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Individual Disability Income Insurance Sustainability Guide

IDII

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Disability Insurance Taskforce of the Actuaries Institute

Actuaries Institute

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About the authors

This document has been prepared by the Disability Insurance Taskforce of the Actuaries Institute (the Taskforce).

Disclaimer

This IDII Sustainability Guide (the 'Guide') is published by the Taskforce for the purpose of providing information on its work on individual disability income insurance (IDII). The Taskforce is comprised of a range of participants and stakeholders in the IDII ecosystem. The work of the Taskforce has been to establish guidelines for a sustainable ecosystem including the development of the Guide for IDII insurers. The work has been undertaken to promote better, more sustainable outcomes for both consumers and the industry. The Taskforce participants have shared knowledge on the basis that the outcome was of public benefit in advancing the debate of more sustainable product design and management practices.

The Guide reflects input from members of the Taskforce and members of its working groups, as well as formal and informal feedback provided to the Taskforce and/or the working groups in response to the draft discussion papers (including a draft of the Guide) released by the Taskforce in September 2020. However, it is acknowledged that there is a range of views on what should be included in the Guide and that the end result cannot and does not reflect the views and preferences of all the various stakeholders in the IDII ecosystem. Furthermore, the dynamic environment within which IDII has operated over recent years and the incomplete industry data and analysis available, means the material drivers of recent disability insurance outcomes and future sustainability are uncertain. Consequently, the assessment of the material matters that may affect future IDII sustainability, and matters and their weights addressed in the Guide, relies significantly on judgement. No warranty is provided by the Actuaries Institute, the Taskforce or its working groups or the members of any of them, that the Guide is complete or appropriately addresses all matters relevant for the sustainable issue of IDII business by an insurer.

The Guide does not address all issues that the Taskforce believes are needed to achieve appropriate ongoing community outcomes and is only one element of a range of proposals from the Taskforce.

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.

About the Actuaries Institute

The Actuaries Institute is the sole 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 (the Guide) has been developed by the Actuaries Institute Disability Insurance Taskforce (the Taskforce) to support actuaries and other insurance professionals create or enhance practices to promote sustainability in the retail Individual Disability Income Insurance (IDII) market. The Guide is intended to help insurers consider critical aspects of product design, operational practices, pricing uncertainty, risk management and risk appetite. It will increase clarity about important practices that may lead to poor sustainability. Insurers should use the Guide to 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

Insurers face a number of conflicting commercial realities that over decades have resulted in poor outcomes for both customers and insurers in the IDII market. 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, for customers with relatively low claims risk cancellation of their insurance with the consequence of further price increases for the remaining customers.

2.2 Response

The Guide recommends that each insurer should have a documented approach to sustainability and proposes:

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

ii. a Reference Product[4] and benchmark operational practices to assist management and the Board understand and discuss aspects of their business that may increase uncertainty and reduce sustainability; and

iii. a framework to measure and monitor over time an insurer's sustainability by reference to the Reference Product and benchmark operations (including a model for an internal and self-assessed sustainability score).

2.3 Philosophy and content

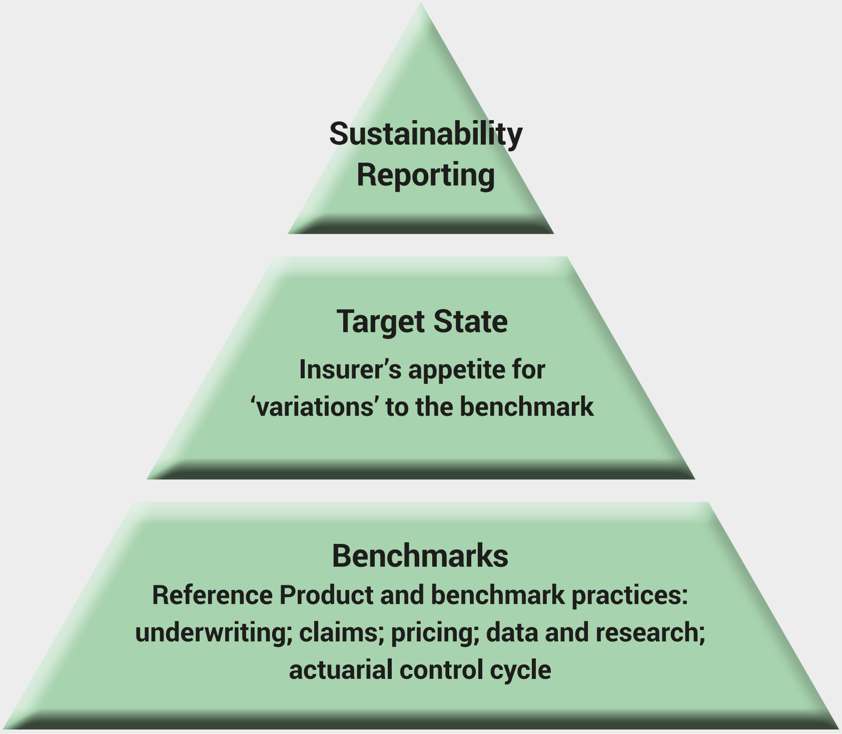
The Guide addresses the most critical practices thought to promote sustainability of IDII business for the industry. It complements, but is no substitute for, an insurer's team of insurance practitioners applying best practice. As such, it articulates aspects of IDII products and operational practices that should be nurtured to achieve sustainable outcomes. It is envisaged that insurers will adopt their own practices within this framework.

1 For the purpose of the 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.
4 The Reference Product is detailed in the Actuaries Institute publication Reference Product Individual Disability Income Insurance published April 2021.

The Guide has been prepared in the context of sustainability for on sale (new business) retail advised products. The approach taken in the Guide is intended to be usable for other distribution channels, product lines and insurers' in-force portfolios. For example, in a direct distribution channel an insurer might choose to deviate from the Reference Product and benchmark practices with more limited benefits and less extensive underwriting standards.

2.4 Executive summary: elements and processes in the Guide

Framework elements



Steps for insurers:

1. Assess the level of IDII uncertainty relative to the benchmarks.
2. Determine features to adopt in the insurer's Target State and their relationship to the benchmarks.
3. Obtain Board approval of the insurer's Target State variations to the benchmarks.
4. Identify and evaluate variations to the benchmarks for their impact on claims cost arising from uncertainty.
5. Monitor and report on variations to the benchmarks and their sustainability.
6. Reduce uncertainty with improvements to data collection, analysis and research and application of the control cycle.

2.5 Potential wider applications

Users of the 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 the Guide to be applied to an insurer's whole portfolio.

Additional observations:

- if an insurer were to develop a reference product for TPD then it may be possible to consider the overall sustainability of combinations of lump sum and income disability benefits. In particular, the 'Sound Product Design/Insurability Principles' summarised in the Reference Product may be useful for this purpose; and
- a reinsurer could adapt the Guide to monitor its portfolio of IDII products and its assessment of the capabilities of cedants.

2.6 Updating the Guide

The Guide should be reviewed on a regular basis to reflect learnings from its application. Ongoing research and analysis of emerging claims experience, premium rate stability and effectiveness of insurer practices is likely to result in improvements to the Guide that should be shared across the industry.

3 Governance and Target State

Governance structures and reporting should enable development, maintenance and continual improvement of sustainable practices over the long term. The following elements are recommended:

i. adoption of a clear Target State linked to risk appetite and delegations to management;

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

iii. Board approval and monitoring of sustainability including of their organisation's sustainability scores.

3.1 Target State

The Guide proposes a reference set of product features (the Reference Product)[5] and benchmark operational practices (including underwriting, pricing and claims) that when taken as a whole provide a robust foundation for assessing and managing sustainability (see section 4). The insurer should set its Target State by defining acceptable 'variations' to this reference/benchmark (see section 5). For each item in the register of these variations, the insurer should define 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.

It is envisaged that the Board would approve the Target State and in doing so it would consider:

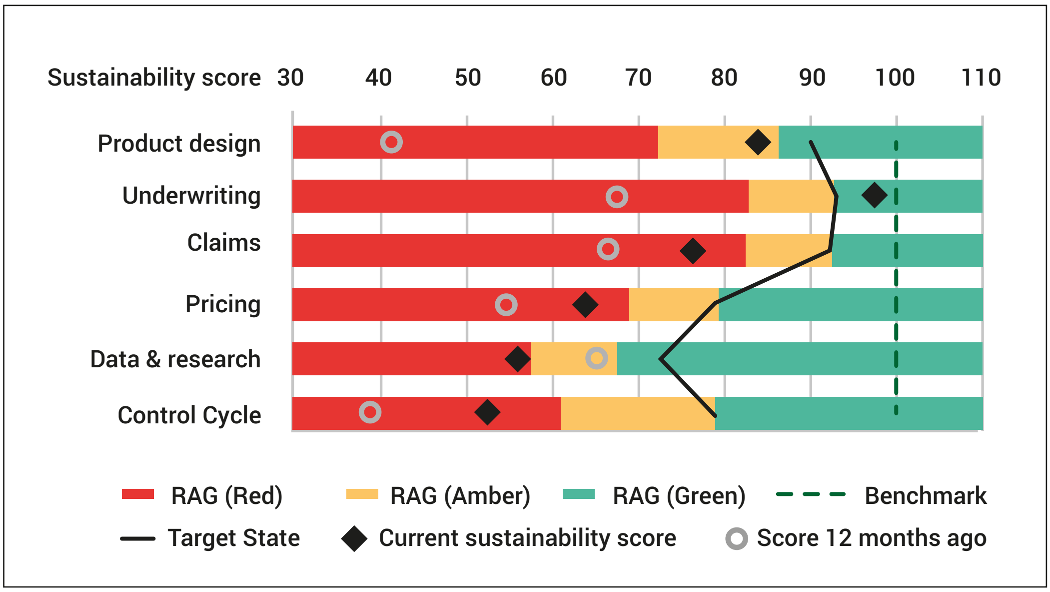
- the detail of all high impact variations to the reference/benchmark including any mitigants adopted;
- the number of medium impact variations and the themes justifying those variations;
- how the insurer's pricing philosophy supports sustainable and equitable outcomes (see section 4.4.2); and
- the 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 should be updated to reflect the Target State and delegations to management should ensure that future product and operational changes that are material to sustainability are considered by the Board.

3.2 Monitoring by the Board / Sustainability Heatmap

The Board should 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.

5 For absolute clarity, the Reference Product features are not set out for marketing purposes; they are an aid to sound prudential management of the product as a foundation for sustainable outcomes.



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

Although not the focus of the 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

An insurer should update its framework(s) to cover sustainability of the product. As a minimum, the framework(s) should set out how the insurer:

i. receives and considers CPS320 specific advice to the company 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 changes;

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

iii. ensures 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. monitors and understands sustainability issues detailed in the Annual Sustainability Assessment (see section 4.6);

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

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

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

4 Reference Product and associated benchmark operations

This section details the main elements of the Reference Product and benchmark operations. These elements are not intended to cover every possible aspect of an insurer's product and organisation. The focus is on the most material outcomes that are expected to lead to a relatively sustainable industry. In developing an insurer's own approach to sustainability, it is envisaged that the rationale for any variations to this benchmark are discussed, documented and agreed (see section 5).

The reference/benchmark aims to deliver on the principles of insurable interest and customer loss minimisation. It is not intended to achieve the 'ultimate' in sustainability; rather deliver more consistent outcomes for both the customer and insurer in a range of potential future social, regulatory and economic scenarios. It is recognised that many of the components interact and similarly sustainable outcomes may be achieved with a different combination of factors. The insurer's Target State and actual go-to-market product and service offerings may be more or less conservative than the benchmark.

The following sections complement rather than substitute for an insurer's team of insurance practitioners applying best practice in their fields.

4.1 Product design

The Reference Product has been designed to meet insurability principles. The following sections detail the outcomes / themes that are central to sustainability and cross references the Reference Product document in the footnotes.

4.1.1 Income definition and replacement ratio incentivise return to work / wellness[6]

The combination of income definition and replacement ratio (including offsets and ancillary benefits) is intended to ensure that the product covers an insurable interest of the customer and incentivises return to work / wellness. The Reference Product provides benefits on an indemnity basis only.

4.1.2 Eligibility for benefits is clear and supports the customer when they are unable to work[7]

The total disability definition in the Reference Product aims to be clear and provide support for the consumer where there is a significant incapacity to work. Partial disability benefits are structured to promote return to work and not encourage remaining on claim. To this end, waiting periods are also limited.

4.1.3 The occupation definitions and replacement ratios encourage the customer to minimise the insured loss[8]

The Reference Product design is intended to ensure that claimants are aligned with the insurer on the insurance principle of loss minimisation. The replacement ratio is higher in the first six months and the

6 Reference Product sections 1.3.2, 1.3.5, 1.3.6, 1.3.7, 1.3.8, 1.3.15
7 Reference Product sections 1.3.1, 1.3.3, 1.3.4
8 Reference Product sections 1.3.1, 1.3.2, 1.3.10

occupation definition moves from own occupation to an education, training or experience definition at two years. A maximum benefit period of 'to age 60' is intended to reduce the incentive to utilise benefits to support early retirement.

4.1.4 Product terms and conditions keep up with environmental changes[9]

Under the Reference Product the insurer retains rights to alter substantive terms and conditions at least every five years 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 implementing this feature may be challenging under the current legislative framework but it is a material risk management feature that should be discussed. If implemented then the right to change product terms should not be used to experiment with unsustainable terms that are likely to be subsequently withdrawn.

4.1.5 Products communicated to promote alignment between insurer and customers

Under the Reference Product, the intention is that customer expectations of the product should be aligned with those of the insurer. This is intended to support the long term expectations and needs of the community. To achieve this, the benchmark practice is to:

- 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 about the uncertainty and claims experience variations of the product so that customers are less surprised by premium rate increases. In support of this, under the benchmark practices the insurer would 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

The Reference Product requires supporting underwriting and claims practices to promote sustainable outcomes including return to work where appropriate. Underwriting and claims practices must 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.

9 Reference Product sections 1.3.13

4.2.1 Financial underwriting ensures that benefits do not exceed insurable interests and promote loss minimisation[10]

Under the benchmark practices, the intention is that 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. The Reference Product has a maximum benefit period of 'to age 60'.

4.2.2 Insured events updated to keep up with the customer's changing circumstances[11]

Under the benchmark practices, the customer is asked annually to confirm their financial information details to ensure that cover continues to deliver on their insurable interest and they are charged the correct premium. This includes the customer's occupation, pastimes and income level.

4.3 Claims practices

The insurer should ensure that its claims practices cover matters identified in SPG250, LPG240 and LICOP. Documentation should 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

Under the benchmark practices, the claims team has a sufficiently skilled and experienced team with sufficient capacity to assess claimants against the claims definitions. Claims assessors must retain ownership of the decision regarding payment of a claim and (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[12]

Under the benchmark practices, during the first 18 months of each claim it is important that the claimant receives regular communication on return to wellness / work expectations at least every six weeks following acceptance of the claim. Communication should include 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[13] and other factors including:

- in a rapidly changing environment, historic data may be inadequate to estimate the future claims cost;

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10 Reference Product sections 1.3.5, 1.3.10
11 Reference Product sections 1.3.12
12 Reference Product sections 1.3.1, 1.3.14
13 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.

- 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).

Sustainability requires that insurers proactively seek to understand and reduce uncertainty through product terms and underwriting and claims practices. Given the high levels of uncertainty inherent in the product, past claims experience may have limitations when considering what product terms, underwriting and claims practices are sustainable. These are important considerations in pricing becoming sustainable. The primary focus of the Guide is to achieve that outcome.

Insurers should acknowledge uncertainty and not default to being optimistic about (i.e. underestimate) the cost of uncertainty. Pricing assumptions / margins should allow for that cost. If insurers are routinely optimistic about uncertainty, then competition results in the ongoing / iterative relaxation of product terms and insurers increasing premium rates in future. An argument can be mounted that no consumer detriment occurs because there is a free market and customers can move to a superior and/or cheaper product. This argument has limitations for IDII products because consumers face high frictional costs[14] that the insurer should consider in their pricing decisions. The customer also has a right to understand how the price of their product may change over time.

4.4.1 Pricing assumptions put a cost on uncertainty for at least five years

Under benchmark practice, careful consideration of uncertainty over at least the first five years from inception of policies is required. It is intended 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[15]. This does not imply that that premium rates should be guaranteed.

Uncertainty should be allowed for explicitly in best estimate assumptions or separately in risk margins. Under benchmark practice, the starting point in setting best estimate assumptions should 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 should 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 under benchmark practice the cost of that uncertainty can be reduced. Equally, evidence may indicate that a cost for uncertainty is required in best estimate assumptions. Section 4.5 details benchmark practices to reduce uncertainty over time.

Under benchmark practice, the uncertainty factors to consider 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. The total claims

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14 Frictional costs for consumers include: (i) the significant cost to understand and transact, (ii) actual inability to transact because of changes in their health and the insurer's medical underwriting, (iii) the risk of cover being lost in transition between insurers and (iv) fear of making a mistake because of the complexity of the product.

15 The insurer should determine the methodology and metric(s) that it wishes to use to assess profitability and profit margins (i.e. the Guide neither defines a technical approach nor whether uncertainty should be included).

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 should be costed; in particular unemployment and underemployment;

iv. the potential that duration based termination assumptions are optimistic 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

Under benchmark practice, the pricing philosophy articulates how the insurer proposes to address factors that impact on the product's cost over time. Factors 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 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[16] is not loss making at least on a marginal cost basis.

4.5 Data, experience investigations and research

IDII products are inherently complex. To reduce uncertainty and understand risk it is necessary for each insurer to collect data, analyse that data and collaborate on industry research.

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

Under benchmark practice, data is collected so that a granular understanding of the product's cost is available. This includes:

- demographic information that is relevant to pricing;
- all the choices made by the customer when purchasing a policy, including features that

16 Product lines includes the separation of income protection and lump sum benefits

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 should be tracked; and
- factors relevant to customer behaviour at and during claim should also be recorded including the replacement ratio and any secondary claim cause.

Under benchmark practice, the data is analysed to provide empirical evidence for product features and processes that positively or negatively affect sustainability. Benchmark practice is to collect data in accordance with a benchmark data specification that the Actuaries Institute will, in consultation with the Financial Services Council (FSC), publish from time to time.

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

Good quality published research is required to promote sustainability of the IDII product. Insurers with inadequate data and/or insights may make poor decisions that in a competitive market can impact on all participants. Subject to appropriate data privacy measures that protect customer and insurer anonymity, insurers should contribute data for publication and research by credible third parties. In particular, data should be collected and provided to support research into topics selected by the Actuaries Institute as high priority (having consulted with the FSC and APRA).

4.6 Annual Sustainability Assessment / actuarial control cycle

Under benchmark practice, there is a process to at least annually bring together the pricing, reserving, experience and analytics, claims, underwriting and product teams to analyse, explain and agree actions to improve sustainability.

Under benchmark practice, 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 Reference Product and benchmark operations

The insurer's actual product design and operating model at any time may be different to the Reference Product and benchmark operations; i.e. there will be 'variations'. Some variations will reduce sustainability and other mitigants will improve sustainability. Under benchmark practice these variations are evaluated for sustainability under potential future scenarios (i.e. neither best estimates nor weighted by likelihood). The cumulative effect of variations is tracked over time.

5.1 Identification of variations

Variations may be a difference to core features of the Reference Product and benchmark practices or an 'add-on' that may alter the claims cost of the product. Whether variations should be split or aggregated may be subjective. Under benchmark practices:

- 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 should be treated as separate variations; e.g. the earnings definition and the maximum replacement ratio; and
- some variations or a group of variations may have a partial mitigant to the likelihood or consequence of adverse claims experience. The mitigant should 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

Under benchmark practices, variations are assessed to determine whether each variation has a low, medium or high impact on claims cost, assuming that uncertainty is realised. The aim is to assess the approximate relative (rather than absolute) importance of each variation to the benchmark and Target State. In addition:

- 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.

Under benchmark practices, each variation is evaluated assuming that an uncertainty scenario emerges[17] over five years (and stabilises thereafter) from inception of new policies and its impact

17 See section 4.4 for examples of uncertainty scenarios

determined by:

- using the examples in Appendix A as guidance;
- 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 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

Under benchmark practice, each variation to the benchmark is 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 %

Under benchmark practice, the variations register is summarised in a table that is used to track variations to the Target State, as illustrated in the table below[18].

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	93	97.5	1 (1)	1 (1)	–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 and research	R	72.5	56.0	3 (5)	1 (-1)	1 (1)
Control cycle	R	79	52.5	3 (1)	3 (4)	1 (2)

18 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.

5.4 Sustainability scores

Under benchmark practice, the summary table above also contains a 'sustainability score' and 'RAG status' (red/amber/green rating) for each category. The current state sustainability score[19] is calculated using the net number of adverse variations compared with the benchmark as: 100 - (0.5 x #Low + 5.0 x #Medium + 10.0 x #High)[20]. The Target State sustainability score is calculated using the same method based only on variations for the Target State. The RAG rating is based on the value of the current state sustainability score (in accordance with a scale determined by the insurer and likely linked to the Target State sustainability score for each category).

Overall sustainability scores are calculated as the weighted average of the category sustainability scores using the weights: 25% / 15% / 15% / 15% / 15% / 15% for each category respectively.

19 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.
20 Initial calibration work has been completed but further refinement of the weights may be required.

Appendix A: Example impact rating for variations

This appendix details the likely impact rating for various medium and high variations. It is neither an exhaustive list nor are the ratings absolute. The rating represents a magnitude of claims cost that may arise from uncertainty being realised: (i) relative to the Reference Product / operational benchmarks, (ii) relative to other factors being assessed and (iii) using professional judgement. It is important that rating of the impact of the variations is consistent between variations. As such, the lists below are also intended to aid the insurer 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 Reference Product is an important consideration. For example, a 5% departure from Reference Product Replacement Ratio may be considered to have a High rating and a 1% variation a Low rating.

Links to the Reference Product are annotated by '**RP(section number)**'.

A.4.1 Product design

Variation	Description	Rating
Replacement ratios greater than Reference Product (RP1.3.2)	Consider the size of gap and length of the period of departure. A replacement ratio exceeding the Reference Product by more than 5% for a period greater than 12 months could be a High rating.	High
Superannuation benefit paid as cash (RP1.3.2)	Above Reference Product replacement ratio arising from payment of the superannuation benefit as cash.	High
Benefit periods greater than to age 60 (RP1.3.10)	Benefit period beyond age 60 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 age 60; • benefit income offsets for retirement incomes; and • financial re-underwriting the benefit period every five years to ensure that there is an ongoing insurable interest for the longer benefit period and it continues to encourage loss minimisation.	High
Broad total disability definition (RP1.3.1)	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 (RP1.3.1)	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 five years (RP1.3.13)	Terms and conditions are not kept contemporary and consistent with community expectations at least every five 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 five year point). Note: The five 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 five 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 10 years then the impact rating may still be Medium but only in conjunction with other highly sustainable product terms.	Medium
Absence of standard exclusions (RP1.3.11)	The product terms do not have the product exclusions in the Reference Product	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 Reference 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	Impact Rating for Group
No definition step down at two years (RP1.3.1)	Absence of switch to ETE at two years reduces the financial incentive to strive to return to work.	Group 1 Medium
Partial benefits disincentivise return to work (RP1.3.3)	Partial benefits do not cease at 80% capacity or 32 hours per week (disincentivising return to work).	
Partial disability benefits are excessive (RP1.3.3)	The extent to which the benefit amount exceeds the Reference Product.	
Inadequate allowance for offsets (RP1.3.7)	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 (RP1.3.7)	Neither is tax deducted from benefits nor the ATO notified of benefit payments.	
Indexation results in over insurance (RP1.3.8)	Sum insured indexation prior to claim results in higher replacement ratios (in the context of indemnity contracts).	
Waiting periods are misaligned (RP1.3.4)	The waiting period terms have features that don't promote alignment between the insurer and consumer on return to wellness/work: • periods less than 30 days or greater than 180 days; • income benefits payable during the waiting period; • more than five 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 (RP1.3.9)	The total disability definition is not ETE after six months of unemployment or leave from work.	
No cover suspension for ceasing work (RP1.3.9)	Insurance cover continues after 12 months of unemployment or leave from work.	
Generous ancillary benefits (RP1.3.15)	Ancillary benefits are not limited to clear and significant additional costs in accordance with the Reference Product.	

A.4.2 Underwriting practices

Variation	Description	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 meet benchmark practice by allowing 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 (RP1.3.12)	Financial, occupation and pastimes information is not confirmed annually. Partial mitigants such as a meaningful opt-in underwriting process and checks at time of claim.	Medium
Unaffected Business Income is allowable (RP1.3.5)	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 (RP1.3.5)	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 (RP1.3.5)	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	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 on GPs or other factors in their assessments.	High
Insurer 'delegates' claims decisions	The claims process relies on 3rd parties to determine the eligibility of the life insured to claim.	High
Failure to set return to work or recovery plan (RP1.3.14)	Claims managers do not set and communicate return to work expectations in accordance with benchmark practice and the Reference Product.	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 section 4.3)	Medium

A.4.4 Pricing for uncertainty

Variation	Description	Rating
Pricing philosophy doesn't 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 five years (including the 'more likely than not' benchmark conditions in section 4.4.1); or • the insurer's approach does not state that adverse historic trends must be assumed to continue into the future (for at least five 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 18 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	Rating
Inadequate data collection	Claims and policy data meeting the Actuaries Institute standard is 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 FSC experience studies program within the published timeframes of the FSC.	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	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 section 3.2).	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

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