned revenue relating to these items under the FER.
6. **That APRA considers how better to align management actions with an insurer's ICAAP**. This would benefit from ensuring a link between an insurer's current going concern capital management processes and the approach taken to the going concern test in the prudential capital requirement. We believe that the requirement for an independent review of the ICAAP should give APRA confidence that effective controls are in place and that assumed management actions are reasonable and appropriate.

2. Discussion of APRA's draft prudential standards

2.1. Gone concern vs going concern

We note there are differences between the proposed capital standards and the LAGIC framework around applying 'gone concern' and 'going concern' concepts. The proposed PHI capital standards assume a going concern basis for 12 months where a capital charge is applied to revenue for the next 12 months based on a stress to net margins. This is different from LAGIC, which is under a gone concern basis.

Our interpretation of the gone concern application is shown below for the current PHI treatment, the proposed PHI treatment and the LAGIC treatment.

Item	Current PHI	Proposed PHI	LAGIC
Going/gone concern	Going for 12 months	Going for 12 months then gone	Gone
Insurance risks (HPS 115)			
Outstanding claims liability risk charge	Capital charge to current balance (gone concern)	Capital charge to current balance (gone concern)	Capital charge to current balance (gone concern)
Premiums liability risk charge	Capital charge to current balance (gone concern)	Capital charge to current balance (gone concern)	Capital charge to current balance (gone concern)
Future exposure risk charge (charge on 12 months future premiums)	Yes (going concern)	Yes (going concern)	N/A[1]
Other insurance liabilities risk charge (including DCL)	Going & charge to current balance	Going & charge to current balance	DCL or future premium risks N/A
Allowance for investment/other income for 12 months	Can offset net margin losses in going concern	Cannot offset net margin losses in going concern	Gone concern so N/A
Allowance for tax benefits	Tax benefit in going concern	No tax benefit in going concern	Gone concern so N/A
Asset risks (HPS 114)			
Investment risks	Stress applied to 12 months forecast	LAGIC basis to current balance	LAGIC basis to current balance
Capital base (HPS 112)			
Gone concern asset write-offs	Nil	LAGIC gone concern basis	LAGIC gone concern basis

As outlined in the table above, the two key elements of the standards that we interpret as under a going concern basis are the FER and Other Insurance Liability Risk Charge (including the DCL). While we acknowledge that these elements have been designed differently from LAGIC to reflect specific risks unique to PHI, it would be beneficial for the industry if APRA could further clarify its thinking around the gone concern and going concern basis for various aspects of the standards.

Internal consistencies within the standards

Ultimately, we believe that it is important for APRA to ensure consistent applications of gone concern and going concern basis within the PHI capital framework. To enhance consistency within the standards, we offer APRA the following considerations.

[1] For life insurance, the capital standards allow for future premium liability incurred over the next 12 months on existing policies that are expected to renew and remain on the book for that period. New business is not included over the 12-month period.

- Treatment of tax, investment and other income
    - No tax benefits or allowance for investment and other income are assumed in the FER. This is inconsistent with the going concern basis we believe has been adopted in the FER and the separate allowance for investment risks on a gone concern basis under the Asset Risk Charge.
    - APRA may want to consider including allowance for tax benefits, investment, and other income in the FER. This approach would be consistent with going concern, which is the basis for FER.
- Treatment of DCL and other similar liabilities under Other Insurance Liabilities Risk Charge
    - A DCL represents a provision for future claiming above expectations, and on a gone concern basis there would be no such liability by definition. However, a capital charge relating to the DCL under the ILRC is on a gone concern basis.
    - As the DCL is expected to run off over the next 12 months, these are the same claims already captured under the FER, resulting in a risk charge being effectively applied twice.
    - As the DCL is included in the ILRC as a gone concern, the deferred tax asset arising from the DCL is not counted towards the capital base under the proposed standards. This effectively represents an additional charge on the DCL due to the writing off of the tax asset.
    - Our suggestion is for APRA to consider allowing for the DCL as part of FER instead of ILRC. This approach would enable consistent application of gone concern in the ILRC and going concern in the FER.
    - In addition, we suggest that APRA ensure consistent treatment of the deferred asset tax arising from the FER, which is on a going concern basis, to avoid any potential double count.
- Treatment of similar risks
    - The proposed standards include Premiums Liability Risk Charge on gone concern basis under the ILRC. As premium liabilities are expected to run off over the next 12 months, these are effectively also included in the FER. However, there is no allowance for a premium liability or other future premium charge offset in the FER.
    - The proposed standards include:
        - 99.5th percentile event resulting from an industry-wide systemic event (Adverse Event Stress) combined with insurer specific event (Prescribed Benefit Stress) in the FER; as well as
        - 99.5th DCL event in the ILRC on a going concern basis.

      However, there is no aggregation benefit to allow for the likelihood that these events will not occur simultaneously. This differs to LAGIC, whereby life insurers apply correlation factors and general insurers apply an offset to avoid double count.

- We suggest that APRA consider including an allowance in the FER to offset any potential overlaps with other insurance risk charges. APRA may want to consider a similar approach taken under LAGIC for general insurers where the Appointed Actuary determines a 'Premiums Liability offset' under the Insurance Concentration Risk Charge to allow for catastrophic losses already included in the premiums liability.

2.2. Approach to management actions

The proposed capital standards allow for management actions when assessing the FER with the following limits:

- a minimum timeframe of nine months before actions can take effect;
- incurred losses cannot be offset by assumed profit after management actions take effect, effectively placing a cap of zero on net margin in the final quarter of the year; and
- the allowances for management actions must be appropriate, justifiable and equitable.

We are supportive of the inclusion of controls in the standards to ensure that insurers make appropriate and justifiable allowance for management actions. We also acknowledge that some controls are necessary to limit insurer discretion in determining the capital requirements, which is one of APRA's primary objectives in reviewing PHI capital standards. We also agree with APRA's objective to prevent a scenario in which an insurer's profitability level is improved due to management actions.

However, in our view, the proposed limits may not reflect the expected actions taken by insurers nor the impact of those actions. We believe that the actions, timeframe and effectiveness of management action are likely to vary between insurers and will be driven by individual insurers' risk appetite, risk management and governance processes captured in the ICAAP.

Under the new standards, insurers are required to have an ICAAP that includes stress testing, capital triggers and sets of potential corrective actions associated with various levels of triggers. In a stress situation, an insurer is expected to respond in accordance with the triggers and actions set out in the ICAAP. Therefore, controls should be designed to encourage insurers to align their management actions with their risk and capital management, including ICAAP.

9-month limitation

Given that the proposed prescribed events occur on (or from) day 1, we believe that better-managed insurers will identify the reasons for the poor experience quite quickly, allowing that insurer to take more immediate corrective actions. Therefore, the prescribed limitation penalises better-managed insurers even though we believe that APRA would want to encourage better monitoring of risks.

In addition, the fact that the Adverse Event Stress is industry-wide may reduce any competitive considerations that might delay an insurer from taking management actions.

Profit cap on the effectiveness of management actions

The proposed limitation that incurred losses cannot be offset by assumed profit after management actions take effect creates inconsistent impacts across the insurers where an insurer with a lower net margin can get more credit for management actions than an insurer with a higher net margin. This does not consider their respective risk management/governance processes and willingness/ability to take corrective action.

While we acknowledge that APRA is trying to avoid a scenario in which insurers end up being more profitable after management actions than before, we request APRA consider if it is consistent with APRA's intentions to encourage better management of risks and capital consistently across capital standards and ICAAP.

Furthermore, the proposed 'profit cap' may not be consistent with the approach under LAGIC, where life insurers, within certain limitations, can assume management action can restore the margins to pre-stress level provided that the action is appropriate and justifiable.

Alternative approach

As an alternative, APRA may want to consider aligning the allowable management actions, timeframe and effectiveness to an insurer's ICAAP. Under this approach:

- Where an insurer's ICAAP allows for 'appropriate, justifiable, and equitable' specific actions under the FER scenario, these should be allowed for, in line with the timeframes imposed under the ICAAP.
- If reasonable and appropriate assumptions have been made, management actions should be allowed to return an insurer to profitability at the pre-stress forecast net margin level.
- The ICAAP review process should include an independent assessment of whether reasonable and appropriate management action assumptions have been made in line with the requirements under the standards.

This approach would have the benefit of ensuring consistency between an insurer's capital management processes and proposed prudential capital requirements. This approach also ensures consistency with life insurers under the LAGIC framework.

Further discussion

The Institute would be pleased to discuss this submission with APRA.

Yours sincerely,

President