Individual Disability Income Insurance Sustainability Guide

December 2022 Version

IDII

Disability Insurance Taskforce of the Actuaries Institute

Actuaries Institute

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About the authors

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Acknowledgement of country

The Actuaries Institute acknowledges the traditional custodians of the lands and waters where we live and work, travel and trade. We pay our respect to the members of those communities, Elders past and present, and recognise and celebrate their continuing custodianship and culture.

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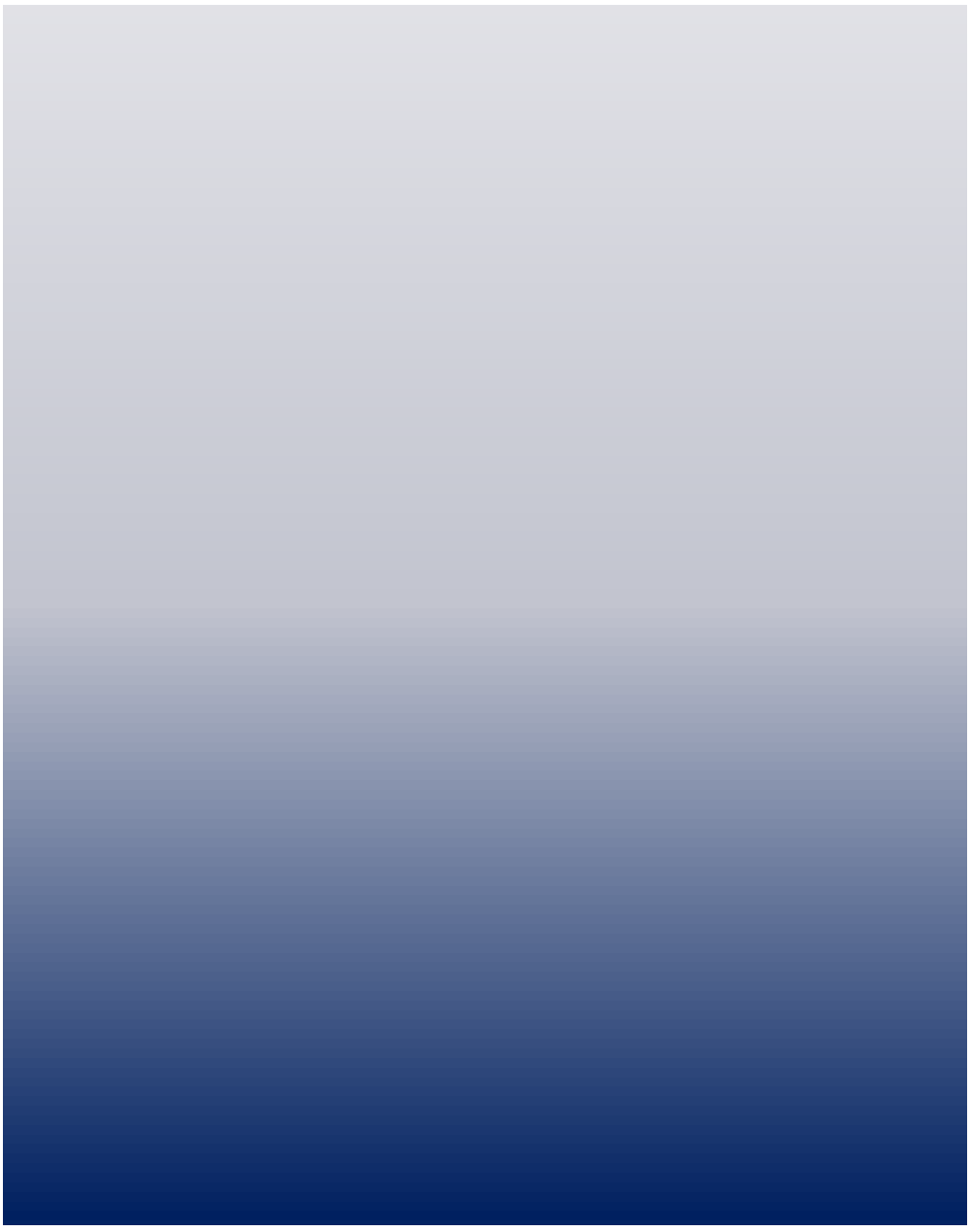
The Actuaries Institute is the peak professional body for Actuaries in Australia. The Institute provides expert comment on public policy issues where there is uncertainty of future financial outcomes. Actuaries have a reputation for a high level of technical financial expertise and integrity. They apply their risk management expertise to allocate capital efficiently, identify and mitigate emerging risks and to help maintain system integrity across multiple segments of the financial and other sectors. This unrivalled expertise enables the profession to comment on a wide range of issues including life insurance, health insurance, general insurance, climate change, retirement income policy, enterprise risk and prudential regulation, finance and investment and health financing.

Contents

1 Purpose

This Sustainability Guide (Guide) has been developed by the Actuaries Institute Disability Insurance Taskforce (the Taskforce) to **support actuaries in their various professional roles**, other insurance professionals, boards, management, regulators, and other interested parties, with the aim of creating or enhancing practices to promote sustainability in the retail Individual Disability Income Insurance (IDII) market, in line with APRA's expectations and sustainability measures. The range of professional roles in which actuaries work includes in pricing and valuation teams, as Appointed Actuaries, in risk management functions, as executive leaders and board members. This Guide is intended to help actuaries and any other readers to consider critical aspects of product design, operational practices, pricing uncertainty, risk management and risk appetite. It provides clarity about important practices that may lead to poor sustainability. Actuaries and other readers should consider using this Guide to help continually improve their frameworks, policies and day to day practices to mitigate risks and improve long term IDII sustainability for consumers and insurers.



2 Introduction

2.1 Background and context

Notes:

- Actuaries work in a wide range of roles in life insurers, including in pricing and valuation teams, as Appointed Actuaries, in risk management functions, as executive leaders and board members. This Guide is intended to assist them in those various professional roles.
- A reference to "insurer" in this Guide is to an individual insurer, not to insurers collectively or to the insurance industry more generally, unless implied by the context. It is not anticipated that details of decisions taken by an insurer based on their application of this Guide would be made public but would remain confidential within an insurer. However, feedback to an insurer on industry good practice in the use of the Guide may be provided by APRA.

Insurers face a number of conflicting commercial realities that over decades have resulted in poor outcomes for both IDII customers and insurers. IDII products are complex and insurers have poorly understood the uncertainty[1] inherent in IDII products that has led to unexpected increases in claims cost. Consequently, the products have proven to be under-priced and have led to substantial industry losses. Consumers have benefited through cheap premiums but have also seen detriment arising from:

i. liberal benefits and poor risk management resulting in all customers paying higher premiums than necessary to the benefit of a minority of claimants who receive benefits in excess of their insurable interest[2] and/or who avoid minimising the insured loss[3];

ii. ongoing underestimation by insurers of the potential variability of experience and the resulting unexpected premium rate increases for customers; and

iii. in response to increasing premiums, customers with relatively low risk of claims cancelling their insurance, with the consequence of further price increases for the remaining customers.

In this document, the words *sustainable* and *sustainability* should be read in the following context.

- Products that perform as expected by customers, with features that, compared with the past:
  - better meet their needs without frills, and reflect their insurable interests – both on policy inception and subsequently, and at individual and community levels; and
  - provide more certain outcomes and are more readily understood.
- Prices for customers that are more stable and predictable over time, better understood and more consistent with underlying risk, compared with the present situation;
- Product features and underwriting that a) promote alignment between customer and insurer through appropriate consideration of each customer's insurable interests, and b) support loss minimisation at time of claim;
- Financial outcomes for insurers that ensure a sustained ability to pay claims and that are sufficient to ensure insurers will continue to compete and provide valuable IDII products to the market; and
- Community confidence as to the enduring value and fairness of disability insurance.

1 For the purpose of this Guide 'uncertainty' is intended to include a range of factors outlined in Section 4.4.

2 'Insurable interest exists when an insured person derives a financial or other kind of benefit from the continuous existence, without repairment or damage, of the insured object (or in the case of a person, their continued survival)' source Macmillan Dictionary. In this case, the insured object is future income

3 An important principle of insurance is that the insured must act to minimise the loss once the insured event occurs – commonly, 'loss minimisation'

2.2 Response

This Guide recommends that each insurer should have a documented approach to sustainability and proposes that each insurer develop their own:

i. governance framework to improve governance over decision making (including the adoption of a Target State);

ii. benchmarks for product features and operational practices to assist management and the Board understand and discuss aspects of their business that may increase uncertainty and reduce sustainability; and

iii. measurement and monitoring framework to measure and monitor over time an insurer's sustainability by reference to the developed benchmark product features and operational practices (including a model for an internal and self-assessed sustainability score). The measurement and monitoring framework would include a Target State for the insurer.

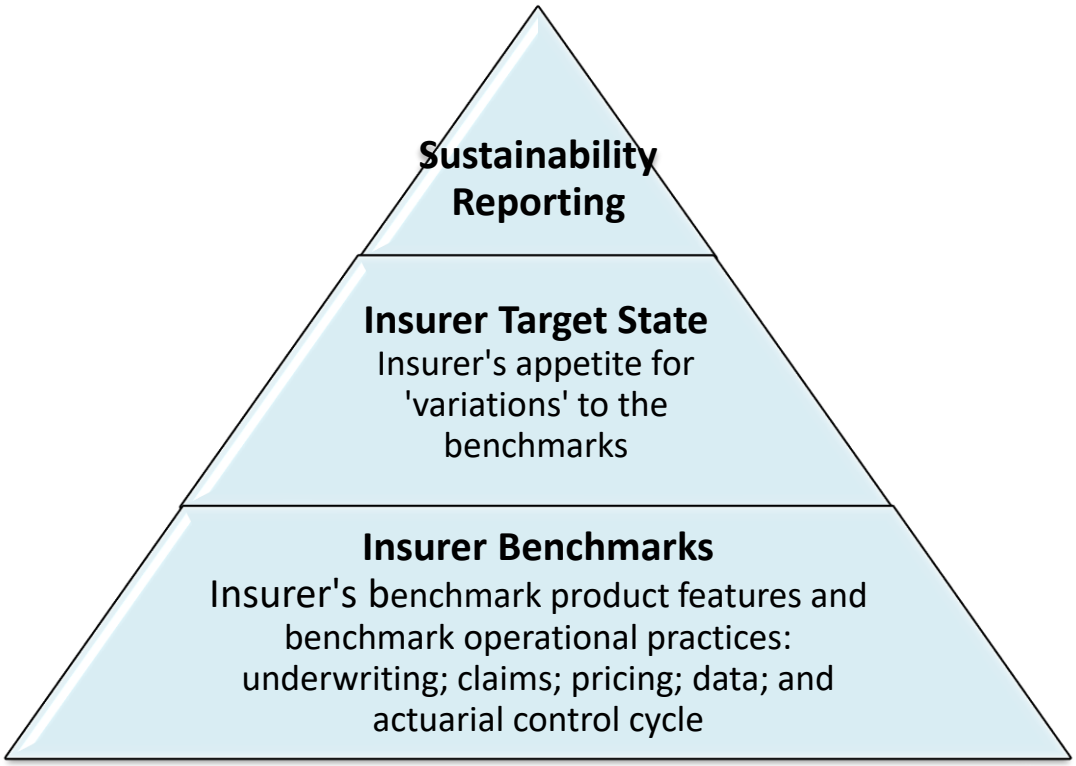
2.3 Philosophy and content

This Guide addresses the most critical practices thought to promote sustainability of IDII business for the industry. It complements, but is no substitute for, an insurer's team of insurance practitioners applying best practice in the context of their own circumstances and risk appetite. As such, it outlines principles insurers could consider in setting benchmark product and operational practices to support sustainable outcomes. It is envisaged that insurers will adopt their own practices and set a Target State (see Section 3) within this framework.

This Guide has been prepared in the context of sustainability for on sale (new business) retail advised products. The approach taken in this Guide is intended to be usable for other distribution channels, product lines and insurers' in-force portfolios.

2.4 Executive summary: elements and processes in this Guide

Framework Elements



Proposed steps for an insurer:

1 Set the insurer's benchmark product features and benchmark operational practices.

2 Assess the insurer's level of IDII uncertainty relative to the benchmarks.

3 Determine product features and operational practices to adopt in the insurer's Target State and their relationship to the benchmarks.

4 Obtain Board approval of the insurer's Target State (being the variations to the insurer's benchmark product features and operational practices).

5 Identify and evaluate variations to the benchmarks for their impact on claims cost arising from uncertainty.

6 Monitor and report on variations to the benchmarks and their sustainability.

7 Reduce uncertainty with improvements to data collection, analysis and research and application of the control cycle.

2.5 Potential wider applications

Users of this Guide could consider its wider application to other benefit types such as Death, Total and Permanent Disability (TPD) and Critical Illness. Appropriate adjustments would be required to allow for the specific features and management practices applicable to each benefit type. This could enable the framework in this Guide to be applied to an insurer's whole portfolio.

Additional observations:

- if an insurer were to develop benchmark product features for TPD, for example, then it may be possible to consider the overall sustainability of combinations of lump sum and income disability benefits; and
- a reinsurer could adapt the frameworks suggested in this Guide to monitor its portfolio of IDII products and its assessment of the capabilities of cedants.

2.6 Updating this Guide

It is intended that this Guide be reviewed from time to time to reflect learnings from its application.

3 Governance and Target State

Insurer governance structures and reporting should enable development, maintenance and continual improvement of sustainable product features and operational practices over the long term.

The following elements for the insurer's governance structures and reporting could be considered:

i. oversight by the Board of development of the insurer's benchmark product features and benchmark operational practices (see below);

ii. approval by the Board of a clear Target State linked to risk appetite and delegations to management;

iii. review by the Board of product performance, product changes and operational performance by senior management to drive sustainability improvements; and

iv. Board approval and monitoring of sustainability, including the insurer's sustainability scores (as explained in Section 5.4.)

3.1 Benchmarks and Target State

To assist the insurer in setting its benchmarks and Target State, this Guide suggests that the insurer determines a set of individual Insurability Principles relevant for that insurer. Such principles ideally would be durable in the context of medical advances and community expectations. An example of a set of such principles is as follows:

Insurability Principles - example

- The event giving rise to a claim is objectively identifiable, definable and measurable. The event should also occur by chance - that is, it should be beyond the control of the beneficiaries.
- The customer's net financial loss on the occurrence of the event is measurable and definable.
- The insured benefit payment does not exceed the net financial loss suffered, after allowing for other sources of financial compensation and/or support.
- Benefits do not provide disincentives to return to work, either initially or over time. A customer is not financially better off while on claim. This helps provide an incentive for customers to return to work where reasonable and for the cover to support those in need.

This Guide suggests that the insurer consider establishing the following:

- a benchmark set of product features (see Section 4) and
- benchmark operational practices (including underwriting, pricing and claims, use and quality of data, and use of the control cycle) that when taken as a whole provide a robust foundation for assessing and managing sustainability (see Section 4).

Note: These benchmarks would be a yardstick against which the insurer can assess its individual riskiness/sustainability of the various product features of the IDII products that it takes to market, and of the supporting operational practices.

These **insurer benchmarks** would provide an anchor for the insurer in assessing their

risks to sustainability and **would likely be conservative positions based on good practice**. They would not be expected to change over time, to ensure a durable measure of sustainability for the insurer's Target State and for the insurer's actual products and practices.

The parameters for the benchmarks would be defined by the insurer – for example, the insurer's benchmark product features could aim to:

- meet the fundamental needs of a customer who wants financial protection against significant loss of income as a result of disability, pending return to work, and hence the product would be quite marketable;
- be reasonably conservative and consistent with the insurer's chosen insurance principles, and hence the product would be quite sustainable.

- For each benchmark, the insurer could identify a range of possible positions the insurer could adopt in practice, together with a spectrum of the associated riskiness/sustainability of various positions.
- The insurer could then set its Target State by defining acceptable 'variations' from the benchmarks (see Section 5).

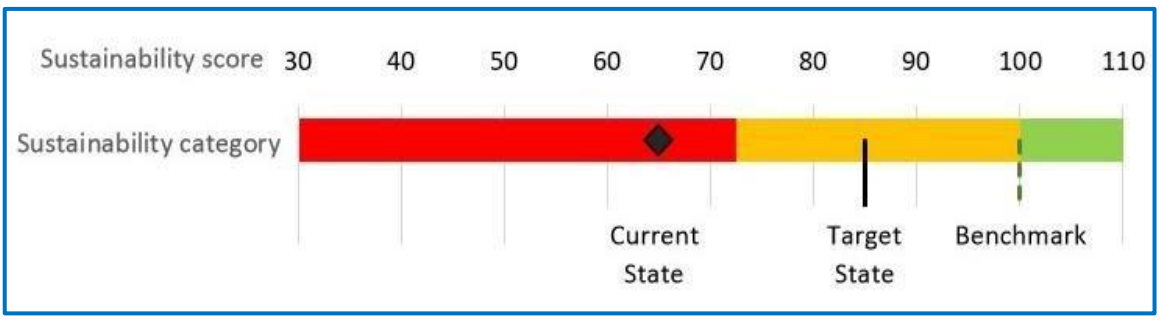
  The insurer's **Target State** would set the insurer's desired position for each of the benchmark product features and operational practices, **according to the insurer's risk appetite, strategy, market conditions, the state of the insurer's portfolio, their desired profitability and sales volumes etc.**

  The insurer's Target State may therefore change over time, as strategy and conditions evolve or the insurer revises its risk appetite, for example.

  The actual marketed product and operational practices, may well differ from the Target State (and the benchmark product features and operational practices), because of, for example, the market conditions, time to develop new products, constraints on practices because of systems etc.

- For each identified variation, the insurer defines whether its risk appetite is such that: (i) the variation is 'to be eliminated', (ii) the variation has a target impact rating of 'Low/Medium/High' or (iii) there is a target level of 'premium exposure %' to the risk involved in the variation (see Section 5).

Conceptually, the insurer would make an assessment along the following lines for *each* major product feature and *each* significant operational practice, with the Red-Amber-Green (RAG) colours indicating the degree of riskiness/sustainability:



Note: The RAG status for sustainability for consideration in this Guide should not be confused with the insurer's RAG status against its risk appetite. For example, while the Target State for sustainability may be in the amber zone, it would likely be in the green zone for risk appetite purposes (given that the insurer has indicated the Target State as an acceptable position).

Under the insurer's governance framework, this Guide suggests that the Board consider approving their own benchmarks and Target State and in doing so it could consider:

- the detail of all high impact variations from the benchmarks, including any

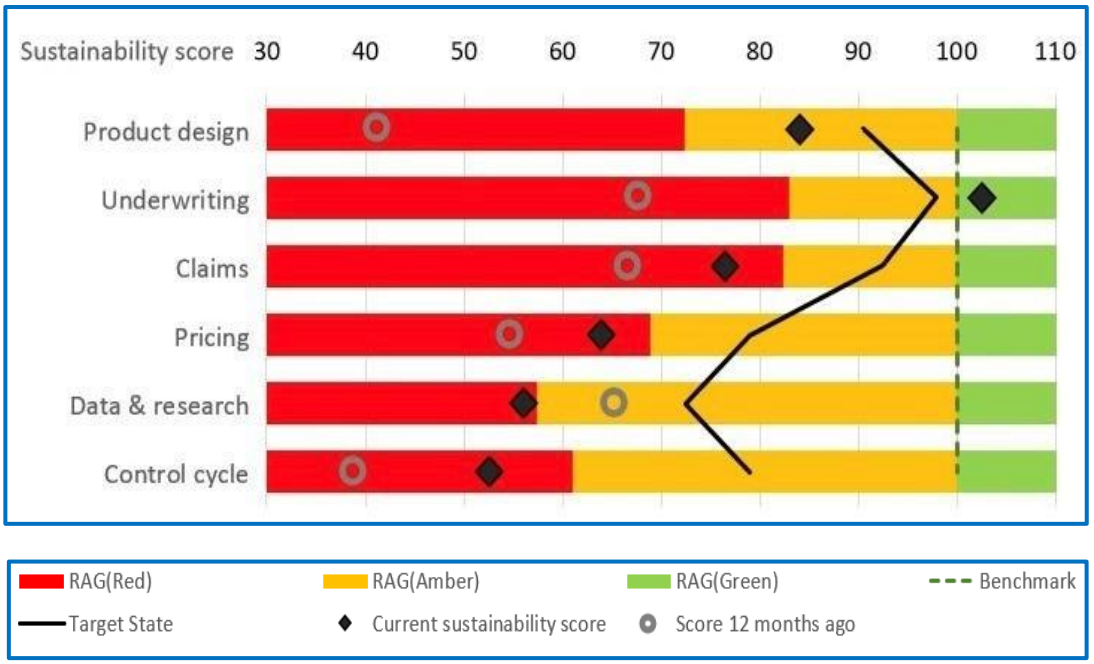
mitigants adopted;

- the number of medium impact variations and the themes justifying those variations;
- how the insurer's pricing philosophy supports sustainable and equitable outcomes (see Section 4.4.2); and
- the consistency of claims practices with SPG250, LPG240 and the Life Insurance Code of Practice (LICOP) (see Section 4.3).

The insurer's risk appetite statement would be updated to reflect the benchmarks and Target State, and delegations to management would ensure that future product and operational practice changes that are material to sustainability are considered by the Board.

3.2 Monitoring by the Board / Sustainability Heatmap

This Guide proposes that the Board monitor the insurer's sustainability scores (see Section 5.4) including how these may change over several years to avoid unintended accumulation of uncertainty. For example, the dashboard for an insurer with a Target State sustainability score averaging 85 relative to the benchmark score of 100 could look like the following.



The example dashboard above shows a consolidated rating for each of product design, underwriting, claims etc. More granular ratings would underpin these ratings. Section 4 provides more detail of the matters that could underpin each of product design, underwriting etc.

The metrics could be forward looking for on-sale products. Multiple dashboards could be presented separately for each major product series. The ongoing effectiveness of mitigants could be monitored and incorporated in the low/medium/high rating within the impact scores. At least annually the Board could review a summary of management's sustainability analysis (see Section 3.3).

Although not the focus of this Guide, the insurer may also develop a separate dashboard to monitor sustainability of the in-force portfolio. For example, a single weighted average dashboard could be developed for historic product series (weighted by premiums for example).

3.3 Product governance and sustainability monitoring

This Guide proposes an insurer update its governance framework(s) to cover sustainability of the product which, for example, could involve the insurer:

i. Receiving and considering CPS320 specific advice to the insurer as well as specific advice from senior representatives from the product, underwriting and claims teams on sustainability and in respect of all significant product and operational practice changes;

ii. making decisions about changes to products and processes when the above advice raises concerns in relation to long-term sustainability;

iii. ensuring that the Appointed Actuary and Chief Risk Officer are provided with the appropriate information, have the opportunity to challenge assessments prior to approval and escalate to the Board where necessary;

iv. monitoring and understanding sustainability issues detailed in the Annual Sustainability Assessment (see Section 4.6);

v. periodically reviewing variations to the benchmark, mitigants, resourcing to support mitigants and the Target State itself;

vi. reporting to the Board on management's sustainability analysis and effectiveness of the sustainability framework; and

vii. considering the ongoing appropriateness of historical product designs and transition of customers to on sale products.

4 Benchmark and Target State product and practices

This Section details what the Taskforce considers to be the main elements of what could comprise an insurer's benchmark product features and benchmark operational practices. These elements are not intended to cover every possible aspect of an insurer's product and organisation. The focus is on what the Taskforce considers to be the most material outcomes that are expected to lead to a relatively sustainable industry. The insurer in developing its benchmarks may include all or some of the below (as well as other matters that they consider relevant). In developing an insurer's own approach to sustainability, it is envisaged that the rationale for any variations to their benchmarks are discussed, documented and agreed to by the Board (see Section 5).

The Taskforce suggests that an insurer give consideration to benchmark operational practices that aim to deliver on the principles of insurable interest and customer loss minimisation[4].

4.1 Product design considerations

There are multiple aspects of IDII product design that can have a significant impact on sustainability. They include, and are not limited to:

- income replacement ratio
- total disablement definition
- partial disablement definition
- eligibility for and level of partial disablement benefits
- coverage of superannuation contributions
- length of benefit periods and age at which benefits cease
- premium rate guarantees
- customer obligations to comply with reasonable requests
- long contract durations with fixed terms
- exclusions
- tax treatment
- benefit indexation
- waiting periods
- allowance for offsets

[4] See, for example, https://www.taxdose.com/principle-of-loss-minimization/

- ancillary benefits, and
- treatment of unemployment.

Product complexity and ease of understanding for customers are also important considerations for sustainability.

Certain combinations of benefits, or of benefits and operational practices (as set out below), may compound the risk to sustainability. Other combinations may act as mitigants to the risk to sustainability. It is important therefore that the insurer assesses its particular combinations against the insurer's risk appetite.

The following sections expand on some of these points that are central to sustainability. They are suggested principles (and elaborations) that an insurer may consider when developing and deciding on the insurer's benchmark product features and operational practices.

4.1.1 Income definition and replacement ratio incentivise return to work / wellness

Consider whether the combination of income definition and replacement ratio (including offsets and ancillary benefits) seeks to ensure that the product covers an insurable interest of the customer and incentivises return to work / wellness. A particular consideration in this respect is indemnity versus agreed value benefits.

It is noted that APRA's expectation[5] is that the benefit be of an indemnity nature.

4.1.2 Eligibility for benefits is clear and supports the customer when they are unable to work

Consider whether the total disability definition is clear and seeks to provide support for the customer where there is a significant incapacity to work.

Consider also whether partial disability benefits seek to promote return to work and not encourage remaining on claim.

Consider whether waiting periods may be a factor also.

4.1.3 The occupation definitions, replacement ratios and benefit periods encourage the customer to minimise the insured loss

Consider whether claimants are aligned with the insurer on the insurance principle of loss minimisation. For example, the replacement ratio could be higher in the early stages of the disability when lifestyle changes cannot be readily made by the claimant. Another possibility is that occupation definition moves from own occupation to an education, training or experience (ETE) definition at a longer-term point in time.

Consider the effectiveness of controls in place to manage the risks associated with long benefit periods, as required by APRA[6]. Consider how the totality of the product design impacts long duration claims – through initial disablement definitions, any changes in these by claim duration, alterations in replacement ratios, effectiveness of rehabilitation and return to work programs, together with claims management practices for long duration claims. Consider the lower level of data available for these durations, the impact of earlier intervention upon the experience of remaining claim cohorts, the psychological impacts of long-term disability, and increased difficulties with return to work for those not in employment for extended periods.

In summary, consider assessing the full range of features and controls that impact long benefit periods to ensure that, as a group, they remain within the insurer's risk appetite.

5 APRA letter of 30 September 2020

6 APRA letter of 30 September 2020

4.1.4 Product terms and conditions keep up with environmental changes

Consider whether the insurer might retain rights to alter substantive terms and conditions at least every five or ten years (as examples) to ensure that changes in environmental and other factors can be reflected in product design. Factors may include social inflation (e.g. societal expectations, attitude to mental health, lawyer involvement), regulatory change, medical advances, change in the structure of the economy (e.g. casualisation of the workforce) and shifting economic conditions (e.g. high to low inflation environment).

It is noted that including such rights for the insurer may be challenging under the current legislative framework but it is a material risk management feature worthy of careful consideration.

If implemented, then consider whether the right to change product terms might be used instead to experiment with unsustainable terms that are likely to be subsequently withdrawn.

4.1.5 Products communicated to promote alignment between insurer and customers

Consider whether under the marketed product customer expectations of the product are aligned with those of the insurer, so as to better support the long-term expectations and needs of the community.

In this respect, the insurer may consider the extent to which its operational practices:

- Describe the product using language that is understandable by customers. Examples of poor use of language are: (i) calling the product 'income protection' when the insurer expects return to work to be a key focus, (ii) complex disability definitions that make it difficult for customers to understand when and what they can claim and (iii) use of the term 'level premium' may be inferred by customers to mean that the dollar premiums will always remain unchanged.
- Clearly and regularly communicate the uncertainty and claims experience variations of the product so that customers are less surprised by premium rate increases. In support of this, the insurer might provide key elements of its pricing philosophy (see 4.4.2) to rating houses for inclusion in their product ratings.
- Support publication by the industry of claims statistics on components of benefits such as key types of disability definitions, claims causes and ancillary benefits.

4.2 Underwriting practices

Under good practice, sound product design needs supporting underwriting and claims practices to promote sustainable outcomes, including return to work where appropriate. Under good practice, underwriting and claims practices would combine with product design to:

- limit claims to the insurable interest of the customer; and
- operate to encourage the consumer to return to health and minimise loss of their income.

4.2.1 Financial underwriting ensures that benefits do not exceed insurable interests and promotes loss minimisation

Consider whether under the proposed benchmark operational practices the combined value of the customer's unaffected business income, passive income, lump sum living benefits and disability income benefits incentivise return to work. Benefit periods that are too long may encourage the use of an insurance claim as an early retirement strategy, for example.

Note: Good practice suggests that the various types of income are clearly defined so that benefit amounts are properly understood and achieve the intended outcomes. Two possible examples are:

> **Passive Income** is income that is not income earned from working or from the conduct of a business. Passive income includes income such as interest, dividend or rent, other investment income or capital gains, ongoing contractual royalties or annuities, or other similar recurrent income.
>
> **Unaffected Business Income** is the insured's share of the net income (revenue less expenses) which they receive or are entitled to receive from current or former business activities, including related business entities, that can be maintained irrespective of disability (e.g. net business income earned above the cost of a locum to replace the insured's product or service delivery role in their business).

4.2.2 Insured events updated to keep up with the customer's changing circumstances

Consider whether the customer ought to be asked annually to confirm their financial information details to ensure that cover continues to be consistent with their insurable interest and they are charged the correct premium. This could also help ensure customer and insurer expectations are consistent. For example, this information might include the customer's occupation, pastimes and income level.

4.3 Claims practices

Under good practice, the insurer would ensure that its claims practices cover matters identified in SPG250, LPG240 and LICOP (and any other relevant regulation or guidance). Documentation would seek to highlight how these claims practices support the product's design, intended customer experience and approach to pricing.

4.3.1 Claims team has the capacity and skills to assess the claims definitions

Consider whether the claims team has sufficient skills and experience with adequate capacity to assess claimants against the disability definitions.

Consider whether claims assessors retain ownership of the decision regarding payment of a claim

Consider also whether they ought to (i) request only factual medical information from GPs and (ii) use assessments from occupational physicians, occupational therapists and other specialist practitioners in assessing function and capacity to work.

4.3.2 Claims team actively plans, encourages and implements return to work / wellness with claimants

Consider whether during the first period of claims payments (say 18 months) the claimant receives regular communication on return to wellness / work expectations (for example, every six weeks) following acceptance of the claim.

Consider whether communication includes the agreed recovery management plan (where appropriate) and future changes in benefits under the product terms and conditions.

4.4 Pricing for uncertainty

Uncertainty is particularly high in IDII products because of product optionality[7] and other factors including:

- in a rapidly changing environment, historic data may be inadequate to estimate the future claims cost;
- limited understanding of customer behaviour and social factors impacting on claims cost; and
- the high potential for social inflation / environmental changes / black swan events to increase costs (including social, medical, economic and regulatory factors).

Consider whether the insurer proactively seeks to understand and reduce uncertainty through product terms and underwriting and claims practices.

Consider whether the uncertainty associated with IDII is acknowledged and understood in management and at the board level.

Consider whether there is a tendency to default to being optimistic about (i.e. underestimate) the cost of uncertainty.

Consider whether pricing assumptions / margins allow for the cost of that optimism.[8]

4.4.1 Pricing assumptions put a cost on uncertainty

Good practice suggests insurers would set a period for which pricing assumptions would consider uncertainty - for example, over at least the first five years from inception of policies.

The insurer could make clear its intention in this respect – for example, that it is more likely than not that allowing for uncertainty over this period: (i) the premium rate schedule will remain unchanged and (ii) the insurer will meet its minimum profit metrics[9]. (This does not imply that premium rates should be guaranteed.)

Consider whether such a requirement might be implemented and how compliance would be monitored.

Consider whether uncertainty would be allowed for explicitly in best estimate assumptions or separately in risk margins.

Consider whether in setting best estimate assumptions the starting point might be the industry table and a credibility approach used to overlay the insurer's own historic experience (and/or alternate rating factors).

In recognition that assumptions are typically built up from historic experience, a number of additional factors might be considered in respect of the allowance for uncertainty in best estimate assumptions or risk margins. Product optionality is one factor where the option cost and/or interaction with future environmental factors may increase cost above what has historically been observed. If there is reasonable empirical data or research to explain why suspected uncertainty will not have a cost, then the cost of that uncertainty might be reduced. Equally, evidence may indicate that a cost for uncertainty is required in best estimate assumptions. Section 4.5 gives examples of benchmark operational practices that could reduce uncertainty over time.

[7] Product optionality means the extent to which definitions permit flexibility in behaviour and includes: multi-tier total disability definitions, partial disability benefit and other features that may result in the customer valuing benefits differently under various future lifestyle, economic and environmental conditions

[8] See Information Note: Analysing Disability Income Experience and Setting Best Estimate Assumptions

[9] It is up to the insurer to determine the methodology and metric(s) that it wishes to use to assess profitability and profit margins (i.e. this Guide neither defines a technical approach nor whether uncertainty should be included).

Other uncertainty factors that might be considered include:

i. continuation of adverse historic trends in experience (unless credibly explained as one-off by factors such as changes in the insurer's operations, social inflation / community attitudes, regulatory expectations or industry and legal practices);

ii. mis-estimation of the mean by assuming that the insurer's own favourable and credible experience compared with the industry will persist into the future. For example, the total claims cost arising from combinations of best estimate assumptions that are more favourable than the lesser of (i) the insurer's credibility weighted experience and (ii) the industry experience may not be sustainable;

iii. to the extent not reflected in the underlying experience, the average cost of cyclical effects such as the impact of the economic cycle; in particular unemployment and underemployment;

iv. potential optimism in duration-based termination assumptions because: (i) the insurer assumes that credible insurer experience at short durations implies credible experience at longer durations or (ii) the shape of the industry table has been altered without evidence that there is not an unaccounted for opposite effect at another duration; and

v. any expectations that customers would reasonably have.

It is recognised that it may take insurers some time to better understand uncertainty and reduce the cost of uncertainty in pricing.

4.4.2 The pricing philosophy addresses key questions of equity

Consider how well the pricing philosophy articulates how the insurer proposes to address factors that impact on the product's cost over time. These factors could include how the insurer:

i. addresses cross subsidies between the early policy years and later periods so that pricing allows for factors including the spread of acquisition costs and known policy duration effects on claims costs;

ii. deals with profitability issues that may arise from uncertainty crystallising and impacting on the disabled lives reserve;

iii. allows for uncertainty in its pricing including the operational practices detailed in Section 4.4.1 and how pricing of uncertainty differs between short and long duration benefits;

iv. exercises its repricing rights if uncertainty crystallises and in particular how it proposes to balance: (i) allowance for uncertainty in upfront pricing, (ii) frictional costs that customers may face if prices increase and (iii) how it will manage its profit metrics; and

v. ensures that pricing for each individual product line[10] is not loss making at least on a marginal cost basis.

4.5 Data, experience investigations and research

To reduce uncertainty and understand risk, it is good practice for an insurer to collect data, analyse that data and collaborate on industry research. This is particularly important for IDII, given its inherent complexity.

[10] Product lines includes the separation of income protection and lump sum benefits

4.5.1 Data is collected to cost all benefits, options and key drivers of claims cost

Consider whether adequate data is collected so that a granular understanding of the product's cost is available. This may include consideration of the following:

- demographic information that is relevant to pricing;
- all the choices made by the customer when purchasing a policy, including features that do not attract a separate premium. This includes changes made by the customer after purchase or exercising options (such as buy-backs);
- the version of the product, underwriting practices and claims practices relevant to the experience on individual policies and claims associated with that version tracked over time; and
- factors relevant to customer behaviour at and during claim recorded over time, including the replacement ratio and any secondary claim cause.

Consider whether the data is analysed to provide empirical evidence for product features and processes that positively or negatively affect sustainability.

Consider whether data is collected in accordance with any appropriate benchmark data specification published from time to time (e.g. by APRA or industry bodies).

4.5.2 Data shared to facilitate industry research topics nominated by the Actuaries Institute

It is good practice for good quality research to be published as this will promote sustainability of the IDII product. Insurers with inadequate data and/or insights may make poor decisions that in a competitive market can impact all participants.

Subject to appropriate data privacy measures that protect customer and insurer anonymity, an insurer could consider contribution of data for publication and research by credible third parties - in particular, data to support research into topics selected by the Actuaries Institute as high priority (having consulted with relevant groups and authorities, including for example the FSC and APRA).

4.6 Annual Sustainability Assessment / actuarial control cycle

Consider whether there is a process to regularly bring together the pricing, reserving, experience and analytics, claims, underwriting and product teams to analyse, explain and agree actions to improve sustainability.

Consider whether the sustainability assessment addresses the following items at a minimum:

i. analysis of granular experience study results compared with the latest industry study results and pricing assumptions;

ii. any trends and variations in experience and how these may link to uncertainty identified in previous CPS320 advices;

iii. experience variations in the insurer's profit and loss including detailed movement analysis of the disabled lives reserve compared with assumptions;

iv. analysis of experience against items in the variations register (see Section 5.3), considering any root cause issues in the insurer's Target State;

v. the outcome of claims case file reviews targeted at assessing the sustainability of product design, underwriting and claims practices;

vi. a review of actual claims practices for effectiveness at achieving the outcomes for product design, customer experience and pricing as described in Section 4.3; and

vii. actions to improve IDII sustainability.

5 Measurement of variations to the benchmarks and Target State

As noted in Section 3, the insurer's actual marketed product and operating model at any time may be different to the insurer's Target State and also to its benchmark product features and operational practices; i.e. there will be 'variations'. Some variations will reduce sustainability and other mitigants will improve sustainability.

Consider whether these variations are evaluated for sustainability under potential future scenarios (i.e. neither best estimates nor weighted by likelihood).

Consider also whether the cumulative effect of variations is tracked over time.

5.1 Identification of variations

Variations may be a difference to benchmark product features and operational practices or may be an 'add-on' that may alter the claims cost of the product. Whether variations might be split or aggregated may be subjective.

Consider whether:

- a single variation would typically be associated with something that would be defined or described separately in the PDS to other product features;
- some variations may interact with each other and might be treated as separate variations; e.g. the earnings definition and the maximum replacement ratio; and
- some variations or a group of variations may be a partial mitigant to the likelihood or consequence of adverse claims experience. The mitigant might be recorded separately (and its link to the risks explained); e.g. reducing the replacement ratio in calculation of sums insured exceeding $X maximum.

5.2 Impact rating of variations

Consider whether each variation has a low, medium or high impact on claims cost, assuming that uncertainty is realised. The aim would be to assess the approximate relative (rather than absolute) importance of each variation to the benchmark and Target State. Consideration may also be given to:

- whether the approach to assessing the impact of adverse variations and favourable variations / mitigants is the same;
- the benchmark or Target State may have mitigants that in the insurer's business are absent or ineffective and those mitigants are treated as variations that reduce sustainability; and
- there are metrics to monitor the ongoing effectiveness of all medium and high impact mitigants.

Consider whether each variation is evaluated assuming that an uncertainty scenario emerges[11] over a medium term such as five years (and stabilises thereafter) from inception of new policies and its impact. This may be determined by considering the following:

- reviewing the examples in Appendix A of possible impact ratings;
- ignoring the likelihood of the change;
- representing a reasonable magnitude of claims cost from the uncertainty being realised relative to the benchmark. This would include consideration of one-off effects and changes in trends in respect of claims incidence and termination rates (including a dislocation between short and long duration rates);
- using professional judgement (rather than actuarial calculation) on the magnitude of impact; and
- not requiring historic statistical information to support the assessment.

This possible approach is intended to be relatively easy to implement and to facilitate discussion within the insurer on the most important sustainability issues.

5.3 Variations register

This Guide suggests consideration be given to each variation to the benchmarks which is then documented in a 'variations register'. The table below provides an example of what may appear in the variations register.

Variation	Description	Type	Category	Rating (L/M/H)	Premium exposed to variation	Target State rating
Name of the variation	Brief description of the variation and what sustainability risk it could introduce / mitigate	• Risk • Mitigant	• Product • Underwriting • Claims • Pricing • Data & research • Control cycle	• Low • Medium • High	Approximate proportion of the portfolio exposed to this variation	• At target • To eliminate • Target level (L/M/H) • Premium exposure %

[11] See Section 4.4 for examples of uncertainty scenarios

It is also suggested that the variations register is summarised in a table that may be used to track variations to the Target State, as illustrated in the table below[12].

Category	RAG status	Target State Sustainability Score	Current State Sustainability score	Net number of adverse variations to Target State (numbers in brackets are from 12 months earlier)		
				#Low	#Medium	#High
Product design	**A**	90.5	84.0	13 (9)	0 (3)	0 (3)
Underwriting	**G**	98	102.5	1 (1)	1 (2)	-1 (2)
Claims	**R**	92.5	76.5	2 (2)	1 (1)	1 (2)
Pricing	**R**	79	64.0	0 (-1)	1 (1)	1 (2)
Data & research	**R**	72.5	56.0	3 (5)	1 (-1)	1 (1)
Control cycle	**R**	79	52.5	3 (1)	3 (4)	1 (2)

5.4 Sustainability scores

Under benchmark operational practice, a summary table such as that set out in Section 5.3 could contain a 'sustainability score' and RAG status for each category. The Current State sustainability score could be calculated using the net number of adverse variations compared with the benchmark – for example as: 100 - (0.5 x #Low + 5.0 x #Medium + 10.0 x #High). The Target State sustainability score could be calculated using the same method based only on variations for the Target State. The RAG rating could be based on the value of the Current State sustainability score (in accordance with a scale determined by the insurer and likely linked to the insurer's Target State sustainability score for each category).

Overall sustainability scores could then be calculated as the weighted average of the category sustainability scores – for example, using weights such as: 25% / 15% / 15% / 15% / 15% / 15% for each category respectively.

12 Variations rated 'at target' in their Target State rating would be excluded from the summary of number of variations and included in the sustainability scores

Appendix A

Example impact rating for variations

As mentioned in section 4.1, there are multiple aspects of IDII product design that can have a significant impact on sustainability. Section 4 also outlines a range of principles an insurer could consider in setting the insurer's benchmarks.

This appendix provides example impact ratings for various medium and high variations from the insurer's benchmarks. It is neither an exhaustive list nor are the ratings absolute, but are provided as examples for an insurer to consider when setting their own ratings. The ratings are designed to represent a magnitude of claims cost that may arise from uncertainty being realised: (i) relative to the insurer's product and operational practices benchmarks, (ii) relative to other factors being assessed by the insurer and (iii) using professional judgement. It is important that rating of the impact of the variations is consistent between variations. As such, the examples listed below provide the insurer with examples that may assist the insurer in assessing the impact of variations that are not listed.

The assessment is not intended to be 'all or nothing' and the extent of departure from the benchmark product features and operational practices is an important consideration. For example, an X% departure from benchmark income replacement ratio may be considered to have a High rating and a Y% variation a Low rating.

A.4.1 Product design

Variation	Description	Example Rating
Replacement ratios greater than insurer's benchmark product features	Consider the size of gap and length of the period of departure. A replacement ratio exceeding the benchmark by more than X% for a period greater than Y months could be a High rating.	High
Superannuation benefit paid as cash	Above benchmark replacement ratio arising from payment of the superannuation benefit as cash.	High
Benefit periods greater than to benchmark age	Benefit period beyond benchmark age without suitable mitigation would be considered High. Consider the length of benefit period in conjunction with other potential mitigating contract terms such as: • tapering of benefits beyond benchmark age; • benefit income offsets for retirement incomes; and • financial re-underwriting the benefit period every X years to ensure that there is an ongoing insurable interest for the longer benefit period and it continues to encourage loss minimisation.	High

Variation	Description	Example Rating
Broad total disability definition	The following examples may individually be regarded as having a High rating: • each additional tier of total disability definition; and • use of one duty definition rather than material duties or not using 'inability to perform work'.	High
Explicit guaranteed premium rates	Contract terms preventing the insurer from altering the premium rate schedule to reflect any unexpected changes.	High
Not required to comply with reasonable requests	Product terms do not include a stipulation that the customer is expected to comply with reasonable requests of their health professionals and/or the insurer under their recovery management plan.	Medium
Product terms are not updated every X years	Terms and conditions are not kept contemporary and consistent with community expectations at least every x years. If this feature is to be rated sustainable then other potentially detrimental consequences would need to be minimal (such as anti-selection risks from additional lapses at the X year point). Note: The X year contract term is a sustainability measure that becomes increasingly important as other product terms become increasingly liberal. For example, higher than benchmark replacement ratios, use of multi-tier disability definitions and absent X-year 'reset' mechanism would likely combine to increase the impact rating to High. Conversely, offering only short duration benefit periods may partly mitigate the absence of the reset mechanism. Equally, if the term of the reset mechanism were increased to X years (for example) then the impact rating may still be Medium but only in conjunction with other highly sustainable product terms.	Medium
Absence of standard exclusions	The product terms do not have the benchmark product exclusions	Medium
Unclear or inconsistent communication to customers	Absence of a mechanism to ensure continuous improvement of the PDS and other materials so that any gaps between consumer understanding and insurer intent of the product reduces over time.	Medium

The following groupings of product features may be considered to see whether there is a compounding effect that could require a single / collective impact rating for each group.

Variation	Description	Example Impact Rating for Group
No definition step down after a certain period	Absence of switch to ETE after a certain number of years on claim reduces the financial incentive to strive to return to work, where this might be medically reasonable.	Group 1 Medium
Partial benefits disincentivise return to work	Partial benefits do not cease at benchmark % capacity or hours per week (disincentivising return to work).	
Partial disability benefits are excessive	The extent to which the benefit amount exceeds the benchmark.	
Inadequate allowance for offsets	Benefits are not offset by sick leave, other insurance benefits, workers compensation or social security benefits (to the extent permitted by law).	Group 2 Medium
Tax is not deducted from benefits	Tax is neither deducted from benefits nor the ATO notified of benefit payments.	
Indexation results in over insurance	Sum insured indexation prior to claim results in higher replacement ratios (in the context of indemnity contracts).	
Waiting periods are misaligned	The waiting period terms have features that do not promote alignment between the insurer and consumer on return to wellness/work: • periods too short or too long; • income benefits payable during the waiting period; • more than X consecutive days of full-time work during the waiting period does not reset the waiting period; or • periods of work during the waiting period do not extend the waiting period.	Group 3 Medium
Over-insurance when not working	The total disability definition is not ETE after X months of unemployment or leave from work.	
No cover suspension for ceasing work	Insurance cover continues after X months of unemployment or leave from work.	
Generous ancillary benefits	Ancillary benefits are not limited to clear and significant additional costs in accordance with benchmark.	

A.4.2 Underwriting practices

Variation	Description	Example Rating
Inadequate underwriting resources	The underwriting team has inadequate capacity or breadth of experience and/or specialist skills to effectively underwriting in accordance with benchmark underwriting practices.	High
Inadequate non-medical underwriting	Non-medical underwriting does not allow for the combination of living benefits (lump sum TPD and trauma and income insurance) in evaluating the sum insured.	High
Non-medical underwriting not updated regularly	Financial, occupation and pastimes information is not confirmed regularly. Partial mitigants include a meaningful opt-in underwriting process and checks at time of claim.	Medium
Unaffected business income is allowable	Financial underwriting and/or product definitions do not exclude unaffected business income. Consider the extent that unaffected business income may influence the replacement ratio when determining the impact rating.	Medium
Passive income is allowable	Financial underwriting and/or product definitions do not exclude passive income. Consider the extent that passive income may influence the replacement ratio when determining the impact rating.	Medium
Generous treatment of atypical income	Financial underwriting and/or product definitions include 'atypical income' without limiting it to say 20% of regular income or without a reliable history of that atypical income.	Medium
Lack of established income history	Allowing sums insured based on income amount with limited history, and/or not considering employment history (and changes in employment, income, etc).	Medium
Narrow occupation definitions	Narrowly defined occupation definitions that enable claimants to opt to 'early retire' rather than change to a similar occupation.	Medium
No continuous improvement process	Underwriting manuals do not have a formal regular review process to consider: (i) emerging industry trends that may reduce sustainability and (ii) current environmental factors.	Medium

A.4.3 Claims practices

Variation	Description	Example Rating
Claims practices and resources subject to regular change	Frequent significant changes in claims practices and/or claims staff responsibilities.	High
Inadequate claims resources	There is insufficient claims resource to reliably service customers and meet benchmark practice.	High
Insufficiently skilled staff	Claims staff has inadequate skills to assess the claims and instead rely solely on GPs or other factors in their assessments.	High
Insurer 'delegates' claims decisions	The claims process relies on third parties to determine the eligibility of the life insured to claim.	High
Failure to set return to work or recovery plan	Claims managers do not set and communicate return to work expectations in accordance with benchmark product features and operational practices.	Medium
Failure to set or manage expectations	Claims managers do not manage the customer's expectations about: (i) any participation required to achieve a return to wellness / work, (ii) following the reasonable requests of health professional and (iii) how any future benefit amount or definition changes may impact on that plan.	Medium
Overly simplistic claims practices	Claims practices do not adequately incorporate biopsychosocial factors when triaging and managing claims	Medium
Inadequate investment in claims quality outcomes	Claims practices result in poor adherence to claims eligibility conditions and, in particular, where benefit payments may increase the replacement ratio above the intended amount in accordance with the product's design.	Medium
Ineffective claims practices	Claims practices related to SPG250, LPG240 and LICOP are: (i) not documented, (ii) not considered by the Board or (iii) assessed as ineffective (see Section4.3).	Medium

A.4.4 Pricing for uncertainty

Variation	Description	Example Rating
Pricing philosophy does not remove optimistic pricing	Any of the following apply: • the insurer does not have a documented approach to pricing for uncertainty; • the insurer's approach does not require optimism to be removed for at least X years (including the 'more likely than not' benchmark conditions in Section4.4.1); or • the insurer's approach does not state that adverse historic trends must be assumed to continue into the future (for at least X years) unless there is empirical rationale to the contrary.	High
Not using the latest industry tables for assumptions	Any of the following apply: • the insurer is using an industry table with a release date older than X months at the time assumptions are set; • assumptions are not using a recent industry table without a strong empirical reason not to do so; or • assumptions are not updated at least annually.	High
Inadequate shape in termination assumptions	The shape of duration based terminations assumptions is not empirically justified against the industry table or is biased towards optimism.	High
Overvaluing repricing rights	The approach to valuing repricing rights does not explicitly consider the insurer's pricing philosophy or other market constraints, or does not take into account practical limitations of executing a reprice (including timing and magnitude).	High
Profitability is short of target minimum requirements	Profit does not meet the insurer's target minimum requirements having fully allowed for uncertainty as part of the best estimate cost of the product.	High
Not applying credibility theory to assumption setting	Absence of a documented approach to credibility in assumption setting (or non-adherence to the process).	Medium
Cyclical effects inadequately priced	Cyclical effects are not fully allowed for in best estimate assumptions.	Medium
Inadequate communication of uncertainty	Unclear communication to the insurer's decision makers that uncertainty is a best estimate cost or risk margin (not profit margin) of the product and that to reduce uncertainty actions are required in product design, underwriting and claims.	Medium

A.4.5 Data, experience investigations and research

Variation	Description	Example Rating
Inadequate data collection	Claims and policy data meeting standards set by industry bodies or APRA are not collected.	High
Infrequent experience investigations	Detailed experience investigations against the appropriate industry table are not conducted at least annually.	High
Data not shared annually	Claims data is not shared with the industry experience studies program within the published timeframes.	High
Data at time of claim is not collected	Data related to income, self employed vs employed status and secondary claim cause features is not captured.	High
Data is not collected on claims processes	Data is not collected on the main claims practices applied to each claim and thus it is not possible to measure effectiveness and improve processes in future.	Medium
Data governance is inadequate	There is no documented data governance process that is regularly applied to ensure continuous improvement of data quality over time.	Medium
Data quality is inadequate	There is: (i) not a robust and repeatable process for ensuring quality data is produced on a timely basis or (ii) data routinely requires material manual fixes.	Medium
Published research is not promoted	The published research priorities of the Actuaries Institute are not actively supported by the insurer.	Medium

A.4.6 Annual Sustainability Assessment / actuarial control cycle

Variation	Description	Example Rating
No formal cross functional team forum	A cross functional team does not meet at least annually to formally consider emerging experience and agree actions to improve sustainability.	High
No sustainability reporting	No record is made of the findings of the cross functional team's analysis of the product's performance or the key findings are not syndicated to senior management and the Board where appropriate.	High
Limited actuarial control cycle	There is an incomplete actuarial control cycle linking experience investigations, assumption setting and financial results.	High
Inadequate governance practices and feedback	Insurance frameworks and policies (product, pricing, claims, underwriting, data) are not in place, not updated regularly or not subject to regular feedback loops based on experience.	High
Inadequate Board reporting on sustainability	The Board does not receive regular updates on sustainability in accordance with benchmark practice (see Section3.2).	Medium
No claims case file reviews	There is not a regular and 'right sized' claims case file review process to identify product and process improvements designed to improve sustainability.	Medium

Institute of Actuaries of Australia
ABN 69 000 423 656
Level 2, 50 Carrington Street,
Sydney NSW Australia 2000
t +61 (0) 2 9239 6100
actuaries@actuaries.asn.au
www.actuaries.asn.au