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APRA

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To: All life insurers and friendly societies

Sustainability measures for individual disability income insurance

This letter sets out measures APRA is introducing to address the poor performance of individual disability income insurance (IDII) and move the product to a sustainable state, which is in the interest of life companies[1] and policyholders alike. These measures address product design aspects and include a Pillar 2 capital charge for insurers and reinsurers.

APRA will engage with industry stakeholders on the implementation of these measures and to ascertain other possible measures to assist returning IDII to sustainability.

Background

The life insurance industry's ongoing failure to design, price and manage IDII in an appropriate manner has resulted in material losses from this product, notwithstanding significant premium increases. Over the last five years, the industry has reported IDII losses in excess of $3 billion[2]. At the same time, policyholders have had to bear significant and frequent premium increases, in excess of what they would have expected at the commencement of their contracts. These factors are posing a threat to the viability of the IDII product and the protection it offers the Australian community.

IDII has been an area of heightened focus for APRA for some time. A phased thematic review was undertaken with the objective of identifying and driving the changes required to improve the long-term sustainability of IDII. On 2 May 2019, APRA released an industry letter[3] which set out clear expectations for improvement in a number of areas.

Sustainability measures

Since APRA's May 2019 letter, IDII losses of $1 billion[4] have been reported and there are no discernible signs of improvement. APRA has not observed sufficient progress by life companies to address the underlying issues. APRA is concerned with the current state of affairs and considers the detrimental impact on life companies and consumers to be a significant prudential risk. A step change is required to address the financial risks of IDII for life companies, as well as the longer-term affordability concerns for consumers.

In light of the current situation, APRA deems it appropriate to take immediate action to address this prudential risk. The measures set out in this letter build on the expectations in the May 2019 letter. These measures consist of three distinct components reflecting APRA's additional expectations and the consequences for not meeting them.

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[1] Life companies include life insurers and friendly societies.
[2] Profit / loss before tax in respect of the five years ended 30 September 2019.
[3] Thematic review of individual disability income insurance - 2 May 2019
[4] Profit / loss before tax in respect of the nine months ended 30 September 2019.

1. Consequence management

To address the shortcomings identified in APRA's May 2019 letter, a significant uplift is required in the intent and efforts of life companies. To ensure an appropriate focus on APRA's expectations from the May 2019 letter, as well as those contained in this letter, APRA is implementing a consequence management framework, which includes a Pillar 2 capital charge. The Pillar 2 capital charge will be imposed upfront and will remain in place until life companies demonstrate sufficient and sustained progress against APRA's expectations. The charge will primarily be based on life companies' gross exposure to IDII, with some adjustment to reflect their responses to the May 2019 letter.

Attachment A contains details on the consequence management framework.

2. Managing riskier product features

Certain IDII product features currently offered by life companies are not consistent with the principle of indemnity[5] and contribute to moral hazard and higher inherent risk. Many of these features are also out of step with those offered by comparable products in other jurisdictions. Unless corrective actions are taken, these features will continue to contribute to significant uncertainty for life companies and consumers, threatening the ongoing viability of IDII.

APRA expects life companies to:

- cease offering IDII *agreed value*[6] contracts as they violate the principle of indemnity;
- have *income at risk*[7] closely linked to the actual earnings at time of claim; and
- limit the *income replacement ratio*[8] to support broader initiatives to encourage claimants to return to work, where appropriate.

Current IDII products typically have policy contract terms and benefit periods set until the insured's retirement age. These long time horizons contribute further uncertainty and complicate the sustainable management of IDII by reducing the ability to respond to changes in the external environment and consumer circumstances.

APRA expects life companies to:

- have a framework to periodically update *policy contract terms*, while ensuring policyholders' insurability rights are maintained; and
- manage their exposure to *long benefit periods* and have effective controls to manage the associated risks.

Attachment B contains details on the above measures. On some of these measures, APRA is seeking feedback on specific design details, but not on the direction of APRA's expectations. Please refer to the questions in **Attachment B** and provide APRA with feedback by 29 February 2020. Feedback should be provided via e-mail to IDIIProjectTeam@apra.gov.au. APRA will finalise and communicate its position on these details by 30 June 2020.

Over time, APRA will consider how best to reflect in its prudential framework the risks associated with features violating the principle of indemnity and the uncertainty of long time horizons.

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[5] An insurance policy benefit should not exceed a policyholder's economic loss.

[6] IDII contracts where the sum assured is based on earnings at policy application and does not consider earnings at time of claim.

[7] The amount of income that is insured.

[8] Portion of earnings replaced by insurance.

3. Data

Availability of relevant, quality and timely data, using consistent definitions, is a key enabler of action to improve IDII sustainability. APRA expects life companies to:

- contribute to APRA's upcoming data collection on IDII;
- contribute to industry experience studies in a timely manner;
- conduct internal experience studies at least annually; and
- set assumptions using the most recent industry table, which is based on industry experience studies not older than 18 months.

Attachment C contains details on APRA's expectations related to data.

Collaboration with other stakeholders

More broadly, APRA is engaging with other industry stakeholders to improve IDII sustainability. In particular, the Actuaries Institute has a Task Force aimed at objectively and analytically assessing the many factors at play in the IDII market with the aim of generating change. APRA is an observer at Task Force meetings. APRA will also consult with ASIC to explore the use of premium transparency as a regulatory tool to drive industry to improve sustainability.

Yours sincerely

Geoff Summerhayes
Executive Board Member

Attachment A: Consequence management framework

Pillar 2 capital charge

In light of the serious prudential concerns outlined in this letter and to ensure appropriate focus on meeting APRA's expectations, APRA has decided to impose an upfront Pillar 2 capital charge on each life company with IDII exposure. The amount of the charge will primarily be based on the life company's gross exposure[9] to IDII business, with some adjustment to account for each life company's current state as reflected in its response to APRA's May 2019 industry letter.

The capital charge will be communicated to affected life companies in December 2019, and will take effect on **31 March 2020.** It will remain unchanged until the first annual review on 31 March 2021.

The following factors can result in a *decrease* in the Pillar 2 capital charge for a life company at its annual review.

- Demonstration of sound and timely progress in meeting APRA's expectations in respect of the key focus areas in the May 2019 letter.
- Sustained improvement in financial performance as a result of better practices in management and control.

Factors that can result in an *increase* in the Pillar 2 capital charge for a life company at its annual review.

- Inadequate progress in meeting APRA's expectations in respect of the key focus areas in the May 2019 letter.
- Not meeting APRA's expectations outlined in **Attachments B and C.**

Directions and licence conditions

In instances where life companies continue to fail to meet APRA's expectations, APRA may issue directions or may amend life companies' licence conditions. In particular, life companies that continue to write agreed value policies after 31 March 2020 face the risk of APRA imposing conditions on their registration to not do so, or being given directions not to issue such policies.

[9] Based on a combination of new business and in-force premiums, gross of reinsurance and retrocession.

ATTACHMENT B: MANAGING RISKIER PRODUCT FEATURES

In addition to the consequence management framework, APRA is introducing measures to drive changes in product features that violate the principle of indemnity or exhibit heightened risk due to the uncertainty arising from long time horizons. These product features contribute to adverse financial impact on life companies, as well as continual premium increases, presenting consumers with affordability challenges. At the extreme, unless corrective action is taken, IDII may become unavailable to the Australian community.

The measures stated below should not be regarded as a definitive list of the areas where change may be required. APRA's actions present insurers with an opportunity to review and modify their IDII offerings, with a particular focus on long-term sustainability and the best interests of policyholders.

1. Income at risk

APRA considers it imperative that claim payments should be linked to income at risk at time of claim, i.e. indemnifying losses. Allowing claim payments to exceed the income at risk is inconsistent with the principle of indemnity. This gives rise to moral hazard, heightens risk and impedes sustainability. A specific application of this principle relates to agreed value (and endorsed agreed value) contracts, where the insurance benefit is based on earnings at policy application and not on earnings at time of claim.

APRA measures:

To address the above issues related to income at risk, APRA is taking the following measures:

- With effect from 31 March 2020, APRA expects that life companies discontinue writing IDII contracts where insurance benefits are not based on income at time of claim, including agreed value (and endorsed agreed value) contracts.
- With effect from 1 July 2021, APRA expects that income at risk for all new IDII contracts be based on annual earnings at the time of claim, not older than 12 months.

Feedback questions:

- Is 12 months an appropriate time frame to determine income at time of claim?
- What protections should be considered for policy owners whose income fluctuates due to reasons such as unpaid parental leave or contract work?

2. Income replacement ratio

Current IDII products have features and ancillary benefits that can cause the insurance benefit to exceed earnings at claim[10]. Evidence shows that returning to work is usually in the best interest of claimants, and the incentive to return to work is undermined by excessive income replacement ratios. Offering IDII products with excessive income replacement ratios can also result in consumers paying extra premium for insurance cover that they don't need. Product characteristics with adverse impact on the income replacement ratio include:

- features, including indexation, that increase the amount of insurance benefit to exceed earnings at claim, either permanently or for a given period of time; and
- features that allow the insured to earn income from continued work, with no offset to the insurance benefit being paid.

APRA measures:

To address the risks of an excessive income replacement ratio, APRA expects that, with effect from 1 July 2021, new IDII contracts will be designed so that:

- insurance benefits do not exceed 100 per cent of earnings at time of claim for the first six months of the claim, taking account of all benefits paid under the IDII product as well as other sources of earned income; and
- after the initial six months, insurance benefits are limited to 75 per cent of earnings at time of claim (subject to a dollar maximum of $30,000 per month).

Feedback questions:

- Is six months an appropriate time period for a higher initial income replacement ratio?
- Is 75 per cent of earnings at time of claim an appropriate limit, and should the limit be varied for different income levels and/or claim durations?
- Is $30,000 per month an appropriate limit?

3. Policy contract term

Most IDII policies in the market are Yearly Renewable Term contracts, where the life company has the right to change the premium every year. The underlying contract terms and conditions are however set for an extended period of time, typically until retirement age. Guaranteed renewability for such extended periods causes significant difficulty in designing products that will remain sustainable and appropriate for consumers. APRA therefore wants to ensure that there is an appropriate mechanism to keep products in step with changing external and consumer circumstances, and moderate the extent of premium increases that may otherwise be needed. APRA views it as not appropriate for life companies to offer IDII contracts with fixed terms and conditions exceeding five years.

[10] i.e. income replacement ratio exceeding 100 per cent.

APRA measures:

With effect from 1 July 2021, APRA expects that life companies will only offer new IDII contracts where:

- the initial contract is for a term not exceeding 5 years; and
- there is a right for the policy owner to elect to renew the contract for further periods (not exceeding 5 years) without a medical review on the terms and conditions applicable to new contracts that are then on offer by the life company. Changes to occupation and financial circumstances should be considered on renewal.

Feedback questions:

- Is five years an appropriate time period to have fixed terms and conditions?
- Are there alternative approaches to achieve the objective of not having fixed terms and conditions for periods exceeding five years?

4. Benefit period

Currently, the majority of the IDII policies sold have long benefit periods, typically to retirement age. If the risks associated with long benefit periods are not managed appropriately, they can detract from claimants' motivation to return to work and have an adverse impact on claim duration. Long benefit periods also exacerbate the impact of other problems that may exist with product design and controls.

APRA measures:

With effect from 1 July 2021, APRA expects that life companies:

- have effective controls in place to manage the risks associated with long benefit periods (e.g. having a stricter disability definition for long benefit periods); and
- set internal benchmarks for new IDII products with long benefit periods which reflect the risk appetite and the effectiveness of the controls.

Feedback question:

- What controls would be effective in managing risks associated with long benefit periods?

ATTACHMENT C: DATA

APRA data collection on IDII

APRA is developing a focussed data collection on IDII which will be released by mid-2020. The aim of the data collection will be to:

- provide further insight on the drivers of IDII results;
- inform APRA's monitoring and oversight of life companies' progress in meeting APRA's expectations; and
- uplift the industry's data capabilities for IDII (and in general).

APRA will continue to work with ASIC on joint data collections where appropriate and may expand this collection to incorporate ASIC requirements.

APRA measure:

- APRA expects that life companies provide quality data in their timely submissions to APRA's data collection on IDII.

Experience investigations

The industry experience study and related industry tables remain outdated. APRA understands that some life companies are not making timely contributions to industry experience studies with quality data. The continuous delay in the industry experience study is unacceptable and industry practices must change.

It is important that life companies set their assumptions based on regularly conducted internal experience investigations and on the most recent industry experience tables.

APRA measures:

From 1 January 2021, APRA expects that life companies:

- contribute to industry experience studies with quality data in a timely manner, enabling the release of results at least every 18 months;
- conduct internal experience investigation at least annually and update underlying assumptions if necessary; and
- set assumptions using the most recent industry tables, which are based on an industry experience study not older than 18 months, with deviations clearly understood and justified.