AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
1 Martin Place (Level 12), Sydney, NSW 2000
GPO Box 9836, Sydney, NSW 2001

T 02 9210 3000 | W www.apra.gov.au

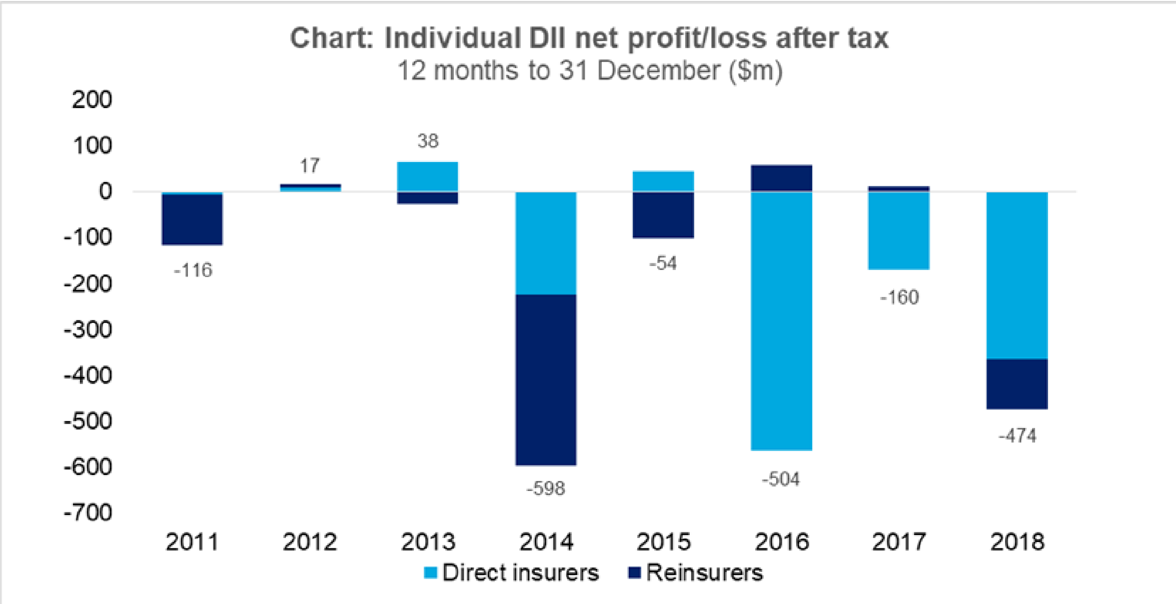
2 May 2019

TO: ALL LIFE INSURERS AND FRIENDLY SOCIETIES

THEMATIC REVIEW OF INDIVIDUAL DISABILITY INCOME INSURANCE – PHASE TWO

This letter sets out APRA's expectations for all APRA-regulated life insurers and friendly societies (collectively referred to as life companies) with exposure to individual disability income insurance (individual DII). Addressing these expectations will be critical to enhancing the sustainability of the market for individual DII.

The life insurance industry's failure to design and price sustainable individual DII products has been an area of heightened focus for APRA. Beyond the pressure on financial performance shown in the chart below, APRA is concerned that product design and pricing decisions may be contrary to the long-term interests of policyholders.



Given these concerns, APRA commenced a phased thematic review of individual DII business in 2017. APRA's objective is to identify and drive changes required to improve the performance of individual DII and enhance the product's sustainability to ensure life companies remain willing to offer this product to consumers.

- Phase one of the thematic review focused on APRA-regulated life reinsurers, and APRA's observations were communicated to reinsurers in mid-2018[1].
- Phase two of the thematic review included: onsite reviews with the top eight primary writers of individual DII (the Participants[2]); engagement with other stakeholders, including rating houses, industry/professional bodies and the Australian Securities and Investments

[1] The findings were also published as *'Seeking sustainability: challenges facing individual disability income insurance'* in APRA Insight Issue 2 2018.

[2] The Participants comprise 91.5 per cent of the individual DII market, based on gross policy revenue as at 31 December 2018, and include: AIA Australia Limited; AMP Life Limited; Colonial Mutual Life Assurance Society Limited; MLC Limited; OnePath Life Limited; Suncorp Life & Superannuation Limited; TAL Life Limited; and Westpac Life Insurance Services Limited.

Commission (ASIC); and the development of metrics for ongoing monitoring and benchmarking of progress by life companies.

In conducting phase two of the thematic review, APRA observed that Participants have recognised the risks associated with individual DII products and have initiated changes in an attempt to address them. However, APRA identified several factors that are impeding life companies' ability to improve the performance and sustainability of individual DII. To address these factors, APRA has identified four themes below where greater attention and action are needed by life companies.

1. Strategy and risk governance

- Formulating and executing a co-ordinated strategy with a clearly defined long-term target state. The board needs to own and drive that strategy with appropriate level of oversight and challenge.
- Clearly articulating risk appetites that are supported by risk and performance metrics at a product level, in this instance, specifically in relation to individual DII.
- Lifting the capacity and capability of risk functions to provide a sufficient level of oversight and challenge on individual DII associated risk matters.

2. Pricing and product design

- Greater consideration of, and transparency around, risks associated with individual DII related pricing decisions and new product developments.
- Ensuring that product designs adhere robustly to the principles of insurability.

3. Data

- Improving the quality, quantity and timeliness of data.
- Proactively contributing to the industry experience study and collaborating with APRA's initiatives to consider options to improve the industry experience data.

4. Resourcing

- Proactively ensuring resourcing and skills in key disciplines are adequate for the workload and complexity associated with individual DII business.

Detailed observations under the four themes, including APRA's expectations, are contained in **Attachment A**.

Specific actions within set timeframes required of Participants, all life reinsurers and other primary writers of individual DII who were not part of the phase two targeted onsite review will be communicated to each entity separately.

APRA will assess the adequacy of each life company's response, and monitor the progress in executing the planned actions. If APRA considers the action plan proposed by the life company to be inappropriate, or the life company's progress in implementing that action plan to be inadequate, APRA will increase its supervisory intensity of that life company and may impose an entity-specific capital charge[3].

APRA is using the thematic review outcomes to inform metrics which will support its supervision activities and benchmarking of life companies. APRA intends to collect data from life companies against these metrics on a periodic basis, to supplement its regular data collection. APRA will separately write to life companies in the near future to provide information

[3] This will be in the form of a supervisory adjustment included in the Prudential Capital Requirement (PCR), consistent with paragraph 44 of *Prudential Standard LPS 110 Capital Adequacy (LPS 110)*.

on timing and expectations for reporting against these metrics. Ultimately, these data will form part of APRA's ongoing data collection.

Boards of all life companies need to also consider whether APRA's expectations set out in Attachment A are applicable to other product groups that may be experiencing performance challenges, such as total and permanent disability insurance, to which the life companies may have a material exposure.

It is APRA's view that the industry collectively, and life companies individually, have the ability to address the core issues and make the changes necessary to enable a sustainable individual DII market.

Yours sincerely

Geoff Summerhayes
APRA Executive Board Member

ATTACHMENT A: OBSERVATIONS AND EXPECTATIONS

Theme 1: Strategy and Risk Governance

Strategy

Participants in phase two of the thematic review on individual DII have generally recognised the issues and risks related to this product and have initiated changes across the value chain to improve performance and better manage associated risks. A range of actions were demonstrated by Participants, including: uplifting claims and underwriting capabilities; pricing at a more granular level; and investing in data analytics. While it is positive to see a heightened focus on this product, APRA saw limited evidence that Participants have instituted a co-ordinated long-term strategy which articulates a view of the desired target state they strive for in relation to their individual DII business. In APRA's view, the absence of such a strategy hampers the ability of life companies to have a holistic view of whether the initiatives they have put in place are delivering the desired results over time.

In better practice strategies observed by APRA, Participants had established a comprehensive project to identify all parts of the value chain that need enhancement and the corresponding action plans. This demonstrates a co-ordinated approach in addressing the issues associated with individual DII. However, evidence of this practice was limited among Participants.

1. APRA expects that:
   - 1.1. life companies have a board-endorsed view of the target state for their individual DII business;
   - 1.2. the board of a life company own and drive a co-ordinated long-term strategy to address the issues pertaining to individual DII and to progress towards the target state; and
   - 1.3. the management of a life company formulate and execute the co-ordinated long-term strategy in a cohesive manner with regular reporting to the board on progress in executing the strategy. Where appropriate, this should include the reporting of actual costs incurred, and benefits realised, against the plan.

Risk Appetite

Most Participants have risk appetites expressed qualitatively at a high level. In general, the risk appetites were not translated into operational limits which can be used by staff within the business units.

Further, while most Participants have established Key Performance Indicators (KPIs) and Key Risk Indicators (KRIs) at the portfolio level (e.g. retail insurance offering), granular indicators at the product level were not universally in place. The absence of appropriate KPIs and KRIs specific to individual DII significantly impedes the management and board's insight into the performance and risks associated with individual DII. In APRA's view, granular metrics, while not a panacea for the problems associated with individual DII, would allow the board and management to identify and assess changes in the underlying performance and risk profile on a regular basis to enable appropriate and timely management actions. APRA considers the suite of metrics should be determined by the life companies, and should be commensurate with the business mix, size and complexity of their individual DII portfolio.

Better practices observed by APRA include Participants having KPIs and KRIs (both leading and lagging indicators) to monitor identified material risks. At a minimum, life companies would need to report to the board on certain metrics such as actual versus expected claims experience and lapse experience, and sales and business mix specifically for DII. APRA also expects that life companies consider other relevant metrics, including income replacement ratios, caseloads per claim assessor and metrics related to conduct risk and customer value.

2. APRA expects that life companies:
   2.1. translate their risk appetites by establishing meaningful operational limits to enable business unit staff to understand the risk boundaries they can operate within;
   2.2. clearly specify in the Risk Appetite Statement (RAS) the particular areas they have no appetite for (e.g. having no appetite for certain design features); and
   2.3. establish and monitor performance against specific KPIs and KRIs for individual DII and report on them to the board and management (where relevant).

Risk Function

The complex characteristics of individual DII, as well as the continuing underperformance of the product, expose life companies to a range of financial and non-financial risks. APRA views the skills and resources of the risk function (second line of defence) as critical to ensuring robust challenge to the business (first line of defence) on individual DII related matters. APRA observed clear room for improvement across Participants in the overall level of challenge provided by the risk function, with risk functions tending to lack expertise in the financial and/or non-financial risks.

APRA expects that the Chief Risk Officer (CRO) and staff within the risk function have sufficient technical capabilities to cover the breadth of risks, both financial and non-financial, to which life companies are exposed in individual DII and more generally. APRA expects that CROs, supported by appropriately experienced and skilled staff in the risk function, form a robust and holistic view of the risk profile for individual DII. This would enable the CROs to provide more effective oversight and robust challenge. While responsibilities of the CRO and Appointed Actuary (AA) relating to the management of financial risks may overlap, APRA considers it unacceptable for the CRO to disregard oversight of financial risks or seek to 'outsource' the oversight to the AA.

The structure of the risk function must be commensurate with the size, mix and complexity of the individual DII business within the life company. One structure that APRA observed as effective in a larger life company involved the risk function being split by risk categories (e.g. financial risk, operational risk, advice and distribution etc.). Each team responsible for a risk category is headed by an executive who has the relevant expertise and seniority to provide adequate oversight of, and robust challenge on, matters specific to that risk category.

3. APRA expects:
   3.1. an increased level of oversight, involvement and challenge from the risk function; and
   3.2. that the entire risk function be adequately resourced, and staff have the appropriate level of skills, experience and knowledge in both financial and non-financial risks.

Theme 2: Pricing and Product Design

Pricing and product development and design are crucial components of the value chain for individual DII. Pricing decisions are integral to sales and marketing strategy, repricing for in-force business and new individual DII product developments. APRA considers that poorly formed pricing and product development and design decisions may have exacerbated the risks life companies are exposed to with their individual DII portfolio.

As part of the review, APRA found most Participants have acknowledged the need to develop simpler individual DII offerings that are more sustainably designed and priced, but are reluctant to develop such products due to first mover disadvantage. APRA acknowledges that few Participants have attempted to launch such products, which have attracted little business from the advised market.

In examining matters associated with pricing and product design, APRA observed practices which impede life companies' ability to offer a sustainable individual DII product to the market.

- Inadequate pricing and unsustainable product features can contribute to an unsatisfactory customer experience, with premiums paid over the lifetime of the contract potentially being significantly more than signalled at inception. APRA believes that product design needs to be more robustly aligned to the commonly accepted principles of insurability, with sustainable product features that are priced appropriately based on underlying assumptions that reflect a realistic view of the future. This will provide a more sustainable offering to policyholders and reduce the possibility that new individual DII products today become the problematic legacy products of the future.

- Underlying assumptions used by some Participants do not reflect their most recent experience. For a product where experience and features have changed significantly, this practice is unacceptable, especially where industry tables are outdated. Given both pricing and valuation are based on the underlying assumptions, using out-of-date experience data can lead to inadequate pricing and reserving.

- A range of sales tactics is used by Participants such as bundling discounts, initial discounts and offering a guaranteed premium period. Although such tactics may improve competitiveness in the short term, APRA considers the associated risks, including the implications for meeting policyholder expectations, need to be better understood and communicated to the board and management to support decisions. Risk boundaries also need to be established to ensure the risk exposure remains within the life companies' risk appetites.

- Compared to products offered globally, many individual DII policies sold in Australia contain features that are inherently riskier.

    - An example is the prevalence of the 'Agreed Value' policies. It is challenging to price these products appropriately, especially as problems can be compounded by weak underwriting practices at the time the policies are issued, and life companies being unable to track income replacement ratios.

    - Ancillary benefits are also seen by some life companies as a key contributor to the poor outcomes of individual DII product offerings. The compounding effect of ancillary benefits may result in claim benefits exceeding pre-disability income. This creates a disincentive for the claimant to return to work and may contribute to lower termination rates. Better practice demonstrated by life companies involved unbundling ancillary benefits from the 'core' individual DII product so that these benefits can be specifically priced to reflect their underlying risk.

- Some Participants expressed the view that individual DII products need to be fully featured to be rated highly by the rating houses and distributed by financial advisers. APRA has engaged with rating houses and ASIC, and has heard messages that are inconsistent with this view. APRA, in consultation with ASIC, re-affirms that the compliance with financial advisers' best interest obligations requires advisers to balance the type, level and structure of coverage with affordability and sustainability considerations for their individual clients. Furthermore, the recently passed Design and Distribution Obligations include a target market determination to be made for every product issued. This effectively means life companies need to design products that are consistent with the objectives, financial situations and needs of their target markets.

4. APRA expects that life companies:

   4.1. set assumptions for future claims experience based on the most recent experience;

   4.2. consider, and be transparent about, financial and non-financial risks associated with various pricing decisions (e.g. pricing for new individual DII products, implementing sales tactics, pricing for ancillary benefits etc.) and new product developments;

   4.3. place more emphasis on providing policyholders with greater certainty about the expected future premiums;

   4.4. ensure that product design adheres robustly to the principles of insurability, including a clear linkage between insurance benefits and pre-disability earnings; and

   4.5. proactively engage with rating houses throughout their product development stage to discuss and agree on how the sustainability characteristics of the product could be better reflected in the product rating.

Theme 3: Data

APRA observed that the quality, quantity and timeliness of data used in the management of individual DII are poor. The thematic review identified instances in life companies where:

- necessary data are unavailable;
- data used are inconsistent or inappropriate; and
- data analysis is conducted within business function 'silos' with no feedback to other relevant areas in the business.

Most Participants recognise their data limitations and have started or plan to start work on enhancing their data analytical capability. However, to realise the full benefit from an enhanced data analytical capability, APRA considers life companies must also invest in the quality and timeliness of data. Investing in data, combined with enhanced data analytical capabilities, will allow life companies to conduct more frequent, in-depth and granular pricing and experience analysis, better identify emerging trends and gain more meaningful insights. Better practices observed during the onsite reviews included Participants:

- measuring, monitoring and reporting underlying insurance experience on a gross and net (of reinsurance) basis;
- having a specific data strategy and developing a target operating model to set themselves up to achieve their vision in data analytics; and

- making appropriate investments to uplift their data management capabilities, including the creation of a 'single source of truth' for all analytics and reporting, and aggregating data across the business to form an end-to-end customer view.

5. APRA expects that:

   5.1. life companies conduct an analysis to identify the gaps that exist between the current and desired states of data; and

   5.2. life companies' boards endorse an action plan to address the findings from the gap analysis, with appropriate investments made to improve the quality, quantity and timeliness of data collected and maintained.

APRA is concerned that the FSC ADI 2007-2011 table is so out-of-date that it is unlikely to be appropriate for life companies to rely on to set their base assumptions. While most life companies have adopted the FSC ADI 2007-2011 table with an overlay to reflect their own individual DII portfolio, APRA observed an instance where a life company continued to rely on the predecessor table, IAD 89-93, without justification for using the out-of-date table.

In the past few weeks, a new industry experience study has been released for the period to 30 June 2015. The delay in finalising this study, which is not a new occurrence, and the fact that the study reflects an experience period that ended nearly four years ago, reflects poorly on industry.

APRA understands that some life companies are not making timely and proactive contributions to industry experience data. APRA is disappointed that industry has been unable to address this and industry practices must change. APRA will work with the industry (including the relevant industry bodies) and consider a range of options to improve the currency and frequency of the updates to the industry experience table. The mechanism to address this may include APRA specifying an appropriate reporting standard.

6. APRA expects that life companies:

   6.1. proactively contribute to the industry experience study in a timely manner;

   6.2. set the underlying assumptions based on the most recent industry experience table with any deviations clearly justified and understood; and

   6.3. actively support APRA's initiative to consider options to improve the industry experience data.

Theme 4: Resourcing

The complex nature of individual DII products requires support from adequately skilled and experienced staff. The resourcing demand within life companies has been compounded by the level of activities in the life insurance industry in general as well as the actions life companies are undertaking to address the issues pertaining to individual DII by making enhancements across the value chain.

While APRA welcomes action by life companies to address issues with the individual DII business, it observed that some Participants have not adjusted resourcing to keep pace with the increased level of workload and complexity. This has resulted in inadequate resourcing and staff expertise in key functions such as risk, data management and analytics, claims handling, and actuarial.

The impact of inadequate resources was demonstrated in data from some Participants which showed a strong positive correlation between high caseloads per claim assessor and poor termination experience. Better practice was observed where Participants had:

- determined the appropriate level of resourcing and skills required for the claims function with appropriate justifications; and
- established metrics to monitor and report on actual versus target levels of claims caseloads, with appropriate management actions and corresponding timeframes if the target level is not met.

7. APRA expects that life companies:

   7.1. determine the current and future resourcing needs, in terms of both quality and quantity of staff, to reflect the types and volume of workload in key functions. This needs to be clearly reflected in a resourcing strategy which is translated into an action plan supported by metrics to regularly track and report on progress against the plan.