APRA

Affordability in PHI

Findings from the APRA investigation into financial sustainability

Presented to the Department of Health - 15 August 2019

Agenda

APRA

1. Perspective on affordability

2. How insurers are managing affordability challenges

   Including APRA's view of responses

3. APRA's strategy for managing affordability in PHI

Perspective on affordability in PHI

APRA

Driven by:

1. PHI being community rated and voluntary

- Sustainability based on younger/lower risk persons retaining cover
- Lower risk policyholders inherently receive less value
- Less lower risk policyholders increases premiums
- Lower risk policyholders are known – young and healthy

2. Cost of health services increase by more than wages

- To cover these costs, premiums have increased continually above wage inflation, which will challenge consumers in the long term
- Affordability concerns will 'bite' eventually – consuming larger share of household Budget

3. Value of 'private' health services difficult to determine

- The 'value' of healthcare is difficult to determine
- Medicare is available for those who leave the system
- Services often focused on acute care

'Free' Medicare

Perspective on affordability in PHI

Recent developments:

1. **Policyholders downgrading and leaving PHI**
   - Mostly younger policyholders leaving PHI
   - Price and value being questioned

2. **Price of premiums is material**
   - Gold and top family cover can be up to $12,000 pa (before rebate)
   - Average premium approx. $3,000 per adult (before rebate)
   - Health insurance fourth highest expense for households after mortgage/rent, car/petrol and eating out. It also increased by 50% between 2010 and 2016
     - Higher than takeaway, electricity, local government rates and mobile phones – ABS 2016 household survey
   - Rebate adjustment factor and means testing rebate increase premiums 'paid'

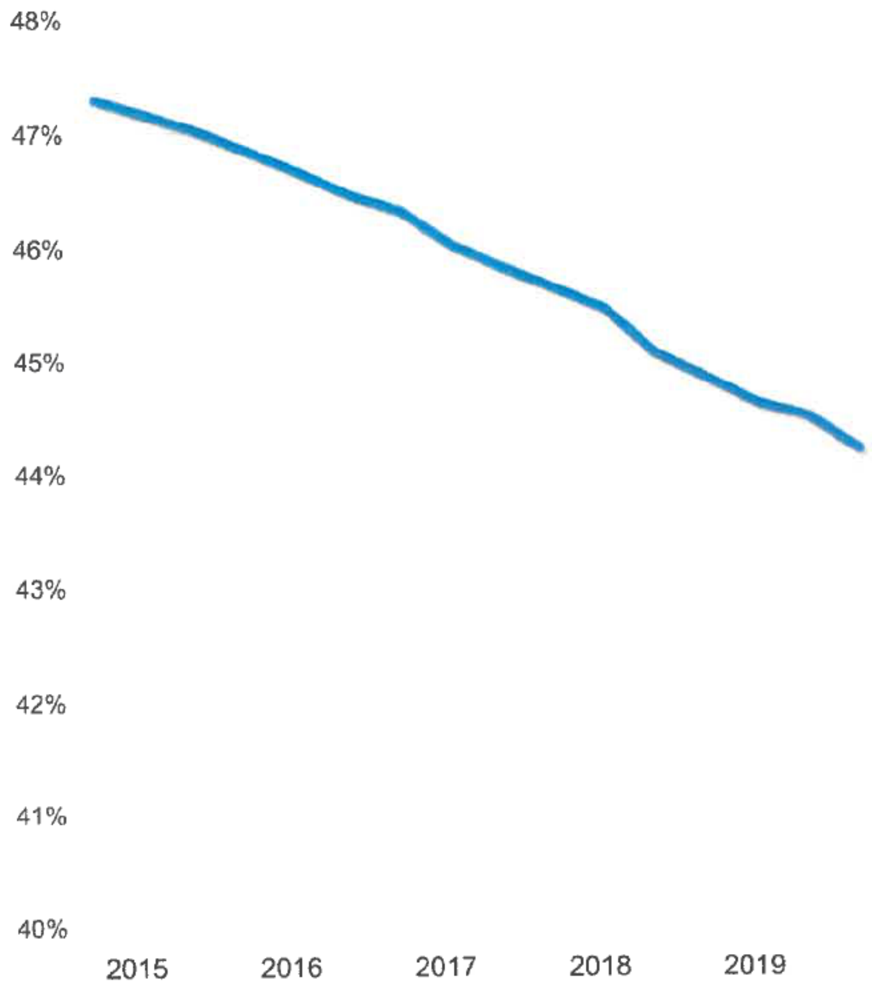
3. **Trends likely to continue**

4. **APRA's Risk Management Standards implemented**
   - This requires all health insurers to manage key risks

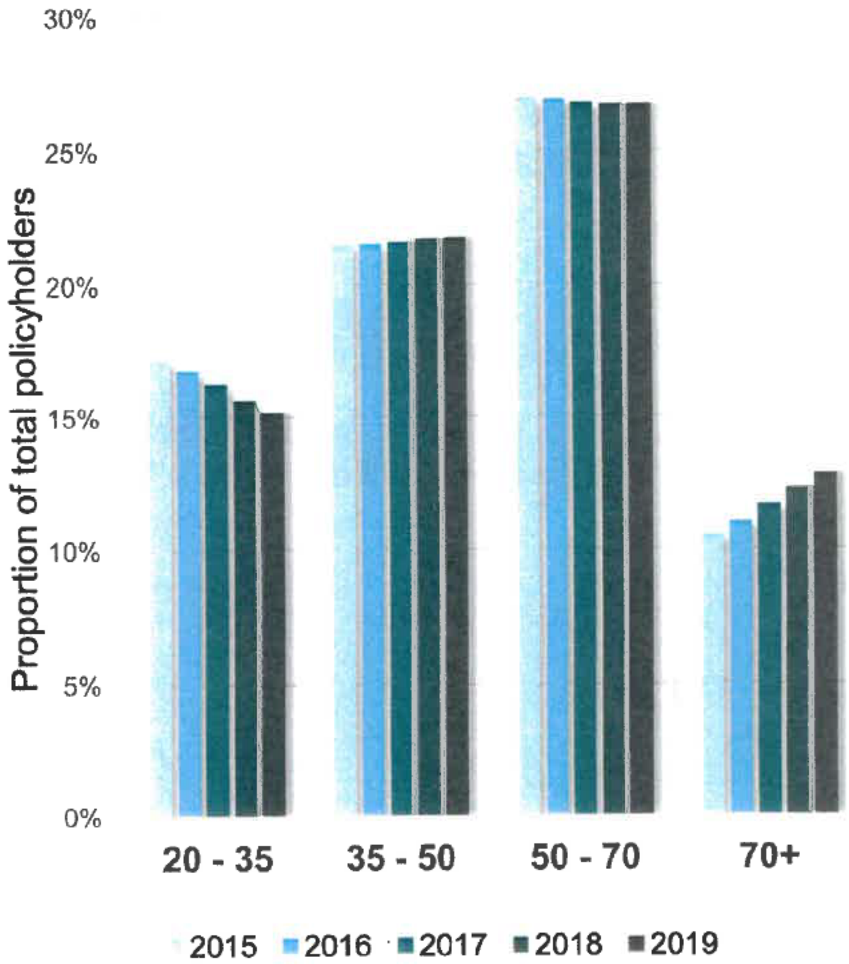
Perspective on affordability in PHI

APRA

Percentage of Australians with Hospital Cover



Insured persons with hospital cover by age



Page 6 is outside the scope of the request and has not been provided

HOW ARE INSURERS MANAGING AFFORDABILITY/SUSTAINABILITY RISK

Insurer awareness & assessment

- Most insurers consider affordability a critical risk
- Understanding of the issue, its causes and implications, is strong across the industry
- Most insurers have assessed the impact of affordability risk on the business, but few had an adverse financial impact

Awareness

Pages 8, 10 and 11 are exempt under section 47E(d) of the FOI Act and have not been provided

2) Supply-side measures

APRA

Removing costs from the system, while maintaining the same level of care, service or outcomes.

- Hospital substitution
- Chronic disease management
- Revised contracting procedures
  - ➢ Either lower increases or additional controls and adherence to guidelines
- Removing low value care
- Vertical integration
- Co-ordinating care
- Preventative measures

s47E(d)

[redacted]

3) Value add for consumers

APRA

Providing something of value outside of a hospital – especially for those unlikely to need hospital treatment

- Preventative measures
  - Incentivising 'healthier' behaviour such physical activity, nutrition, mental health prevention, health check-ups, reduce alcohol and smoking etc
  - Reducing risks of chronic diseases and needing acute treatment
- Greater transparency – cost, performance and risks
- Health & medical advice
  - Choosing which medical service to get, reviews and options
  - Life stage advice, eg pregnancy, young children, pre-admission
- Co-ordinating care
- Non-PHI benefits

s47E(d)

[redacted]

Pages 14-19 are exempt under section 47E(d) of the FOI Act and have not been provided

APRA

APRA'S STRATEGY FOR AFFORDABILITY/SUSTAINABILITY

APRA's strategy for affordability

APRA

s 22

From: s 22
Sent: Wednesday, 5 June 2019 12:08 PM
To: s 22
Subject: FW: APRA publishes speech on private health insurer resilience [SEC=UNCLASSIFIED]

For info – a speech from APRA on the challenges in the private health insurance space.

From: APRA web updates
Sent: Wednesday, 5 June 2019 12:07 PM
To s 22
Subject: APRA publishes speech on private health insurer resilience

APRA publishes speech on private health insurer resilience

The Australian Prudential Regulation Authority (APRA) has published a speech delivered to the Health Insurance Summit in Sydney today by Senior Manager Peter Kohlhagen.

In *A tale of two insurers*, Mr Kohlhagen expanded on the concerns raised by APRA in this week's letter calling on private health insurers to address challenges that threatened the industry's financial sustainability.

Mr Kohlhagen's comments include:

- "Navigating through challenges such as declining affordability and participation, together with the policy responses to those challenges, demands a deftness of strategy and maturity of risk management and governance that hasn't previously been required in this industry. Approaches that were successful for navigating past challenges cannot be assumed to be successful in the future as the environment shifts dramatically."
- "Rising premiums are only a symptom; as long as the costs of healthcare grow at 5-6 per cent per annum, there will be pressure on premiums to rise by a similar amount, continuing to damage affordability."
- "Insurers need to quantify the impact of an adverse affordability scenario at meaningful extremes and start implementing actions to address the materialising risk. Deferring action or waiting for a third party to 'serve-up' a solution is not a defensible strategy."
- "Our key message is that insurers should proactively develop recovery options, including a Plan B. For many insurers, the likely Plan B will be a merger with a like-minded partner. APRA will not hesitate to act to protect the interests of policyholders should it become necessary due to viability concerns with an insurer."

A full version of the speech can be found on the APRA website here.

FOI 2612
Document 3

Meeting between APRA and Treasury
26 June 2019 2:00pm – 3:00pm
Treasury Sydney Office, Level 5, 100 Market St, Sydney

Agenda items

s 22 [redacted]

s 22 [redacted]

APRA's focus in PHI:

s 22 [redacted]

- Financial sustainability review & its outcomes

s 22 [redacted]

s 22 [redacted]

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3 June 2019

TO: ALL PRIVATE HEALTH INSURERS

FINANCIAL SUSTAINABILITY CHALLENGES IN PRIVATE HEALTH INSURANCE

This letter sets out APRA's expectations for private health insurers (PHIs) to improve their resilience to sustainability challenges. APRA signalled its focus on financial sustainability challenges in early 2018[1], calling out the risks posed by declining affordability for policyholders, and the impact on PHIs of government policy changes in response to cost pressure across the wider health system.

APRA recently completed an assessment of PHI resilience and their approaches to managing affordability and government policy change risks. APRA reviewed 15 PHIs chosen to provide a representative sample across the industry. Disappointingly, the review found many areas for improvement. This letter provides observations from the review and sets out APRA's expectations for PHIs to improve resilience to these risks.

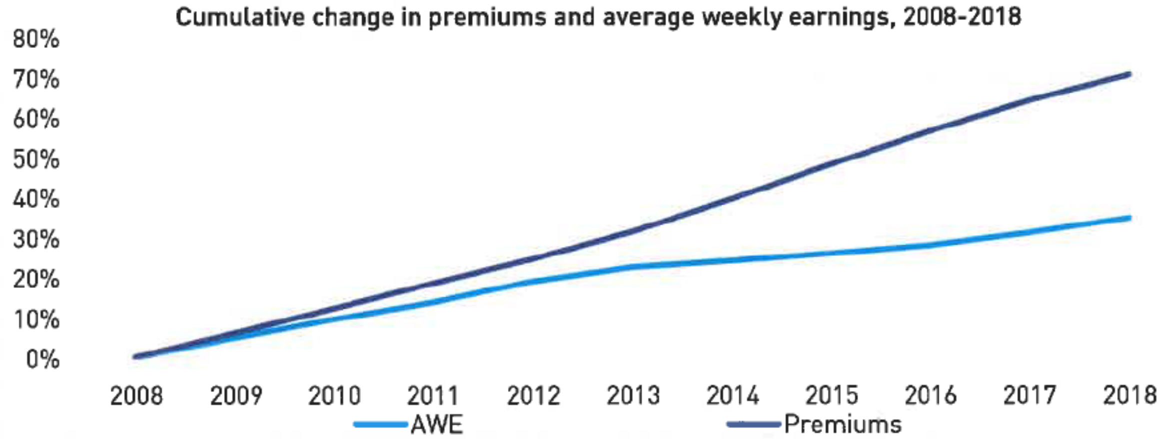
The review found PHIs had a strong awareness of these sustainability challenges. However, APRA's assessment found many PHIs lacked credible strategies to mitigate the risks. APRA observed a concerning assumption made by many PHIs that Government would provide solutions. APRA believes that the complacent approach observed in the review is out of step with the significance of these risks to the industry.

APRA recognises the important role a stable and robust private health insurance industry plays to complement the universal public healthcare system in supporting the well-being of Australians. APRA's role is to ensure the resilience of PHIs so they can continue to meet the promises made to policyholders and provide choice to consumers in managing their healthcare.

The industry is facing heightened pressures on a range of fronts. Higher demand for medical services by policyholders and increasing health costs are pushing premiums up. The resulting impact on affordability for policyholders is demonstrated in the following chart, which shows premiums have consistently grown faster than average weekly earnings over the last decade. Further, increasing out-of-pocket costs, changing consumer demands and the perception of low value are leading to a decline in the number of younger policyholders who play an important role in the sustainability of Australia's community-rated system. Over the last decade, these pressures have contributed to an almost doubling of the proportion of insured persons who are aged 65 and over. These pressures are likely to continue into the foreseeable future.

While aspects of these sustainability risks are beyond the direct control of industry, APRA expects PHIs to be doing more than simply identifying these risks. In APRA's view, sustainability pressures will continue to intensify for PHIs that do not take proactive steps to manage the impact of these risks. Consequently, APRA expects all PHIs to rapidly develop robust and actionable strategies to build resilience to these risks and engage regularly with APRA on the effectiveness of those strategies.

[1] *Health insurer, heal thyself: APRA's prescription for financial sustainability*, speech to the Members Health Directors' Professional Development Program, February 2018.



Source: APRA analysis, based on Department of Health and ABS.

However, even well-developed strategies may not be successful, nor can they fortify PHIs against other events that impact solvency. Therefore, APRA also expects that all PHIs develop recovery plans to set out the actions they will take to respond to material risks that could threaten their solvency. Early preparation of recovery plans, including consideration of potential merger partners, will give PHIs more discretion when under pressure. In considering recovery actions, boards should ensure member interests always retain primacy. APRA will separately write to individual PHIs to provide guidance on expectations for an effective recovery plan.

Evidence from the review reiterates APRA's consistent message to industry that PHIs with superior governance, business planning and risk management will be better placed to adapt to change and overcome threats. APRA's review identified that PHIs better placed to manage sustainability risks had clear processes to monitor developments affecting their business. They used their risk management framework to analyse the impact of material risks and inform the board's decisions on proactive responses. Further, APRA observed that responses more likely to be effective in mitigating the impact of these risks demonstrated:

- broader value for policyholders, including to meet the needs of younger and healthier members who are likely to value other services more highly than hospital treatment;
- managing claims costs by facilitating alternative models of care, as well as measures to support well-being and preventative health that assist policyholders in avoiding claims; and
- use of partnerships and outsourcing of material business functions to deliver better value for policyholders and manage costs.

The review found significant scope for improvement across the industry. For example, only one PHI had conducted quantitative analysis of a truly adverse affordability scenario. Further detailed observations from the review and APRA's expectations for all PHIs are set out in **Attachment A**.

Inaction or inertia in the face of these challenges is likely to result in negative outcomes for PHIs and policyholders. A PHI that continues to take a passive approach to these risks can expect a more assertive response from APRA via entity-specific supervisory action to protect policyholders and the stability of the industry as a whole.

APRA supervisors will be working with PHIs on these matters over the coming period and will be challenging PHIs to make material improvements in their approach to managing these risks.

Yours sincerely,

Geoff Summerhayes
APRA Member

ATTACHMENT A: OBSERVATIONS AND EXPECTATIONS FROM APRA's REVIEW OF PHI RESILIENCE

Over the last few years APRA has become increasingly concerned about heightened risks facing the private health insurance industry. Affordability risk is becoming more pronounced as premiums continue to rise faster than wages and as a consequence there is reduced participation by policyholders, particularly younger and healthier Australians. At the same time, PHIs face risks in adapting to government policy changes designed to respond to pressure on the wider healthcare system. These sustainability risks in private health insurance pose challenges to traditional business models of PHIs and, if not well managed, have may have negative implications for policyholders with respect to PHI sustainability.

In response to this increasing concern, APRA commenced a review of PHI resilience in mid-2018 to get a better understanding of whether PHIs were adequately prepared to manage these risks. The review was also intended to inform APRA's action to protect the interests of policy holders in the face of heightened risks to sustainability.

APRA assessed the readiness of 15 PHIs, chosen to provide a representative sample across the industry. The review included the five largest PHIs and a selection of smaller PHIs, with the sample covering both open and restricted membership PHIs as well as for-profit and not-for-profit PHIs. The review included those PHIs that appeared to be more proactive in managing these risks.

In conducting the review, APRA considered information from board reports, risk registers, scenario and financial analysis and any other documents related to the assessment and management of these issues.

The review assessed each PHI's approach to:

1) Its **awareness** of these issues, including the extent the issues were incorporated in risk registers, risk management plans, strategic plans and board reporting.
2) The **depth of assessment**, in particular how the PHI assessed these issues, the view on severity, impact on the business, potential ways the risks could materialise and any scenario analysis completed.
3) **Strategy** to manage these risks, including whether the PHI had a clear strategy, the detail of the strategy including responsibilities and governance, the PHI's view on effectiveness and an assessment of its likely success.
4) **Actions taken** to date, including the extent to which the strategy had been implemented, the success of the strategy to date, reporting, milestones and governance on actions taken.

The findings of the review are below, along with APRA's expectations for PHIs to enhance their resilience to manage these risks.

1. Awareness

There was consistently strong awareness of the sustainability challenge posed by affordability and government policy change risks across the industry, with both risks being identified in almost all PHIs' risk registers. PHIs demonstrated a strong understanding of the causes and most considered them among the biggest challenges facing their business.

PHIs demonstrated differing practices for the monitoring of these issues. Some entities had established clear processes to help them keep informed of developments, understand the impact on their business and regularly review the PHI's strategy. Other PHIs had less structured approaches, with the board and other decision-makers being informed by infrequent updates, for example at an annual planning day or in passing references in other reports.

PHIs that demonstrated greater awareness were those that had established internal work streams to monitor industry developments, nominated key responsible people and disseminated this knowledge throughout the organisation. APRA observed better practices within those PHIs that are monitoring and disseminating information on a regular basis, drawing from a variety of sources that represent different perspectives including those of consumers, PHIs, regulators and suppliers.

Expectation – Awareness

1.1. *That PHIs formalise the process that will be used to keep them informed of changes in the environment, including considering the timeliness of reporting to the board on how these could impact the PHI and whether the PHI's strategy remains appropriate to manage within the new environment.*

2. Assessment

The review found all PHIs had assessed the impact of potential government action to impose a 2 per cent cap on premium increases. This assessment included a quantified stress test of the impact on profitability, capital and prudential position over the next two to three years.

However, APRA observed narrow consideration by PHIs of ways their business may be affected by other policy changes, and consequently limited testing of alternative policy change scenarios. This narrow perspective ignores the history of the industry in which a number of changes in government policy have had a significant impact on the expectations of policy holders, industry structure and profitability.

APRA observed that better assessments of government policy change risk by PHIs included broader thinking on how these risks may impact their business and the identification of a variety of alternative scenarios for policy change. These assessments were supported by quantitative analysis of the impact of these scenarios at meaningful severities to examine the impact on capital and the profitability of the PHI. PHIs that demonstrated a higher level of engagement with the risks, as evidenced by deeper assessments were also found to have better strategies in place for addressing them.

There was less emphasis among PHIs on assessing the impact of affordability risk relative to the emphasis placed on the assessment of the impact of a cap on premium increases. This imbalance in assessment does not match industry's own recognition of the importance of both risks.

In terms of affordability risk, the review found that PHIs had typically assessed the impacts in qualitative terms only, with few PHIs conducting quantitative analysis of an affordability scenario. For PHIs that did quantify the scenario, in all but one PHI the scenarios considered were benign, in that they did not stress the PHI. The review found that only one PHI had prepared an adverse affordability scenario. The disregard for assessing severe affordability stress scenarios is out-of-step with industry's own view of the significance of the risk.

Better practice involved PHIs more severely stressing key risks. The boards of PHIs that are presented with analysis that challenges the core business are more likely to take the risk seriously, understand the implications of the risk and be able to make decisions on a more effective response. In APRA's view, PHIs that quantify 'extreme' events as only having a low impact are less likely to effectively manage the issue.

Similarly, it is APRA's view that PHIs that conducted a more credible qualitative assessment of affordability risk included the views of multiple stakeholders including various policy holders, health providers, other PHIs, industry groups and Government. Robust assessments were more detailed and demonstrated an understanding of the root cause of issues, highlighted areas to monitor and areas where the PHI could take action.

Expectations – Risk Assessment

2.1. That PHIs stress test the most material risks in their risk register. Scenarios should demonstrate how risks could materialise, stress the business model at meaningful severities and assess the likely impact of mitigation strategies.

2.2. The scenarios should consider a variety of alternative scenarios for policy change, across different calibrations and be over a time horizon sufficiently long to stress the business and assess the long-term impact of mitigating strategies.

3. Strategy

APRA assessed the extent of each PHI's strategy to address sustainability risks. These strategies were evaluated on their likelihood to be effective in boosting resilience.

APRA observed that the majority of strategies were still at a very early stage of development. For example, many PHIs were yet to formalise and document implementation plans. APRA frequently observed a heavy reliance on industry associations, and many assumed the Government would take responsibility to address these risks.

A number of PHIs had also assessed their own strategy as likely to be ineffective, showing little to no difference between the risk impact before and after the PHI's management of these risks. A credible strategy would involve the assessment of proposed actions to verify that those actions would meaningfully mitigate risk and a plan to monitor effectiveness. A credible strategy would also include the development of a recovery plan for if those actions were less effective than expected. Waiting for Government to 'serve-up a solution' is not a defensible strategy. In APRA's view, policy holders are not well served by PHIs that defer action to others or that disregard their own responsibility to take steps to address these risks.

APRA observed strategies more likely to build resilience to Government policy changes are those that develop specific insurance offerings that provide value to policy holders while meeting the objectives of government. Better prepared PHIs were also observed to be using their expertise and data to conduct scenario analysis that informed the board's strategic decisions, and could also be used to inform policy solutions that can be proposed to Government. PHIs that followed this approach had proactive strategies that were not solely reliant on the Government to change policy or increase funding for the sector.

APRA observed that more credible strategies to address affordability risks included a clear overall purpose, specific deliverables, responsibilities and timings. Typically, PHIs demonstrating these practices were informed by a robust assessment of the risks, feedback from policy holders and had strategies that involved various actions to address each underlying issue.

Better prepared PHIs were observed to be those making active efforts to adjust their business to reduce, rather than absorb the impact of affordability risk. Strategies observed in the review, included negotiation of supplier contracts to exert control over their claims costs, facilitating substitutes to in-hospital care, use of outsourcing and partnerships to achieve strategic objectives and participation in the delivery of medical services. The most effective strategies also demonstrated value to all policy holders, enhancing the customer experience by providing preventative health and well-being advice, increasing touch-points with policy holders and developing new product offerings that cater to policyholder interests.

PHIs with more robust strategies provide value to all policy holders and demonstrate two key characteristics:

- A focus on providing more cost-effective measures for delivery of medical services.
- A focus on providing services of value to all policy holders, especially to those who are younger and healthier and may not require hospital treatment.

Expectations – Strategy

3.1. That PHIs develop robust and proactive strategies to manage these risks, taking into account the perspectives of a range of stakeholders.

3.2. That PHIs assess whether their proposed actions would meaningfully mitigate the risks, and consider whether mitigation could be strengthened through outsourcing or strategic partnerships.

3.3. That PHIs develop a recovery plan for how they will respond should their strategy not be successful

4. Actions taken

Where PHIs had a developed and documented strategy to address risks, these were generally at the early stage of implementation. The review found pilot programs are being trialled and monitoring metrics are still being built. For PHIs that are further progressed, APRA observed that in a number of cases it has taken several years to develop and implement such programs.

While not widely available, the review found tangible evidence of the cost savings achieved, benefits provided to policy holders and additional value created. This evidence was typically observed from PHIs that had established clear governance and responsibilities for the monitoring of strategy implementation and deliverables.

Better practice implementation was observed where PHIs had assigned risk owners with responsibility for monitoring implementation progress and were monitoring performance against clear metrics for strategy effectiveness. These entities also demonstrated an iterative approach to implementation by assessing effectiveness and reviewing strategy accordingly.

Expectations – Strategy Implementation

4.1. That PHIs have clear responsibility assigned for the development and implementation of these strategies. These strategies should articulate milestones with defined metrics and trigger points, along with governance and monitoring practices. This should be reported to the PHI's board.

FOI 2612
Document 5

APRA's role and focus in PHI

Meeting with Australian Treasury

26 June 2019

APRA's role and mandate

APRA'S STRATEGY 2018-2022

OUR MANDATE

We protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.

OUR OPERATING MODEL

Supervision	Policy	Resolution
People and culture		
Risk intelligence and frameworks		
Organisational effectiveness and infrastructure		

OUR VISION

To deliver a sound and resilient financial system, founded on excellence in prudential supervision.

OUR VALUES

Integrity
Respect
Collaboration
Excellence
Accountability

OUR STRATEGIC PRIORITIES

- Broaden risk-based supervision
- Improve data-enabled decision-making
- Build resolution capability
- Strengthen external engagement and collaboration
- Enhance leadership, people and culture
- Lift organisational capability

Pages 3 and 4 are outside the scope of the request and have not been provided

APRA's areas of focus for 2019/20

1. Resilience and sustainability

Ensuring insurers to have robust risk management, strategies and governance especially in relation to:

- *Affordability challenges*
- *Lower premium increases*
- *Policy changes*

s 22

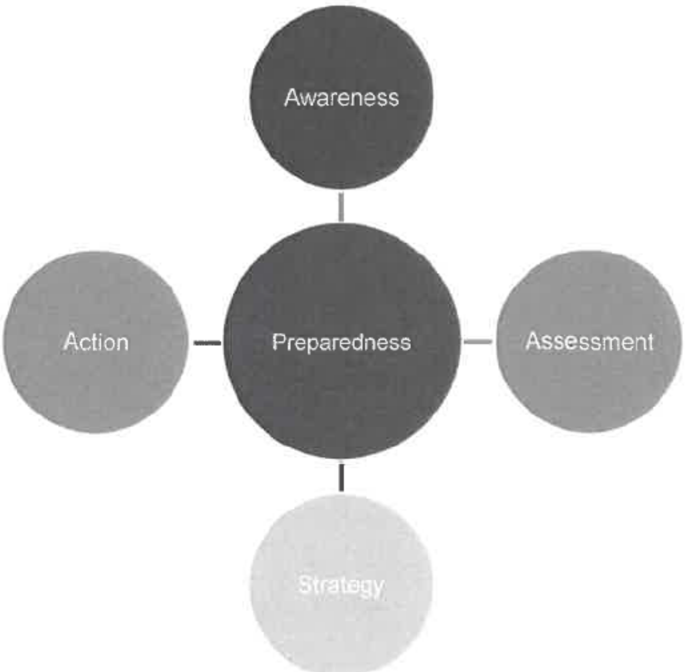
Pages 6-8 are outside the scope of the request and have not been provided

Financial sustainability review

What did we do?

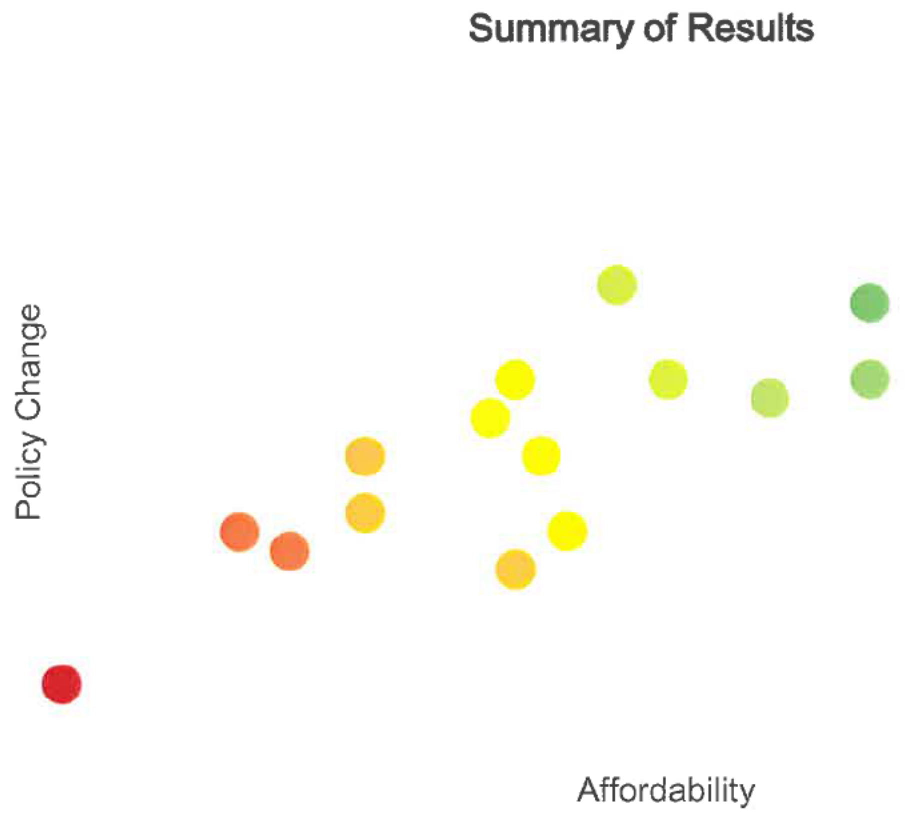
Concerns led APRA to review how the PHI industry is assessing, treating and managing the risks associated with Affordability and Policy Change.

A strategy was developed in late 2017/early 2018 to request documents from 15 insurers to assess performance across the following criteria:



Sustainability review findings

What did we find?



Detail of review findings

APRA

High awareness

- Strong understanding of causes and implications
- s 47E(d) [redacted]
- Varying risk monitoring practices

Limited quantitative risk assessment

- s 47E(d) [redacted]s
- Narrow consideration of policy change impacts other than 2% premium cap
  - Alternative policy change scenarios were rarely assessed
- Typically only qualitative assessment of affordability risk

Underdeveloped responses

- Assumption on action by government
- s 47E(d) [redacted]

Limited and tentative strategy implementation

- Strategies take time to have impact, but there is some tangible evidence of cost savings
- Varied monitoring of strategy implementation

Pages 12-14 are outside the scope of the request and have not been provided

FOI 2612
Document 6

A tale of two insurers

5 June 2019

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, […] it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way…"

The private health insurance industry finds itself at somewhat of a crossroads. While the Charles Dickens quote above opens 'A Tale of Two Cities', the theme of my remarks today is a tale of two insurers.

Navigating through challenges such as declining affordability and participation, together with the policy responses to those challenges, demands a deftness of strategy and maturity of risk management and governance that hasn't previously been required in this industry. Approaches that were successful for navigating past challenges cannot be assumed to be successful in the future as the environment shifts dramatically.

Today I will speak on three key topics:

- The first is APRA's observations of insurer better practices and areas for improvement in managing affordability challenges and policy change risks. Overall our conclusion is that there needs to be a material uplift in insurer strategies for management of these risks.
- Second, while a robust strategy is critical to navigating those challenges, we should also recognise that the strategy may not be successful. APRA has spoken previously about the need for insurers to have a sound Plan B so they are prepared if their business model comes under sustainability pressures. Today my key message is that APRA will be moving with some urgency to ramp up the pressure on insurers to be prepared.
- Third, I will provide an update on the review of capital requirements. Capital is a key tool for driving the resilience of insurers to emerging challenges.

Before I come to the detail of my comments, let me situate them in the broader context of the debate around private health insurance. Some of the detail may sound a bit esoteric or technical but the reason we take these steps to improve resilience is fundamental to the well-being of Australians. For many years, Australians have benefited from a combined public/private healthcare system, however the ability of the private insurance sector to continue to make its contribution is coming under increasing threat from the challenges of affordability. APRA's role in the system is to ensure the resilience of private health insurers so they can meet the promises they've made to policyholders, and continue to play their role in supporting the broader public health system.

The costs of healthcare continue to rise, across both the private and public systems[1]. It is these increasing costs, together with higher demand for healthcare services, which are the root cause of increasing premiums. Rising premiums are only a symptom; as long as the costs of healthcare grow at 5-6 per cent per annum, there will be pressure on premiums to rise by a similar amount, continuing to damage affordability. The affordability challenge in private health insurance then is part of a broader context – how should society fund healthcare costs?

I should be clear that APRA doesn't have or desire a position in that debate; it is rightly a question for the community, governments and the Parliament. But neither are we passive bystanders. APRA has an important role to play:

- Firstly, by working with insurers and the industry to increase resilience, so that they are able to respond to the challenges. And if those responses are ultimately not effective, to ensure that policyholders are protected.
- Secondly, APRA aims to aid an informed debate on the role of private health insurance in the broader system. In particular, where we see emerging threats to the sustainability of an insurer or private health insurance generally, to call these to the attention of stakeholders so that decisions can be made with full understanding of the prudential consequences.

With that said, and in the spirit of my literary opening, let me introduce you to the two insurers that are the main protagonists of my comments today. I'll start with a disclaimer – these are stylised composites included for illustrative purposes, and no resemblance to any health insurer current or departed is intended. The descriptions incorporate a significant amount of poetic licence. With that said, let me introduce:

- Resilient Health Fund; and
- Complacent Health Fund.

In recent years, Resilient Health Fund has invested significantly in its risk management approach. While further improvement can always be made, Resilient is justifiably proud of its progress. Resilient is overseen by a board that has been refreshed to bring in new perspectives. The directors have a range of tenures, skills and experiences, and the board has a robust board renewal policy guided by a board skills matrix. The management team is supported by strong financial and actuarial analysis capabilities. In short, Resilient has invested heavily in its capabilities and is now positioned to reap the benefits.

Complacent Health Fund has been successful historically and is justifiably proud of the service it has provided to its members over a long period of time. The current directors have been on the board for an extended period and there is very limited acceptance of fresh perspectives. They are a bit bewildered by the ongoing calls to enhance risk management and governance – why would we need to change now when we've been successful for so long? As a result, Complacent finds itself confronting a challenging future with a set of practices that are lagging well behind better practice.

Having introduced the two insurers, I'll now discuss affordability and policy change risks in more detail. Afterwards, we can return to the story of Resilient and Complacent and see how they fare in responding to the risks.

Managing affordability and policy change risks

Policy change risk has long been recognised as one of the major risks to the private health insurance industry. In recent years the risk has increased in prominence, as policymakers respond to widespread dissatisfaction with the value provided to policyholders. Rapidly rising costs and demand for healthcare have driven premium increases significantly above CPI and average weekly earnings, making affordability of private health insurance front page news. Unsurprisingly then, affordability and policy change risk are two of the key risks on APRA's industry risk register.

Last year, APRA requested a range of information from insurers to help us form a view about how these risks are being managed. Earlier this week, we released a letter to industry setting out our findings including better practices we observed and areas for improvement. The headline story is that while some insurers are more advanced than others, we aren't convinced that any insurer yet has a robust strategy for managing the risks.

In some ways, that no one has yet solved this problem is unsurprising – these are challenging issues and the path forward is not clear. Aspects of the problems are outside the control of insurers. But preparation is always better than cure and there is still opportunity for insurers to become more resilient through robust approaches to these issues. Early movers have the opportunity to find a competitive advantage by developing innovative strategies.

One pleasing outcome from APRA's review is that there is a high degree of awareness of policy change and affordability risks. Yet it remains troubling that few insurers are translating their awareness or understanding into actionable plans – dare I say, an element of being Complacent?

While these risks are often considered as a pair, I will deal them separately today as I draw out some findings from APRA's information request – and as you will see, this reflects that differing strategies are likely to be needed to address each issue.

You'll see as we work through the detail that while many insurers are taking at least some steps to respond to the risks, no one can yet lay claim to a genuinely Resilient approach.

Affordability risk

Firstly on affordability risk, APRA has seen that insurers are considering a range of strategies. APRA welcomes this diversity – it is important that the strategies take account of the individual insurers' business and member characteristics. Yet, often the strategies are vague, fail to address the material risk or rely heavily on actions by others. This is especially the case for insurers that use third parties to support core business functions that are critical to the strategy.

With 82 per cent of Australian households concerned about the cost of private health insurance[2], awareness is no longer an adequate stance. Insurers need to quantify the impact of an adverse affordability scenario at meaningful extremes and start implementing actions to address the materialising risk. Deferring action or waiting for a third party to 'serve-up' a solution is not a defensible strategy. So perhaps most concerning is that many insurers are taking only tentative steps to deliver on their strategies.

When it comes to thinking about what insurers can do to mitigate affordability risk, APRA considers promising strategies are those where the insurer is actively changing how they provide services to their members – for example where insurers are facilitating substitutes for traditional in-hospital services, revising their health supplier contracts or developing preventative health and well-being offerings for members. These are actions which are well within the control of insurers. Those that move early can benefit from a more open field, with less need to navigate through what others have already implemented.

Policy change risk

Turning now to policy change. There is no doubt the heavily regulated nature of the industry means insurers are exposed to policy change risk. This is not a new phenomenon – but I expect most of you would agree we are seeing a heightened period of impact from policy reforms as governments grapple with changing demands on the health care system.

In this context, APRA welcomes steps insurers have taken to understand and model scenarios for the most evident policy change: a period of premium increases being constrained below increases in claims costs. But as we know, shocks to the system rarely follow expectations. Insurers that are not thinking broadly about how policy change may impact their business therefore risk encountering their own "winter of despair".

I can almost hear some of you sigh, thinking "but what can we do? Policy settings are beyond our control". While I won't try to tell you otherwise, APRA's view is that this does not preclude actions by insurers to mitigate the impact of changes. So it is concerning to APRA that we see passivity among insurers.

APRA expects to see insurers drawing on their expertise to develop specific policy proposals, undertaking evidence-based analysis and using these insights to engage with policy makers and others in the health care system on reform proposals. Looking within their business, APRA would expect that better prepared insurers are taking actions to improve the value of services for members. This might be via service quality offerings, non-PHI benefits or strategies that can control costs. Together these types of actions may help insurers address affordability risk and so position them to tolerate policy changes.

Let's pick up the story of Complacent Health Fund in the light of the findings of APRA's letter.

Complacent's under-developed risk management and governance approaches meant they were slow to react to the emerging challenges. They took comfort from their past successes and the fact that in the past when participation rates fell, policymakers had responded by adjusting policy settings. They didn't develop a proactive strategy and instead saw themselves as passengers rather than in the driving seat.

Resilient moves far more quickly, gaining a competitive advantage that sets them up for future success.

APRA's work on affordability and policy change risks shows there is still a path forward for Complacent Health. By taking steps to translate awareness of the risks into proactive strategic plans, there is time to increase their resilience and avoid going "the other way".

Recovery planning and plan B

We all hope that all insurers are able to respond to the challenges and continue to serve their policyholders for a long time to come. But there is no guarantee that will be the case, and so developing a robust plan to recover from stress should be on the agenda for any responsible insurer.

This is not unique to your industry; APRA has been working with the major banks and other insurers on recovery planning since 2011. But the need amongst private health insurers is particularly heightened at present given the challenging conditions in the industry. We are already in a period of premium growth being constrained at a level below the growth in underlying costs. APRA is on the record as stating that such an environment will challenge the sustainability of insurers and that it is likely to lead to consolidation if it continues for an extended period.

APRA has already commenced bilateral discussions with a number of insurers who we have identified as the most likely to face sustainability challenges. As flagged in our letter to industry this week, our work with relevant insurers on recovery plans will continue to intensify. Our key message is that insurers should proactively develop recovery options, including a Plan B. For many insurers, the likely Plan B will be a merger with a like-minded partner. APRA will not hesitate to act to protect the interests of policyholders should it become necessary due to viability concerns with an insurer. That can take the form of an orderly merger or other exit from the market. Importantly, an insurer that has a plan and executes it when it becomes necessary can control its own destiny; an insurer that fails to plan will find that it loses that opportunity.

We pick up the story of Complacent and Resilient as their strategy for addressing affordability and policy change risks falter and their business models come under sustainability pressures.

Complacent doesn't grasp the severity of the challenge until the situation has deteriorated significantly. Rather than receiving and acting on the early warning signals, the board doesn't act until APRA imposes strong pressure. By that time, the options available to the insurer have narrowed, and the insurer is pushed into a hastily arranged merger. Policyholders are protected, but the process is somewhat disorderly and reflects poorly on both Complacent and the industry more broadly.

Resilient commences its preparations far earlier. Although the board has confidence that their strategy for managing the risks will be successful, they also recognise the need to prepare just in case. The board and management develop a recovery plan that has escalating metrics or triggers to determine when action should be taken. As they come under sustainability pressure, consideration is given to the range of possible actions outlined in the recovery plan, and the board determines that a merger would be the best outcome for its members.

In developing the recovery plan, the board had exploratory discussions with potential preferred merger partners, and these discussions firm up as the situation continues to deteriorate. At the point determined in the plan, the board agrees to implement its plan B. As a result, policyholders are transitioned in an orderly way with plenty of time for communication. The merged entity emerges stronger than the sum of its parts and the reputation of the insurers involved and the industry as a whole is protected.

APRA's letter to industry from earlier in the week outlines some practical steps that insurers can take to prepare. We will follow that up with further detailed guidance on an insurer-by-insurer basis, together with clear timeframes for each insurer to respond. I urge insurers to consider that guidance seriously, engage openly with APRA and to put in place a plan well ahead of any urgent need for action.

Review of capital standards

Before I leave you today, I want to touch briefly on APRA's thinking on the review of capital requirements. Without doubt, a robust and well-managed capital position is one source of resilience for an insurer.

As most of you would know, in November last year APRA outlined its planned approach to reviewing the capital framework for private health insurers. The current capital framework has been in place since 2014, and this review provides an opportunity to ensure that capital standards in the industry provide for an appropriate level of resilience to protect policyholders.

As outlined in its earlier letter to industry, APRA intends to consult on proposals which adapt the capital framework already in place for the life and general insurance sectors – or LAGIC – for the private health insurance industry. This does not mean APRA will apply LAGIC as is, in an unconsidered way. Rather, APRA is identifying areas where sector-specific adjustments are warranted to recognise the differing risk profile and business models in the private health insurance industry.

In particular, APRA is considering adjustments that reflect the characteristics of insurance risk in the industry to take account of factors like the short-tail nature of claims, risk equalisation, health-related business and the constraints on premium setting and product design in a Gold/Silver/Bronze/Basic world. We are also considering how to think about potential insurance concentration risks and how the capital framework should recognise the legislative requirements for community rating that underpin the industry. I expect you would not be surprised that APRA is also considering how to address policy change risk in the capital framework, given that such changes have been a source of insurer stress in the past.

We are pleased that the Actuaries Institute is assisting us by providing some early advice on these matters. The Institute has established a technical working group to identify issues and suggest approaches that APRA could take to address them in the capital framework. This group has provided early feedback to APRA on a range of issues and this is a valuable input to our thinking.

Beyond the work with the Actuaries Institute, APRA is engaging broadly through industry roundtables and bilateral discussions with a range of interested parties. APRA's door remains open to anyone who would like to discuss the review with us. The discussions are extremely useful as we continue to firm up our proposals for consultation.

We expect to release an initial discussion paper in the coming months outlining in principle APRA's proposed new capital framework for private health insurers. The release of that paper will kick off an extended formal consultation period and we're looking forward to continuing to work with the industry to develop a capital framework that supports insurer resilience for the protection of policyholders. To reiterate our earlier messaging, APRA does not expect that a revised capital framework would be implemented before the end of 2021.

Conclusion

The industry is under significant and increasing pressure. The challenges of affordability, and existing and potential policy changes, are difficult to resolve, and we anticipate they will continue to intensify. While some of these pressures reflect challenges being felt across the healthcare system, the industry needs to step forward to address the impacts on their business. These challenges demand a proactive response – waiting for someone else to solve them is not an option. Doing nothing is a sure-fire way to forgo the opportunity to steer your own destiny.

Actions to mitigate these risks and establish robust recovery plans are part of preparing for the challenging conditions facing the industry. More forward-looking insurers that invest in developing new strategies and approaches will find themselves not only more resilient to stress but can also benefit from competitive advantages as new opportunities emerge. Complacent insurers are likely to find themselves without a sustainable business model and under pressure to exit the industry.

While APRA doesn't have any predetermined view on the future structure of the industry, we will not hesitate to act to protect policyholders should an insurer's viability come into question.

Times of challenge like these are the opportunity to shape a new future. To borrow again from Dickens, this time from Great Expectations, suffering is stronger than all other teaching. We encourage you to seize the opportunity to develop bold strategies to address the challenges and emerge stronger. More Resilient and less Complacent.

Footnotes

[1] Australian Institute of Health and Welfare 2018. Health expenditure Australia 2016-17. Health and welfare expenditure series no. 64. Cat. No. HWE 74. Canberra: AIHW.
[2] CHOICE March 2019 Consumer pulse. https://www.choice.com.au/money/insurance/health/articles/health-insuran... accessed 26 March 2019.

s 22 [redacted]

From: s 22 [redacted]
Sent: Monday, 3 June 2019 12:59 PM
To: APRA Capability Review Secretariat
Subject: FW: APRA calls out private health insurers over inaction to address financial sustainability challenges [SEC=UNCLASSIFIED]

Fyi – the PHI announcement I referred to in the meeting. Its unusually blunt.

From: APRA web updates
Sent: Monday, 3 June 2019 11:04 AM
To: s 22 [redacted]
Subject: APRA calls out private health insurers over inaction to address financial sustainability challenges

APRA calls out private health insurers over inaction to address financial sustainability challenges

The Australian Prudential Regulatory Authority (APRA) has warned private health insurers (PHIs) to urgently address rising challenges that threaten the industry's financial sustainability.

As the prudential regulator, APRA is responsible for ensuring PHIs have the financial means to pay all legitimate claims from their policyholders.

In a letter to industry released today, APRA urged PHIs to swiftly develop robust, actionable strategies to address sustainability risks, as well as a recovery plan that outlines how they will respond if their strategy is not successful or other material risks threaten their solvency.

The directive follows the completion of an APRA review of PHI resilience that raised concerns about insurers' lack of preparedness to deal with growing risks, including declining affordability, a shrinking and ageing membership base, and changes in government policy.

The review found that while insurers were well aware of the risks, very few had credible strategies to mitigate their impact on sustainability. APRA observed a heavy reliance on lobbying politicians and other industry stakeholders due to a concerning assumption by many insurers that Government would provide solutions.

APRA Executive Board Member Geoff Summerhayes said insurers must be far more proactive in developing plans to boost their resilience.

"Despite APRA's work with industry to improve governance and risk management capability over recent years, it is frustrating to see little evidence that insurers are taking actions that reflect their own assessment of the heightened risks in this challenging environment," Mr Summerhayes said.

"APRA recognises the industry has been under duress for some time, and the main factors, such as rising demand for health services and the soaring cost of treatments, are beyond insurers' direct control. But that's not an excuse for doing nothing and hoping the Government will fix everything."

The letter provides examples of better industry practice that can enhance sustainability, including by providing greater value for younger and healthier policyholders, putting more focus on preventative treatments and facilitating alternative models of care.

Recognising the scale of the sustainability challenge, Mr Summerhayes said APRA also expected PHIs to develop a "Plan B", including consideration of potential mergers or restructures, should their primary strategy prove ineffective.

"APRA has no immediate concerns for the financial viability of any PHI, but the coming challenges are likely to significantly threaten the business models of a number of insurers. On that basis, APRA expects every insurer to develop a recovery plan for how it would respond if its sustainability came under acute threat," he said.

"Our message to private health insurers is simple: they must step-up and implement robust strategies to deal with these challenges. Insurers that continue to take a passive approach can expect more assertive action from APRA via entity-specific supervisory action."

APRA has been raising concerns about the sustainability challenges facing PHIs for several years, and has focused on lifting industry resilience through its PHI Roadmap. APRA is currently reviewing PHI capital requirements, after previously working to lift standards of risk management and governance.

A copy of the letter is available on the APRA website here.