Impact of COVID-19 on PHI

Briefing to Actuaries advising Private Health Insurers in respect of impact of COVID-19

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Objective, Scope and Context

This pandemic briefing note is a draft. As events and views evolve during this pandemic, this note will be updated accordingly. The thoughts and views contained in this note are not final and have been provided to assist actuaries during this period of uncertainty.

Objective: The purpose of this note is to assist actuaries assess the impact of COVID-19 on Private Health Insurers (insurers) at 30 June 2020 accounts through:

- Exploring financial year end reporting issues
- Looking for pathways
- While NOT specifying actions that may be insurer specific

[Pandemic Briefing Notes are designed to assist and support members in considering how to deal with issues raised by COVID-19 and are not professional requirements]

Scope: This note focuses on the preparation of 30 June 2020 year end accounts. It is part of a three note series with other notes intended to cover:

- ***Context*** – the overall context and uncertainty facing private health insurers in this time of pandemic and economic disruption
- ***Financial Condition and Strategy*** - Financial Condition Reporting including issues when considering capital management and strategy resilience.

Background

COVID-19 has increased the level of uncertainty in the private health insurance environment. The use of historical data is less relevant and in some cases irrelevant to the development of key assumptions. Furthermore, the situation is subject to rapid change as information evolves, with some assumptions becoming obsolete quickly.

Even now as governments consider and allow the resumption of elective surgery, there remains significant uncertainty as to how policyholders, providers and government will respond as the health system navigates a way to servicing an accumulating backlog of surgeries and hospital admissions.

Key decision areas

The following table sets out key issue areas for the consideration of PHI actuaries:

Component	Issues
I. Accounts	
1. Outstanding claims (OSC) (a) Central estimate (b) Risk margin	• Assessing the appropriateness of past development patterns • Assessing the appropriateness of existing approach to estimating risk equalisation outstanding claims • Developing appropriate scenarios or sensitivity testing • Addressing increased uncertainty in the risk margin • Providing appropriate sensitivities and other disclosures
2. Unearned premium (UEP)	No change to earning pattern is currently anticipated.

3. Liability Adequacy Test – Is the UEP adequate? [LAT]
(a) Contributions in advance
(b) Constructive obligation/ expected premium renewals
	• Time period/contract boundary for LAT
	  o Is 1 April 2020 still appropriate?
	• Estimating size and timing of cash flows
	  o Addressing hardship initiatives
	  o Will the health system service more policyholders than usual after restrictions are lifted?
	  o Are two premium increases likely in six months?
	• Addressing increased projection uncertainty in the risk margin
	• Considering any interaction with the 'ASIC deferred claims liability' (if adopted)
	• Providing appropriate sensitivities and other disclosures

4. ASIC's deferred claims liability (see ASIC FAQ Q6)	• What is the insurer's intended accounting practice? Will a separate provision be recognised? • Working with the insurer and auditor to agree a basis for the calculation and supporting that basis • Is a risk margin required? • Has the company made any statements or commitments to returning COVID-19 related benefits to customers?
5. Dividends	• Capital management in the context of increased uncertainty • Considerations set out in APRA's letter to insurers (7 April)

II. APRA Returns

6. Future Claims Liability	• Consideration set out in APRA communications to insurers (7 April, 20 April) • Consideration of whether a different risk margin should be used for the future claims liability (contributions in advance) as distinct from the constructive obligation (or expected premium renewals) given the varying exposure periods?
7. xth percentile	• Communicating potential changes to the xth percentile amidst many other changes
8. Stressed net margin estimate	• Considerations set out in APRA communications to insurers (7 April, 20 April) • In addressing the increased uncertainty in the 12 month outlook for PHIs, what approaches/scenarios should be considered?
9. Stressed investment income & stressed HRB income	• Should the investment stress be varied? • [Subject to specific nature of HRB exposures] Adapting the HRB income stress with limited relevant data
10. Liquidity – stressed net cash outflow	• The allowance for claims rebound may not match historical cash flow patterns • Addressing increased uncertainty in the liquidity stress considered

We find it useful to consider the above issues on merit rather than a broad label of 'Financial Reporting". In particular, the considerations for financial reporting and additional components for APRA reporting.

Questions to consider in relation to evaluating options for the purpose of financial reporting are:

1. What is the impact on adequacy of funds for capital and solvency requirements?
2. Is profit emerging consistent with value created for stakeholders?
3. Are results disclosed in a proper manner for informed readers?
4. Will there be comparability between funds in the APRA operations report?

No single approach will provide a perfect answer to each question resulting in a need for judgement in deliberations.

1. Outstanding claims liability

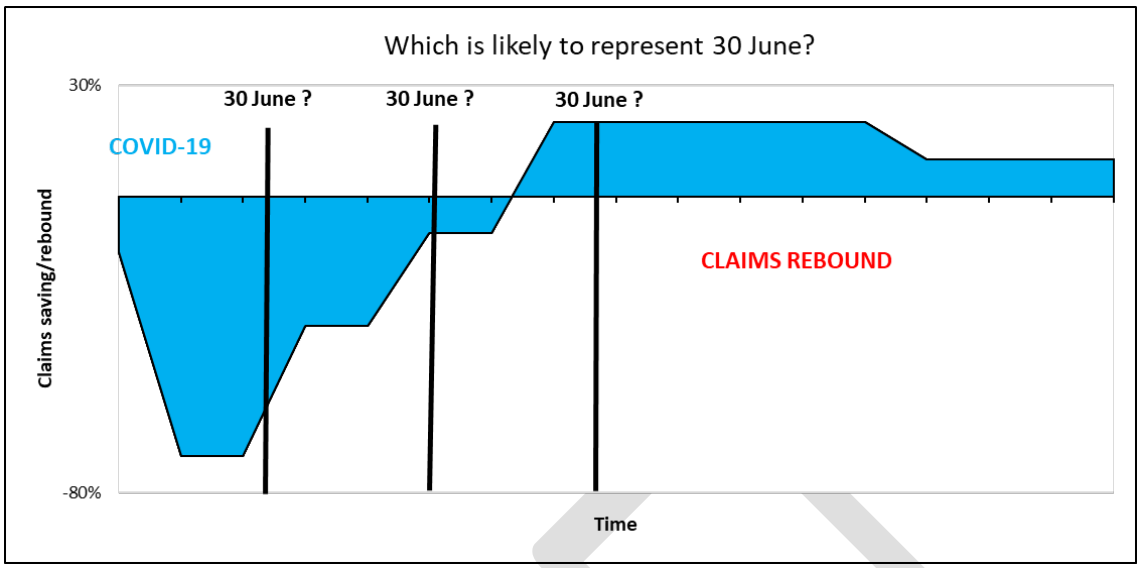
Decisions Required:

a) ***The central estimate to recommend for booking in financial accounts for outstanding claims***
b) ***The risk margin on the central estimate (per Fund policy)***

Recommend – AAs recommend a central estimate and a framework for risk margins
Audit – Auditors will want evidence and rationale for amounts recommended
Finance – CFOs and teams have responsibility for preparing accounts
Input – A range of management will provide relevant perspectives
Decide – Ultimate decision is with Board

Under normal circumstances the uncertainties involved in the Outstanding Claims Liability are minor – often in a range of 4%-10% at the 75th percentile. That may not be the case this year with ultimate claims more uncertain. The graph below shows that, standing at 30 June, the total claim amount incurred in the past will depend on how far we have progressed through phases 1(COVID-19 deferral of claims) and 2 (Claims rebound or catch up).

It is worth noting that in this discussion, the definition for "claims incurred" is only satisfied when a service has been performed. For services that were scheduled but postponed, and not yet performed at the valuation date, there is an argument that these will also eventually result in an expense for the fund. However, whether they fit the technical definition of "claims incurred" is a question that funds must consider, taking into account any written or verbal commitments they may have made to their members. Funds will also need to take care that these "claims" are not double counted in their accounts.



In this environment typical valuation methods are likely to give very different results. The application of standard techniques such as chain-ladder, Bornhuetter-Ferguson and ultimate loss ratio will all require significant judgement, particularly in respect to the ultimate claims levels in respect of the May and June service months for hospital claims.

We note the following changes arising from COVID-19 to standard techniques.

- Development factors are likely to be affected by the lower volume of procedures and any impact on claims lodgement (provider) and claims handling (insurer) procedures.
- Provider procedures could be impacted by staff output (e.g. remote working, absenteeism etc.) or changes in processing direction/priority (e.g. to optimise funding, to facilitate compliance with government requirements).
- Insurer procedures could be impacted by staff output (e.g. remote working operations, absenteeism etc.) or changes to existing processes (e.g. increased scrutiny, or more straight through processing).
- Ultimate loss ratios are also likely to be difficult to determine as there is considerable uncertainty in the total value of claims that will materialise by 30 June.

In estimating the outstanding claims liability at 30 June 2020 it could be beneficial to:

- Assess the outcomes of a variety of methods to estimate the liability
- Undertake sensitivity testing where alternative ultimate claims levels are assumed for the May and June 2020 service months

- Clearly document the process used to recommend a valuation for Outstanding Claims Liability
- If possible, consider the use of July or July and August claims data to calculate the Outstanding Claims for the year-end accounts.

The increased uncertainty inherent in the 30 June 2020 outstanding claims estimates challenges whether historical risk margins for the outstanding claims liability remain appropriate, and whether analysis of past adequacy of estimates is relevant to the assessment at 30 June 2020.

As part of the assessment of the risk margin, an insurer may consider whether the liability should be held at a different probability of adequacy than in previous years reflecting an adjusted risk appetite. In this circumstance the members could consider providing a range of risk margins to cater for alternative PoAs.

In recommending risk margins at 30 June 2020 members could consider the results of sensitivity testing to explore the range of potential outcomes.

2. Unearned Premium Liability

Decision Required:

The unearned premium liability booked in the accounts is the premium revenue not recognised as earned in accordance with the pattern of the incidence of risk expected.

Recommend: Finance/CFO
Audit: Review
Input: AA will need to consider in other work
Decide: Board (understanding is that current position is for no change)

Insurer's premium earning patterns are normally formula based and earned on a time basis (365th method). Ultimately the premium earning pattern is determined by accounting policy recommended to the Board by management with review from the auditor. While not directly an actuarial determination it will be important the members will need to be across any change in the basis used as an input to other calculations (e.g. LAT).

3. Liability Adequacy Test (LAT)

Decisions required:

1. Confirmation of contract boundary
2. Apply a variety assumptions to estimate cash flows incorporating insurer's COVID-19 member response packages, in particular, benefits for those experiencing financial hardship and the revenue impacts of membership suspensions
3. Review /confirmation of the PoA to be used for the LAT
4. Selection of a risk margin at the insurer's required PoA
5. Consider interaction with any deferred claims liability if applicable (ASIC's specific liability provision).

The LAT is officially detailed in section 9 of AASB1023 General Insurance Contracts. The Institute's Guidance note PG699.02 Valuation of health insurance liabilities – March 2018 outlines considerations for actuaries undertaking LAT assessment. APRA has also provided by email some considerations for insurers in relation to this topic.

In private health insurance the application of the LAT ordinarily makes two key assumptions:

1) Future cash flows are evaluated until 1 April (being the time of the next premium rate increase) or the first date at which new premium rates take effect after 1 April

2) The assumption that the next premium rate increase creates the practical ability to re-price the risks.

The use of the 1 April timeframe is the standard industry practice based on accounting interpretation informed by audit firms in a PHA commissioned work paper (AHIA 2005).

Accounting Standards outline the cash flows to consider where the insurer has a 'constructive obligation' to settle future claims that may arise. As health insurance contracts do not have an official end date, the 1 April date was chosen on the basis that losses could be expected to be addressed following a premium round.

If an insurer expects losses will occur past 1 April 2021, this may be indicative that the 'constructive obligation' could be extended beyond the historically adopted 1 April date. Due to the guaranteed renewability of PHI and the moral hazard of members

maintaining their cover if they are expecting to claim, the effective end date for the LAT could be:

1. When the claims 'rebound' period ends and losses cease;
2. At the first premium round after 2021 that corrects for the losses e.g. 1 April 2022, 2023 etc.

Principles for consideration are:

- Comparability to prior years – while different insurers may adopt different accounting interpretations, it would be desirable for an insurer to maintain consistency across years
- Rebound pattern for an insurer – for example, whether an insurer considers a longer period of smaller losses, or a shorter period of larger losses, may be driven by its views and information on the hospital system response. This response may play out differently by state and region and so impact insurers differently depending on their geographic spread of their membership
- Rebound pattern of claims net of risk equalisation – if rebound patterns are different by insurer, the expected outcome from the risk equalisation pool may also be different to historical patterns
- The premium increases applied over the projection period
- Ensuring allowance is made for member hardship initiatives – including initiatives of known and unknown (estimated) cost
- Projected future membership mix – noting historical membership stability may be less certain in the short-term. Consideration for downgrading behaviour, lapses (particularly of younger and healthier members) and the resulting mix of membership could be considered.

4. Deferred claims liability or COVID-19 liabilities for insurers

Decision Required:

ASIC recently announced *"that Private Health Insurance (PHI) companies should recognise a liability where an insured person who knows that they have a condition is likely to continue their cover until the surgical procedure has been performed."*

Insurers decide whether to book an amount with Audit opinion being a consideration.

Actuaries will need to be aware of any such amount and any interaction with the Outstanding Claims and LAT. It is likely that Actuaries will be engaged to provide input on the calculation basis and providing evidence to support the reasonableness of the adopted method.

ASIC released an FAQ on the implications COVID-19 for financial statements and its expectations. Question 6 of the FAQ outlines matter specific to insurers.

> *6. What are the reporting considerations where there is increased revenue or reduced expenditure?*
>
> *…Some entities may have obligations that give rise to liabilities at balance date in the specific circumstances. For example, the suspension of non-urgent or non-essential elective surgery for a period may result in a backlog of surgical procedures that has not been fully cleared by balance date. Private health insurers should recognise a liability where an insured person who knows that they have a condition is likely to continue their cover until the surgical procedure has been performed. Community rating and waiting periods may be relevant to the decision by an insured person with a pre-existing condition to retain their cover. The liability estimate should typically have regard to the pattern of claims in prior periods compared to the pattern of claims in the current year.*

There is some debate in the industry as to whether the liability adequacy test will suffice or whether a specific additional liability is required at 30 June 2020.

We understand the intention of creating a specific additional liability is to allow insurers time to assess the full impact of any savings from surgical procedures that would have ordinarily been expected to be incurred prior to 30 June 2020.

Procedures scheduled prior to 30 June that have been postponed to a date after 30 June, could be captured in the LAT as part of the claims "rebound" assumptions. However, there may also be additional liabilities created by commitments that are yet to be made by funds or yet to be tested by policyholder reasonable expectations.

The creation of a specific provision may be especially relevant where a PHI has committed that "any permanent benefits in excess of the current package due to COVID-19 will be assessed when they are known and only then returned to customers." It might also include, for example, how policyholders are treated if they ultimately lapsed or downgraded their cover by the time their procedure is rescheduled. Any such decision may depend on specific statements or commitments made by individual insurer.

If such a liability is created:

- A key issue will be how to measure such a provision and how to isolate it from usual claims trends observed into the lead-up to COVID restrictions and post
- Consideration may need to be given to the uncertainty inherent in the estimate and whether any risk margin to account for this uncertainty should be incorporated
- It is important for the member to discuss with auditors as to how 'promises' should be provisioned, and any requirements as to the nature of such promises that would increase the likelihood of the projection.

Actuaries are encouraged to explore specific conditions relating to an insurer in relation to such a liability and the interaction with other components of reporting.

5. Dividends

Many 'for profit' insurers also strike a dividend from the Health Benefits Fund including the transfer of funds to a parent entity. This will form part of the 30 June accounting considerations and interacts both with reported profit and with Capital Management Policies.

Given the increased uncertainty and abnormal profit patterns that might emerge, actuaries will need to help their funds anticipate the likely impact on dividend policy (if any) in a timely fashion.

APRA 602 Return (Determining the Capital Requirement)

6. Future claims liability (FCL)

Decision Required:

Approve a risk margin on premium liabilities for those liabilities in respect of contributions in advance.

It is common practice to adopt a risk margin framework consistent with that in the financial accounts. While the risk margin here only applies to contributions in advance there is currently no expectation to change insurer's existing practice.

If a member considers adopting an alternative risk margin for the future claims liability to reflect the different period of exposure relative to the LAT, the member should take care to set out the basis for each selection and clearly communicate this basis to the client and audit team.

7. Selecting and communicating the xth percentile

Decision Required -

To approve the 'xth' percentile stated where Section 25 outlines that:

xth percentile means the percentile with which the:
(a) net margin for the health insurance business; and
(b) investment income; and
(c) health-related business income and all other income, less associated expenses;

must be measured at, in order to achieve a second percentile profit margin, incorporating allowance for correlation between (a), (b) and (c) of this paragraph

Given the increased uncertainty and potentially large change in the value of these three components, there is a question of whether it is appropriate to keep the xth percentile at historical levels. Actuaries may be asked this by APRA.

Given the high levels of uncertainty, considerations for changes in the covariance structure between net margins, investment income and other income and therefore the xth percentile will be particularly challenging. Ultimately, qualitative arguments may be more useful this year for justifying the xth percentile adopted, with reference to the historically used x.

Actuaries can help their Boards understand this uncertainty through:

- The sensitivity of the Capital Adequacy Requirement to this assumption
- Whether it materially impacts any scenario analysis performed
- Whether the size of the components has materially changed
- Implications of these assumptions
- Documenting consideration of these issues.

8. Net margin stress

This section specifically considers the health benefits fund's stressed net margin estimate calculated under 19(b) and 20-22 of HPS110. Section 28 (a) of HPS 110 has also been considered which outlines a supervisory adjustment may be considered where:

> *(a) There is a less than 98 per cent probability that the health benefits fund will meet its prudent liabilities in 12 months' time…*

The next 12 months is subject to a significantly higher amount of uncertainty than usual. Determining liabilities and cash flow will be more difficult than usual. Demonstrating the appropriateness of these assumptions at the 98th percentile raises a number of challenges.

Key assumption	Consideration
Ability of health system to increase procedures	An approach is to assume a full rebound in claims over the next 12 months, in addition to claims that would have been usually expected. Should this be considered unlikely at the 98th percentile, the rationale for the lack of a full rebound should be clearly demonstrated to justify the approach to interested stakeholders. Considerations could also be given to the potential for additional claims (or new sources of claims) including for example additional mental health claims and tele-health claims at the 98th percentile.
Premium increases & premiums	Whether either or both premium increases are likely when considering the 98th percentile probability of adequacy rather than for a central estimate. The extent of premium relief measures (e.g. the potential for increased take-up of hardship payments, suspensions etc.) at the 98th percentile.

Timing on procedures recommencing	For the purposes of the stressed net margin estimate, the member could explore a range of claims trajectories.
Membership mix	Whether membership growth assumptions are likely to hold. Whether an increased risk of downgrades and lapses increases adverse selection.

9. Investment income & HRB income stress

In respect to the stressed investment income the member could consider the changes to the risk return assumptions for each asset class.

In respect to the stressed HRB income the member could consider the specific nature of the activities undertaken. For insurers with clinic income, consideration should be given to the term of any shutdown of services, the costs of re-starting and any reduced revenue (utilisation) as services return to normal levels. Such consideration would reasonably be expected to include scenario analysis.

10. Liquidity – stressed net cash outflow amount

Liquidity monitoring will increase in importance.

The future rebound pattern may alter the typical levels of cash available for the fund. Whilst ongoing monitoring is important, future forecasts to anticipate liquidity challenges may also be required.

11. Taxation

In this note we have not directly considered taxation implications. It is noted that this will be an important factor for a number of entities. Appointed Actuaries will need to be aware of taxation considerations where applicable.