Australian Prudential Regulation Authority

400 George Street (Level 26)
Sydney NSW 2000

GPO Box 9836
Sydney NSW 2001

T 02 9210 3000
F 02 9210 3411
W www.apra.gov.au

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To: Life Insurers

On 13 December 2013, APRA wrote to all direct insurers and reinsurers (collectively referred to as 'insurers') involved in group insurance to advise them of APRA's concerns about poor experience for participants in this market. That letter also discussed the actions APRA would take over the next period to encourage improved risk and business management practices. APRA indicated the possibility of further supervisory action, including increasing capital requirements, where an insurer did not adequately improve its risk and business management practices.

APRA met with the CEOs of insurers involved in group insurance in February 2014. In March 2014, APRA sent an information request to these insurers asking for a summary of experience over the last three years and details of actions taken in the light of that experience.

In October 2014, APRA released the *Prudential Practice Guide LPG 270 – Group Insurance Arrangements*[1] (LPG 270).

The attached summary of the information provided by insurers highlights key themes and trends in relation to the poor experience in the group insurance market, with particular emphasis on the various actions taken by boards and management and their assessment of the effectiveness of actions taken.

It is important that insurers carefully consider the various matters discussed, particularly as some of the issues in more recent times have also been seen in the past. APRA encourages insurers to document lessons learned from this recent experience and where necessary adopt revised approaches so as to be better prepared to respond in future. Where appropriate, the board rather than management should consider or address matters raised.

In our regular interactions over coming months, we will discuss with each insurer the findings set out in the attachment to this letter together with the insurer's views and intentions with respect to those findings.

Yours sincerely

Brandon Khoo
Executive General Manager
Diversified Institutions Division

[1] See http://www.apra.gov.au/lifs/PrudentialFramework/Documents/Prudential-Practice-Guide-LPG-270-Group-Insurance-Arrangements-October-2014.pdf

Attachment

GENERAL OBSERVATIONS

APRA has been closely monitoring the experience in the group insurance market for some time and has had extensive discussions with insurer boards and senior management.

The information gathered indicates that those insurers which acted on early indicators of deteriorating experience and so took action sooner (in 2011 and 2012) were generally better prepared for worsening conditions and sustained smaller losses (particularly in 2013). In addition, these 'early movers' typically required smaller capital injections to statutory funds to support existing business and future new business.

APRA is of the view that a strong risk management framework, an effective risk appetite statement and an appropriate use of the Internal Capital Adequacy Assessment Process (ICAAP) were vital and valuable tools in assisting insurers to monitor and respond to the experience in the group insurance market. Overall, APRA observed that the success of the insurer's response to the worsening market conditions reflected the effectiveness of enhanced oversight by the board.

APRA also observed that those direct insurers which instigated stronger communication with trustees and reinsurers had a better understanding of the issues in the group insurance market and could react more effectively. Where insurers engaged more closely with other stakeholders, identification and implementation of solutions appears to have been more effective. In addition, insurers which enhanced their communication with these other parties also achieved better results in other areas of shared responsibility, such as data management.

APRA also noted that increased attention and an increased level of engagement at an industry level to identify issues and possible solutions appeared to be effective in galvanising insurers to address some of the underlying issues in the group insurance market, and in developing coordinated responses. An example of such an industry response is insurers raising key issues with professional and industry bodies and participating in industry working groups to consider specific technical issues. In addition, industry round tables in 2013 focusing on definitions, and group insurance 'summits', were also effective methods of engaging relevant stakeholders and developing possible industry responses.

APRA RESPONSE TO INFORMATION REQUEST DATA

Recent Experience – measurement and mitigation

The summary of recent group risk experience provided by the insurers surveyed confirmed that total and permanent disability (TPD) was the main source of loss for insurers, particularly in FY2013, with group salary continuance (GSC) also performing below expectations. This observation is demonstrated in Table 3A of the *Quarterly Life Insurance Performance* statistics, published quarterly and available on APRA's website[2].

The main source of loss for direct insurers has been through policies issued to trustees of industry superannuation funds. Several insurers reported profits on a net basis, but ceded

[2] See http://www.apra.gov.au/lifs/Publications/Pages/quarterly-life-insurance-statistics.aspx

substantial losses to their reinsurers. This was reflected in some reinsurers reporting proportionately larger losses than direct insurers.

APRA observed that different key performance measures are used by insurers to monitor and record experience. The most common measures applied for inforce business included profit, profit margins, premium revenue, return on capital, loss ratio and embedded value. Other less common performance measures adopted by insurers specifically for new business include new business margin, value of new business, internal rate of return (on capital) and sales (new premium).

APRA has not formed a view on which key performance measures are most appropriate but considers that this is an area for insurers to investigate further. APRA also suggests that the industry supports consistent and timely reporting of experience across the life insurance industry, to more easily analyse data and identify trends.

For consideration

- *What steps has the insurer taken to consider its own experience in comparison to the rest of the life insurance industry and what reasons there may be for any differences?*

- *What steps has the insurer taken to review its key performance measures in light of recent experience and satisfy itself that the most appropriate measures are in place to identify adverse experience trends and assist in the early identification of causes and possible solutions?*

- *Are there any learnings about warnings of adverse experience and could earlier steps have been taken to mitigate that experience?*

Assessment of Experience

The most common factors cited by insurers as drivers for the difference between the original pricing basis and assumptions and actual experience are set out below. It should be noted that the points made do not necessarily reflect the root cause, and they should be read in the context of findings made later in this document (e.g. in respect of pricing and product terms and conditions). Further, the comments should not be read as criticism of superannuation fund member behaviour or exercise of rights. The factors cited by insurers were:

- unemployment/underemployment and adverse changes in the economic environment, providing greater incentives for members to claim;
- increased member awareness of insured benefits (due to government, scheme and lawyer promotional activity);
- increased lawyer involvement in the claims process;
- increase in mental illness/stress-related claims (and for GSC these claims tending to be of longer than expected duration);
- increased automatic acceptance limits;
- generous terms and conditions (including weaker eligibility and underwriting) leading to increased anti-selection by members); and

- increased prevalence of large, late-notified claims (many of which are associated with increased lawyer involvement in the claims process).

Each insurer should be aware of the impact, if any, of each of these drivers on their business and, more importantly, the substantial cumulative impact each may have on their business over time. The impact of some of these drivers may be more easily managed than others but each insurer should consider what measures it can put in place to mitigate their effects.

For consideration

- *How has the insurer altered its risk and business management practices in light of the observed drivers of experience?*

- *What changes has the insurer considered in its group insurance policy terms and conditions to give more certainty of outcomes?*

Governance

Board and Management Reporting

Generally, insurers advised that under usual circumstances management receives a mix of quarterly and monthly reporting on group insurance business, which includes reporting on performance of specific schemes. Insurers advised that these reports are in addition to the annual board reporting requirements such as the financial condition report (FCR), ICAAP, financial statements, business plans, and ad-hoc LPS 320 Actuarial and Related Matters (LPS 320) special purpose review advices.

When assessing whether there was any increase in the level of board engagement, and whether this was initiated by the board or management, the responses were varied:

- most insurers considered their existing governance and reporting structures provided sufficient information to the board regarding the group insurance environment;

- other insurers advised that board engagement and reporting had significantly increased and that this was due to the combined requests of both board and management;

- very few insurers implemented additional engagement and reporting at the behest of management alone; and

- some insurers were silent on whether the board or management initiated any intensification of board and management engagement.

For consideration

- *How has the insurer satisfied itself that it has the appropriate reporting structures in place to ensure the board has adequate oversight of its group insurance business?*

- *How has the insurer satisfied itself that the board's engagement with management is appropriate when the insurer is dealing with poor experience?*

Risk Appetite and Risk Management Framework

Most insurers advised that their existing risk management framework and risk appetite did not change in light of the recent experience in group insurance business. These insurers indicated that the issues facing the group insurance market had already been captured by their risk management frameworks and risk assessment processes, and were carefully considered by the board.

Several insurers made changes to certain risk appetite metrics and business acceptance criteria in response to the recent issues facing the group insurance market. Some of these changes included extending time-frames for tender responses, including additional risk mitigating conditions in proposals, only quoting to clients who already had group policies in place or no longer tendering for group insurance schemes.

For consideration

- *What changes has the insurer made to its risk appetite and supporting metrics in light of recent experience in the group insurance market? Does the risk appetite give clear guidance on the acceptable risk level for group insurance business?*

- *How has the insurer determined that its business / risk acceptance criteria are sufficiently effective to respond to the issues like those recently experienced in the group insurance market?*

Data and Experience Investigations

Data available to insurers often has been inadequate and of poor quality in the past. This undermines an insurer's ability to analyse claims experience and set premium rates. This has not been helped by a failure to link data quality to conditions in tenders (for example, by allowing the insurer to take remedial action if data errors are subsequently discovered).

APRA's observation from responses received from insurers is that the impact of poor data tends to increase over time. Insurers have responded to the issue, and now appear increasingly to be including data quality requirements as conditions in tenders. This includes the ongoing right to audit data post-appointment and retaining the right to adjust the pricing should the audit identify significant discrepancies in the data used for the tender. Paragraphs 37-40 of LPG 270 also provide guidance to prospective insurers in relation to data management in tender situations.

In addition, APRA has observed that standard terms of insurers have recently been adjusted to place more responsibility on superannuation trustees in respect of data quality as a result of the introduction of SPS 250 Insurance In Superannuation (SPS 250)[3]. The understanding of trustees of their obligations regarding data quality, and their capability to collect and maintain the required information, is critical in developing and maintaining constructive relationships with insurers. Paragraph 15 of SPS 250 makes it clear that the trustee is responsible for maintaining the required insurance data; and paragraphs 29-40 of LPG 270 provide guidance on data management.

[3] SPS 250 Insurance in Superannuation (introduced with effect from 1 July 2013.)

Most insurers advised there had been significant changes made to enhance data quality, including a combination of collecting more data and/or improved data checking. These changes were made in respect of data for both claims experience and scheme membership. These changes varied across insurers and typically related to:

- the method of obtaining cover;
- member rehabilitation;
- lawyer involvement and date of involvement;
- changes in TPD definition; and
- claim re-open reason and date.

Having greater data capture capability allows insurers to better understand their group insurance business. As examples, Insurers demonstrating better practice in this area may be able to identify data items such as:

- each life insured, including where one life has been covered multiple times; and
- whether policyholders are permanent full-time employees and potentially have an indication of their salary (if the fund is receiving SGC contributions).

However, APRA recognises that some insurers face challenges in obtaining enhanced data due to the varying levels of trustee maturity in either systems or processes. In addition, some trustees are still moving towards meeting the requirements of SPS 250.

Insurers that maintain more comprehensive, higher quality data are able to perform more detailed analysis of their book of business. In this way, some insurers have been identifying new factors to consider in pricing such as how often the benefit design has altered, how frequently the scheme has changed insurer and other more qualitative measures.

Insurers will be familiar with the FSC / KPMG individual business lump sum and disability income experience investigations. Industry-wide support for such investigations and agreement on what data should be collected is critical to their success. Insurers also need to ensure that such data is captured and provided in a timely fashion to enable analysis to take place to gain valuable insights into experience more quickly.

For consideration

- *How has the insurer satisfied itself that it has taken all reasonable steps to request as part of the tender process the data it requires to analyse experience and properly price schemes?*
- *How has the insurer satisfied itself that it is working collaboratively with trustees to ensure all relevant data is being collected?*
- *How has the insurer ensured that there are adequate systems and resources available to properly analyse and investigate the data to identify any additional rating factors or leading indicators of experience?*

Regulatory Capital and Target Capital

In considering regulatory capital impacts as a result of poor group insurance experience, most insurers did not make any changes to stress margins used in calculating the Insurance Risk Charge.

However some insurers strengthened incurred but not reported (IBNR) reserves, and typically also increased regulatory capital. In addition, the TPD future stress margin was increased by several insurers to reflect increased uncertainty around future trends in experience.

The majority of insurers advised that no changes were made to their target capital policy as per LPS 110 Capital Adequacy (LPS 110) arising from recent group insurance experience, even where substantial capital injections were required. Where changes to the target capital policy had been made, these were typically minor. We also observed that, despite significant changes in market conditions as indicated by the group insurance experience, no insurer reported that they had reviewed or updated their target capital policy outside the normal review cycle.

Under LPS 110, the ICAAP must be reviewed by boards at least every three years but also more frequently where the insurer's business profile or risk appetite changes. In this way, the ICAAP and target capital policies will be sufficiently dynamic to allow boards to consider emerging uncertainty and changes in risks. This includes boards reviewing the triggers in the ICAAP to ensure early losses are used as an indicator of potential substantial losses in the future.

Nine out of the sixteen insurers surveyed required capital injections to their statutory funds to support the group business. The size of these capital injections varied significantly but the majority of insurers required significant capital support for both existing business and future new business. In all cases it appears that additional capital support was readily obtained when required. Notwithstanding this, insurers cannot assume that such capital support will always be forthcoming in times of poor conditions, and APRA would expect their ICAAP to reflect this.

For consideration

- *How has the insurer satisfied itself that the ICAAP is fit for purpose in light of the recent poor experience?*
- *How has it satisfied itself that the ICAAP was appropriately followed leading up to the decision to inject capital?*
- *How has the insurer satisfied itself that its ICAAP and stress testing scenarios appropriately address the possibility that its parent or shareholder fund cannot provide a capital injection to its statutory funds if required?*
- *Were there any lessons from this recent experience in the group insurance market that could lead to changes to the ICAAP?*

Pricing

Most insurers reported changes to pricing assumptions and methodology in response to recent experience in the group insurance market. The more common were:

- changing the allowance for trends in best estimate assumptions (typically allowing for a worsening of TPD experience, but some insurers also reported that they have removed their previous allowances for mortality improvements);
- adding contingency loadings for TPD and GSC claims assumptions;
- adding additional margins if experience data is poor quality;
- conducting more sophisticated analysis of IBNR; and
- conducting more sophisticated sensitivity analysis.

For consideration

- *How has the insurer satisfied itself that its pricing assumptions and methodology have been appropriately reviewed in light of recent experience in the group insurance market?*

Product Terms and Conditions

Common changes to standard product terms and conditions offered in tenders include guarantee periods reduced to two years or one year (previously these often were for three years) and greater prevalence of profit-sharing or other arrangements so that experience is reflected in pricing in a more timely manner.

A range of changes have also been made by direct insurers to eligibility, automatic acceptance limits (AALs), exclusions and benefit definitions. At this stage, it appears that the industry is in a transition stage where each insurer is making its own changes. Over time, there may be a degree of convergence across industry.

Changes include:

- no longer making 'opt-in' offers that allow members to take or increase cover with little or no evidence of health status;
- increasing the length of the 'at work' period for members to become eligible for cover (e.g. from one day to one month);
- tightening the definition of TPD (for example, from 'unlikely to work' to 'unable to work');
- introducing severity-based TPD benefits;
- introducing TPD benefits payable via instalments rather than as a lump sum;
- reducing default TPD benefits and increasing default GSC benefits;
- reducing automatic acceptance limits;
- making greater use of health questions for optional cover; and
- making greater use of exclusions for pre-existing conditions, hazardous occupations, suicides and pandemics.

In addition, most insurers are currently trying to negotiate similar changes to terms and conditions with existing schemes when their premium guarantee period ends. If scheme trustees are not willing to change the terms and conditions the scheme typically is repriced accordingly.

For consideration

- *How has the insurer determined that it currently has the most appropriate terms and conditions in place for its group insurance schemes?*

- *How has the insurer satisfied itself that there is a systematic process to identify and analyse any potential changes to product terms and conditions for its group insurance policies so it is well-prepared for negotiations when the premium guarantee period ends?*

Reinsurance

Existing reinsurance arrangements are being closely monitored by all insurers. Some direct insurers advised that they were limited to engaging with incumbent reinsurers due to other reinsurers withdrawing from the market. Other direct insurers have been proactive in undertaking initiatives to optimise their reinsurance arrangements in response to the experience in the group insurance market. Examples include:

- insurers ceding less business to current reinsurers;
- exploring the possibility of diversifying reinsurance arrangements, such as engaging additional reinsurers, using non-traditional risk transfers and structures such as collateral arrangements; and
- sourcing quotes from overseas reinsurers.

Where insurers advised changes were made to their existing reinsurance arrangements, there was no specific discussion as to whether this had been done in accordance with *LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117) requirements and *LPS 230 Reinsurance* (LPS 230) requirements. APRA encourages all direct insurers to ensure that they are at all times compliant with relevant prudential requirements and, if any queries arise, to contact their APRA supervisor.

Amongst the reinsurers, there were no significant changes to retrocession arrangements.

For consideration

- *How has the insurer reviewed its reinsurance arrangements to ensure they are appropriate given recent experience in the group insurance market?*

- *For insurers considering new and alternative forms of reinsurance, how has the insurer satisfied itself these potential strategies are within its risk appetite?*

- *What processes are in place for the insurer to ensure that it is complying with the requirements of LPS 117 and LPS 230 on an ongoing basis?*

Claims Management

Most insurers advised of changes to claims assessment procedures and resourcing in response to the recent experience in the group insurance market. While many different actions were described, common changes in relation to claims management were:

- increasing focus on early intervention and rehabilitation;
- increasing focus on mental health issues;
- increasing staff training;
- increasing resourcing in the claims department;

- better forecasting of future resourcing requirements;
- reviewing claims processes more frequently;
- making system enhancements;
- enhancing claims reporting;
- establishing service levels for turnaround times on reinsurance referrals; and
- utilising additional specialist medical officers.

We encourage insurers to review their claims assessment procedures and make improvements where appropriate to incorporate lessons learned.

APRA would be concerned if insurers chose simply to take a 'harder line' in considering claims in an effort to reduce claims costs. Insurers need to be satisfied that claims are assessed fairly and in accordance with the policy terms. This is an important requirement in order for the board to be confident that it is meeting its obligations under section 48 of the *Life Insurance Act 1995*.

Paragraph 22(a) of SPS 250 requires a trustee to consider (among other things) a prospective insurer's claims philosophy. Paragraphs 7 to 9 of LPG 270 provide guidance to insurers on important factors to consider when developing a claims philosophy and on what APRA considers is good practice in this regard. The claims philosophy should reflect the insurer's current approach to dealing with claims.

Recent circumstances highlight the importance of a clear claims philosophy; and the need for insurers and trustees to have a deep and shared understanding of how claims will be dealt with. If an insurer seeks to change its approach to dealing with claims, this would typically be reflected in its claims philosophy and discussed with the trustee. APRA considers that active dialogue between insurers and trustees on this issue builds trust between the parties and we encourage insurers and trustees to discuss in detail proposed changes to the claims philosophy or approach before they are implemented.

Claimants will also benefit from close alignment between the insurer's and trustee's approach by reducing onerous paperwork; reducing the possibility of miscommunications and disputation; and simplifying the claims process for claimants, trustees and insurers.

For consideration

- *How has the insurer satisfied itself that its claims management process remains appropriate in light of recent experience in the group insurance market?*

- *How has the insurer satisfied itself that any change in claims philosophy has been subject to due process?*

- *If the insurer has made changes to its claims philosophy, how has it engaged with the relevant trustees to ensure that there is a shared understanding of that claims philosophy?*

- *How has the insurer satisfied itself that changes made to the claims management process are aligned to the claims philosophy agreed with the trustee and not merely a more stringent claims standard intended to reduce claims paid and enhance profitability?*

Tender Process

Most insurers have become more selective in their decision as to whether to participate in tenders. There is a general unwillingness to participate if deadlines do not allow sufficient time for thorough analysis. This has resulted in a lengthening of deadlines. A sample of responses follows:

- certain direct insurers will decline to quote new business if reinsurance is not available at the time of tender;
- some direct insurers will only quote to clients who already have group insurance policies in place with the insurer;
- some reinsurers are or were no longer tendering for new group TPD business; and
- some insurers are not tendering at all for new schemes.

Most insurers reported increased rigour in checking and validating externally sourced data provided with a tender. In addition, some insurers advised that they retain a right to audit data after the contract commences and adjust pricing if necessary. One direct insurer reported that it now asks for at least ten years of data for tenders.

Interestingly, one reinsurer reported that as a reinsurer they rely on the insurer to validate data. In contrast, other reinsurers in the market advised that they perform their own in-depth analysis of the data to look for anomalies or inconsistencies.

For consideration

- *Has the insurer amended its tender processes to ensure the new group insurance schemes it accepts are within the insurer's risk appetite?*
- *How has the insurer satisfied itself that there are appropriate controls in place throughout the tender process to ensure the appropriate evaluation of the risks of the scheme?*

Interaction with trustee

More direct insurers are now engaging more with trustees than was the case 12 – 18 months ago. This reflects experience in the group insurance market, the new MySuper insurance requirements, service level agreements under SPS 250, and premium reviews.

In addition, some reinsurers have increased their direct engagement with the trustees of major group superannuation schemes. This interaction has largely focused on renewal of the schemes and has incorporated direct discussion with the senior management of trustees (and insurers) on scheme performance, sustainability of premium rates and terms and condition changes intended to ensure improved sustainability for members.

For consideration

- *How has the insurer engaged with trustees to discuss current experience in the group insurance market and obtain their views on the experience within their schemes?*
- *How has the insurer used the information a trustee has on its own scheme membership to improve pricing and assumptions and better predict claims experience?*

Impediments to Effectiveness of Actions Taken

Several insurers noted that there are numerous factors which they consider limit or inhibit the effectiveness of actions that could or have been taken in response to the worsening group insurance experience. These factors include:

- rising levels of claims;
- changing TPD claims development patterns (for example late notification);
- changing regulation, including the introduction of MySuper, higher limits for lost accounts and mandatory account consolidation;
- provisions of the *Insurance Contracts Act 1984* and *Private Health Insurance Act 2007* limiting the scope for changes to benefit designs (e.g. the *Insurance Contracts Act 1984* may inhibit the introduction of claims time limits; the *Private Health Insurance Act 2007* may restrict reimbursement of some medical costs);
- reducing reinsurance support;
- changing workers compensation laws;
- reluctance and lack of understanding by some superannuation trustees of the need to engage with life insurers and address sustainability issues;
- challenges associated with superannuation funds that have switched insurers. This includes the previous insurer(s) not having obligations to provide historical data to the new insurers and the reinsurer; and
- challenges regarding product terms and conditions.

For consideration

- *How has the insurer identified any limitations or challenges when formulating responses to experience in the group insurance market?*
- *How has the insurer dealt with limitations when designing and implementing responses to recent experience?*
- *Is the insurer satisfied that it has access to claims data under previous group policies? Is access to this data included as a proposed term of any new scheme contract?*