



RESPONSE TO SUBMISSIONS

Risk management prudential standard for
private health insurers

July 2017

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Executive Summary

On 15 December 2016, the Australian Prudential Regulation Authority (APRA) released for consultation a discussion paper proposing to apply cross-industry *Prudential Standard CPS 220 Risk Management* (CPS 220) to the private health insurance (PHI) industry. APRA invited feedback on the standard and *Prudential Practice Guide CPG 220 Risk Management* (CPG 220), developed to assist APRA-regulated institutions to comply with the requirements of the standard. APRA received submissions from a range of stakeholders including the two PHI industry associations, 12 APRA-regulated institutions and the Actuaries Institute. The insurer submissions represented a broad cross-section of the industry (approximately 83 per cent by market share).

All submissions supported the introduction of a risk management standard for the industry and the overarching objective of CPS 220 - to enhance the risk management practices of all authorised deposit-taking institutions, general insurers, life companies and private health insurers. There was agreement that the core principles of CPS 220 are appropriate for the PHI industry and that the proposed modifications to the standard to incorporate private health insurers are appropriate. Most observed that the requirements of CPS 220 represented sensible business practice, which will replace or enhance other processes currently in place.

The two issues raised most frequently in submissions were requests for further clarification about the role of the Chief Risk Officer, and to extend the transition period to enable some insurers to recruit specialist staff and to successfully rollout, or upgrade existing risk management information systems.

The submissions that costed the new prudential requirements found the costs were not material and that the benefits of implementing the standard would outweigh any new costs incurred to strengthen existing risk management practices.

This paper sets out APRA's response to the key issues raised in submissions. In summary, APRA has extended the implementation date of CPS 220 for private health insurers to 1 April 2018 and made a number of minor changes to the versions of CPS 220, CPG 220 and *Prudential Standard HPS 001 Definitions* (HPS 001) released for consultation in December 2016. The amendments provide additional clarity about compliance with CPS 220.

This response paper, prudential standards, practice guide and non-confidential submissions are available on APRA's website at www.apra.gov.au

Chapter 1 – Introduction

In May 2016, APRA commenced consultation with the PHI industry and other stakeholders on APRA's medium term prudential policy outlook for the PHI industry. APRA indicated that it would review the prudential framework in three phases – risk management, governance and capital – as part of a structured roadmap. The initial priority for review is risk management, with governance and capital to be addressed in 2017/18 and 2018/19 respectively.

APRA released a discussion paper proposing to apply CPS 220 to the PHI industry in December 2016. The objective of CPS 220 is to ensure that all authorised deposit-taking institutions, general insurers, life companies and private health insurers have in place appropriately structured and systematic approaches to the identification and management of risk. The proposals contained in the December 2016 discussion paper were designed to enhance financial soundness, avoid unnecessary cost impacts and accommodate the diversity of private health insurers in the market.

Feedback from consultation

APRA received submissions from a range of stakeholders including the two PHI industry associations, 12 APRA-regulated institutions and the Actuaries Institute. Three submissions were provided in confidence. The insurer submissions represented a broad cross-section of the industry (approximately 83 per cent by market share).

Submissions were broadly supportive of the proposal, with all submissions finding the core principles of CPS 220 appropriate to the PHI industry. Submissions also noted the merits of taking a harmonised approach to regulating risk management across the industry and the value of a common language and common approach across all APRA-regulated industries.

Respondents generally noted that the estimated costs of complying with CPS 220 were not material, that they would not influence an insurer's product range, profitability of premiums, or generate additional economic burden for consumers. Most observed that the requirements of CPS 220 represented sensible business practice, which will replace or enhance other processes currently in place, rather than generate significant new compliance costs.

Structure of this paper

This paper includes responses to matters raised in submissions.

Chapter 2 summarises the main issues raised in submissions, along with APRA's responses.

Chapter 3 discusses minor amendments to the prudential standards and prudential practice guide suggested by stakeholders.

Next steps

In light of the limited extent of change to CPS 220 in response to submissions, APRA is releasing with this paper final versions of CPS 220, CPG 220 and HPS 001.

APRA has extended the date for implementation of CPS 220 to 1 April 2018. The additional three months should ensure an orderly implementation and transition for the majority of private health insurers.

APRA will consider applications to vary a requirement of the standard or to extend the transition period on a case-by-case basis. Where an insurer wishes to apply for such arrangements, the following process will apply:

- the application should be submitted in writing to APRA by 1 November 2017;
- the application must address:
 - for an application for additional time for transition: the provision/s of CPS 220 which the private health insurer is not able to comply, the reasons why the insurer is unable to comply and the date by which the private health insurer expects to be able to comply with the identified provision/s;
 - for an application for an alternative arrangement on an ongoing basis: the material constraints or circumstances peculiar to the institution that give rise to a need for an alternative arrangement, the proposed alternative arrangement, how the board of the insurer has satisfied itself that the proposed alternative arrangement can achieve the principles of CPS 220, and an assessment of the overall robustness of the institution's risk management framework under the alternative arrangement;
- there is no approved form for such applications; and
- APRA will consider each application on its merits and notify the insurer in writing of its decision.

APRA will shortly commence consultation on APRA's expectations of good governance. Similar to CPS 220, APRA anticipates that the existing cross industry *Prudential Standard CPS 510 Governance* and *Prudential Standard CPS 520 Fit and Proper* will be broadly appropriate to the PHI industry. APRA continues to encourage insurers to familiarise themselves with these standards and consider applying the principles to their own operations in preparation for the next policy discussions.

Chapter 2 – Specific proposals

This Chapter sets out the main issues raised in submissions and APRA's response to those issues.

2.1 Chief Risk Officer

CPS 220 requires APRA-regulated institutions designate a Chief Risk Officer (CRO) to be responsible for the institution's risk management function. The standard provides scope for an institution to propose an alternative arrangement to APRA where the institution can demonstrate that a CRO requirement is inappropriate for their particular circumstances and that the alternative arrangement can achieve the objectives of CPS 220.

Alternative arrangements

All submissions expressed support for APRA's preparedness to consider applications for alternative arrangements on a case-by-case basis. A number of submissions requested APRA provide greater clarity about what might constitute acceptable alternative arrangements to the CRO requirements. This included requests for APRA to:

- publish guidelines to expedite applications for consideration of alternative arrangements;
- publish examples of acceptable alternative arrangements; and
- extend the alternative arrangements provision to larger insurers and insurers in group structures who may be able to provide compelling arguments to vary the CRO requirements of CPS 220.

APRA response

To seek a variation to the CRO requirements of CPS 220, regulated institutions must write to APRA setting out the proposed alternative arrangement and outline the exceptional circumstances that would warrant APRA considering the alternative proposal. Such applications are to clearly identify any resulting conflicts of interest, the structural oversight and controls that have been/will be established to mitigate the additional risk, and include a statement from the board of the institution that it is satisfied that the risk management framework of the institution will support the proposal.

Alternative arrangements to the CRO requirement for other industries regulated by APRA in the past have included:

- exemptions from the CRO requirement where an institution was in run-off and the APRA supervisor was receiving regular reporting from the institution during the run-off period;
- dual-hatting with another senior management position, the Appointed Actuary or a board committee. Typically, such arrangements have been endorsed only in smaller regulated institutions, with simple product lines and no feasible alternative

arrangements. Such applications were, in the main, approved subject to conditions such as periodic review of the effectiveness of the risk management function, or approved as a short term solution, with the institution committed to a transition plan which would see separation of the functions in the medium term;

- outsourcing the CRO position to a suitably qualified contractor – an option primarily approved for smaller, less complex APRA-regulated institutions, to help ease the administrative burden and costs;
- the CRO to undertake additional functions – endorsed where the additional functions were not fundamentally inconsistent with the risk role, and APRA was satisfied that appropriate controls were in place to manage or mitigate potential conflicts of interest;
- alternative reporting lines – in some cases, these have been approved where the regulated institution was part of a larger group of entities, or an Australian branch operation, where APRA was satisfied that appropriate controls were in place to manage or mitigate potential conflicts of interest arising from the alternative reporting line.

APRA is aware that the larger insurers and insurers with businesses and business lines that extend beyond the provision of private health insurance are likely to pursue different operating models, organisational structures and reporting protocols for the implementation of risk functions across their business than the smaller insurers. Whilst APRA anticipates that applications for alternative arrangements are more likely to be approved in relation to smaller, less complex insurers, APRA will assess the appropriateness all applications on a case-by-case basis, reviewing each application on its merits. Paragraph 70 of CPG 220 has been amended to clarify this position.

Reporting structures

Submissions acknowledged the importance of the CRO having unfettered access to the board and the Chief Executive Officer. A number of submissions suggested the CRO should not be required to report directly to the Chief Executive Officer, as the board of an APRA-regulated institution should be able to decide what reporting structure is appropriate for its operations.

APRA response

APRA's approach was developed having regard to the importance of the CRO having the stature and authority to influence actions and decisions that may materially influence an APRA-regulated institution's risk profile. To reflect this importance, the CRO needs to have a seat at the executive management table - reporting directly to the Chief Executive Officer. Accordingly, APRA has not changed its position on the requirement that the CRO report to the Chief Executive Officer.

Acknowledging the diversity of organisational structures in the industry, APRA will consider applications for alternative CRO reporting structures on their individual merits. This is most likely to occur in organisations with complex reporting structures where the applicant can demonstrate that appropriate controls are in place to manage or mitigate potential conflicts of interest arising from the alternative reporting line.

Separation of functions

One submission noted the potential for overlap between the roles and responsibilities of the CRO and the Appointed Actuary. It requested clarification as to how the two positions might interact and complement each other given the less prescriptive scope of the Appointed Actuary role in private health insurance sector compared to the general insurance and life insurance industries.

APRA response

Insurers would be aware that in tandem with APRA's ongoing review of risk management practices in the PHI industry, APRA is reviewing the role of the Appointed Actuary and the provision of actuarial advice across the general insurance, life insurance and PHI industries. The review is looking to improve the functioning of the Appointed Actuary role by reducing emphasis on compliance matters to enable Appointed Actuaries to focus on matters of strategic importance to an insurer. Given the significant contribution Appointed Actuaries can make to the debate of strategic issues at the executive level, APRA agrees that there are strongly aligned interests between insurers and the actuarial profession in ensuring clarity of the roles and responsibilities of the Appointed Actuary and the CRO.

APRA sees the CRO position as strictly a second line-of-defence position, with a critical role of providing review and challenge throughout the institution to support risks being managed by the first line-of-defence i.e. business operations. APRA expects the CRO to have influence on and provide appropriate challenge to the first line-of-defence, but does not expect the function to be undertaking the roles and responsibilities or owning the risks undertaken by the first line-of-defence.

The Appointed Actuary role, in contrast, performs important functions in both the first and second lines-of-defence. In APRA's view, unmanageable conflicts of interest arise where the same person undertakes the CRO and Appointed Actuary roles. Accordingly, CPS 220 does not permit institutions to combine the two roles. There is provision within the standard, however, for APRA to consider on a case-by-case basis, applications for alternative arrangements to this requirement.

Such applications will only be approved where an institution can demonstrate exceptional circumstances and strong controls for monitoring and managing the conflicts of interest that will arise from the owner of the risk management framework also reviewing the effectiveness of the framework.

2.2 Board committees

A number of submissions commented on the expectation that, following APRA's review of governance requirements, private health insurers will be required to separate their existing audit and risk committee into two separate committees. While many insurers have already done this, some submissions requested clarification regarding the proposed structure of the two committees, guidance on how independence can be achieved for boards with a minimum number of non-executive directors able to serve on committees, and examples of acceptable alternative arrangements.

APRA response

In APRA's view, separation of the Board Risk Committee and the Board Audit Committee ensures a clear and distinct focus on the oversight of risk management and audit issues. From the perspective of the three lines-of-defence model, the focus of the Board Risk Committee is oversight of the second line-of-defence. In contrast, the Board Audit Committee oversees independent assurance of the first and second lines-of-defence provided by auditors in the third line-of-defence.

APRA does not preclude the Board Risk Committee having the same membership as the Board Audit Committee, noting however, that the discipline of separate meetings, separate agendas, and a diversity of membership, can assist in the clear delineation of oversight responsibilities. It can also ensure members allocate sufficient resources to meet their responsibilities to the respective committees. For example, a board may decide to have the same membership of both committees, but have different chairpersons.

It is APRA's view that the benefit of separating the committees outweighs the minor costs in making the adjustments. The establishment of a separate Board Risk Committee is also consistent with the elevated stature and authority of the designated risk management function arising from the introduction of CPS 220.

2.3 Management information systems

A number of submissions noted that comprehensive management information systems could be expensive, complicated and time-consuming. They suggested that the requirements regarding management information systems in CPS 220 should have regard to the complexity of the APRA-regulated institution.

APRA response

Management information systems are a key element of the risk management framework of APRA-regulated institutions. They are required to be fit for purpose and support the management of risk across business lines, by allowing APRA-regulated institutions to collect, analyse and drive review and reporting of risks and controls.

APRA leaves it to each institution to determine which management information system best meets their needs. APRA does not prescribe the complexity of an institution's system, only evidence that they have applied due diligence in determining the sophistication of the system adopted.

CPS 220 notes at paragraph 23 that the management information system of an APRA-regulated institution must be *'adequate, both under normal circumstances and in periods of stress, to measure, assess and report on the material risks of the institution'*. The practice guide CPG 220 goes further, noting at paragraph 77 that the management information system should be *'commensurate with the size, business mix and complexity of the institution's operations'*.

The majority of submissions observed that the benefits of purchasing or upgrading an existing management information system, such as improved visibility and accountability for risk management across the institution, will outweigh any new costs.

2.4 Material risks

A number of submissions expressed concern at paragraph 26 of CPS 220, which lists the minimum material risks an APRA-regulated institution's risk management framework must address. Concerns included whether all the risks listed at paragraph 26 are material to all private health insurers and the potential cost of stress testing/reporting against each material risk. Submissions requested APRA permit private health insurers to apply alternative approaches that could achieve the same objective.

APRA response

The intent of paragraph 26 is for each APRA-regulated institution to routinely identify, measure, monitor and report to its board on the risks which could have a material impact on the institution or on the interests of its policyholders. Emphasis on each risk category may differ from industry to industry and with the size, business mix and complexity of individual institutions. Where a private health insurer identifies that a risk listed at paragraph 26 is not material to its operations, there is no expectation by APRA that the risk will be considered in detail by the institution. APRA does, however expect that in making such an assessment, the institution would document how it has determined that a risk category is not material to its operations. This documentation will assist not only the day-to-day oversight of the institution, but also all external reviews of the effectiveness of the institution's risk management framework.

The suggestion that APRA insert additional notes into CPS 220 at paragraph 26, or into CPG 220 at paragraph 41, to identify which risks are material for each APRA-regulated industry is not supported. The intent of the standard is that each institution make this assessment of its own operations, noting that many APRA-regulated institutions encompass more than one business or industry sector.

The suggestion by one submission that stress testing be mandatory for solvency and liquidity risks, but optional for other material risks is also not supported by APRA. Stress testing is important in considering potential changes that could occur in the external operating environment and provides a forward-looking view of the institution's risk profile.

In relation to the potential cost of stress testing/reporting against each material risk, CPS 220 offers a degree of flexibility for the smaller institutions by noting that the level of stress testing is to be commensurate with the institution's size, business mix and complexity.

2.5 Other adjustments and exclusions

One submission noted that given the significant discrepancies in the risk profile, size and operational complexity of private health insurers, APRA should allow private health insurers to apply for alternative arrangements to requirements of CPS 220 where they can demonstrate that the alternative approach can achieve the aim of the requirement at a lower cost.

APRA response

Paragraph 56 of CPS 220 enables APRA-regulated institutions to apply to adjust or exclude a specific requirement in the prudential standard in relation to the APRA-regulated institution. To pursue such a request, the application must:

- set out the business case, outline the exceptional circumstance that would warrant APRA considering the alternative proposal;
- identify why the alternative proposal is preferred;
- identify the structural oversight and controls established to mitigate the risk; and
- include a statement that the board of the APRA-regulated institution is satisfied the risk management framework will support the proposal.

2.6 Periodic reporting

A number of submissions observed that if CPS 220 is introduced on 1 January 2018, insurers will be required to conduct the first of their annual reviews of the effectiveness of their risk management framework less than six months after adoption of the standard.

One submission felt that the requirement for both annual and three yearly reviews of the risk management framework is excessive. The submission requested clarity as to whether in year three, private health insurers are required to produce both the annual and the three yearly review of the effectiveness of the institution's risk management framework. The respondent also requested additional clarity as to the differences between the two reviews.

APRA response

APRA has modified the implementation date of CPS 220 to 1 April 2018. APRA will allow the first annual review to cover the period 1 April 2018 to 30 June 2019.

Appropriate review of the risk management framework is an important prudential control, particularly where frameworks are relatively immature. CPS 220 requires institutions to undertake two types of reviews of the risk management framework – an annual review that covers compliance with and effectiveness of the risk management framework by internal and/or external audit, and a comprehensive review of the appropriateness, effectiveness and adequacy of the framework by independent experts at least every three years. Each review has a different focus and will, in practice, require the involvement of different persons.

Paragraphs 83 to 92 of CPG 220 set out in detail APRA's expectations of each review, and the differences in content and focus. Private health insurers can draw on the results of the annual reviews to inform the comprehensive review (as noted in CPG 220), but the two exercises are distinct.

Paragraph 47 of CPS 220 has been amended to clarify that it references the comprehensive review, not the annual review.

2.7 Transition period

A number of submissions requested APRA extend the period of transition by a further six or twelve months beyond 1 January 2018. They argued that this would enable the recruitment of specialist risk and compliance professionals, the successful rollout or upgrading of risk management information systems and the establishment of effective change management programs across the industry.

Against this, a number of insurers expressed confidence that they will be fully compliant with the requirements of CPS 220 by 1 January 2018.

APRA response

APRA is sympathetic to concerns at the proposed date of effect being 1 January 2018 and notes the arguments for a further six to twelve month delay. APRA has also considered the findings of the risk management thematic review, which found a strong commitment by the industry to the principles of risk management, but varying levels of preparedness to comply fully with the requirements of CPS 220 by 1 January 2018.

To ensure an orderly implementation and transition to the new prudential requirements, APRA has decided that CPS 220 for PHIs will take effect on 1 April 2018. The extension will provide sufficient time for insurers to undertake appropriate due diligence, and for those who believe they will be unable to be fully compliant by 1 April 2018, to apply in writing to APRA for individual transition arrangements.

The transition arrangements for private health insurers (paragraphs 58-60 of the CPS 220 circulated to private health insurers in December 2016) have been removed as CPS 220 operates on a cross-industry basis and retention could be seen to impose a requirement on private health insurers prior to the entry into force of the standard.

APRA's expectations regarding the process for making applications for additional transition time are set out in Chapter 1. APRA expects that insurers applying for additional transition time will have a clear plan for achieving compliance with CPS 220.

Given consultation on strengthening risk management requirements has been ongoing since 2014, and the additional industry-wide transition period through to 1 April 2018, APRA expects applications for institution-specific extensions to be exceptions not the norm, and that each applicant will provide compelling argument for an extension.

Chapter 3 – Minor editorial changes

A range of other minor technical matters and clarifications were suggested in submissions and have been incorporated where appropriate into the attached revised versions of CPS 220, CPG 220 and HPS 001.

The more material items, together with APRA's response to each follow:

- APRA does not consider it necessary to explicitly reference the Capital Management Policy requirements for private health insurers within the body of CPS 220 (for example at paragraph 23(f)) as insurers can rely on footnote 6 of CPS 220.
- The reference to a management information system in paragraph 23(g) of CPS 220 has been made plural to reflect that an institution may use multiple systems depending on the size, scale or type of risk being reported upon.
- Paragraph 30(e) of CPS 220 has been reworded to reflect individuals need to have an awareness of the risk management framework *as it relates to their role*.
- Paragraph 70 of CPG 220 has been amended to clarify that all APRA-regulated institutions may propose alternative arrangements.
- The request to amend paragraph 1(f) of the Risk Management Declaration at Attachment A to CPS 220 to identify that some non-financial information can also assist an insurer to be satisfied with the efficacy of the processes and systems surrounding the production of financial information at an institution, has not been adopted. Paragraph 97 of CPG 220 notes APRA's expectation that the term financial information will be read broadly and capture more than information related to the financial statements.
- For clarity, the group definition in HPS 001 has been amended to corporate group. This will enable private health insurers in group structures to apply the principles contained in paragraphs 10-13 of CPS 220: *reliance on group risk management structures* to their operations.

Glossary

APRA	Australian Prudential Regulation Authority
APRA-regulated institution	An authorised-deposit taking institution under the <i>Banking Act 1959</i> , a general insurer under the <i>Insurance Act 1973</i> , a life company under the <i>Life Insurance Act 1995</i> , a private health insurer under the <i>Private Health Insurance (Prudential Supervision) Act 2015</i> , a non-operating holding company registered under the Banking Act, the Insurance Act or the Life Insurance Act and a Level 2 Head or a Level 3 Head.
CRO	Chief Risk Officer
Level 2 group and Level 3 group	<p>A Level 2 group is a consolidated group within a single APRA-regulated industry, headed by an authorised-deposit taking institution, general insurer or an authorised non-operating holding company.</p> <p>A Level 3 group is a consolidated group that has been determined as a Level 3 group by APRA in writing where APRA considers that material activities are performed within the group across more than one prudentially regulated industry and/or in one or more non-prudentially regulated industries.</p>
PHI	Private Health Insurance
private health insurer	A private health insurer registered under section 15 of the <i>Private Health Insurance (Prudential Supervision) Act 2015</i> .
prudential requirements	Includes requirements imposed by APRA on any APRA-regulated institution either through legislation, the APRA prudential standards, APRA rules, reporting standards made under the <i>Financial Sector (Collection of Data) Act 2001</i> and any other requirements imposed by APRA under legislation.
prudential standards	Those made under sub-section 92(1) of the <i>Private Health Insurance (Prudential Supervision) Act 2015</i> .

Prudential standard references

CPG 220	<i>Prudential Practice Guide CPG 220 Risk Management</i>
CPS 220	<i>Prudential Standard CPS 220 Risk Management</i>
HPS 001	<i>Prudential Standard HPS 001 Definitions</i>
HPS 110	<i>Prudential Standard HPS 110 Capital Adequacy</i>



APRA