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How to lose your shirt in private health insurance

Insights session

Sydney: 17 October

Melbourne: 28 October

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Purpose

Key questions

- What causes financial distress for health insurers?
- How to build financial readiness and resilience

Purpose

- Inform discussion around these circumstances
- And regulatory capital / capital management in PHI
- And the differences to general insurance

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Presentation based on our May 2016 Actuaries Digital article

Contents

Questions and comments encouraged throughout

What caused recent stresses in PHI?

- Following table lists the **primary contributing factors** to and broad themes behind **14 instances of financial distress** for Australian private health insurers between **2000 and 2012**
- Derived from an internal study conducted by the Private Health Insurance Administration Council (PHIAC)
- Not an exhaustive list of factors—if one studies the instances through other ‘lenses’, other factors such as quality of governance, strategy and relationships could also be identified.

Contributing factor to financial stress	Proportion of insurers
Under-pricing	100%
Capital management	>80%
Rapid membership growth (>10%)	70%
Membership shrinking	10%

Focus on underpricing

Contributing factor to financial stress	Proportion of insurers
Under-pricing	**100%**
Under-estimation of benefit costs for new products, new markets or new policy holders	>80%
Did not reflect all the key drivers of experience (in particular drawing rates by duration of membership)	>80%
Government intervention in pricing	60%
Intentionally setting low prices to drive growth	30%

Focus on capital management

Contributing factor to financial stress	Proportion of insurers
Capital management	**>80%**
Thin capital targets	40%
Lack of robust capital management practices (including setting targets and triggers, regular monitoring, and implementing remedial management responses)	>80%

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What caused recent stresses: conclusion

- Weaknesses in **pricing practices** – all 14 insurers
  - Coupled with **rapid membership growth** – 10 insurers
  - And **capital management problems** – 12 insurers
- **Government decisions** were a contributing factor for 10 insurers
  - Either through **policy change** increasing membership
  - Or Ministerial intervention in **pricing process**
- Factors which are not major drivers include:
  - Investment losses – played a secondary role in only one case
  - Inadequate provisions – played a minor role in one other case.

Comparison to GI

- The table below sets out the reasons for failure in general insurance
- We comment on whether these could also be principal causes for failure in PHI.

The key risk that is more significant for PHI than GI is the potential for Government decisions (policy and premium approval) and structural reform to drive sudden growth or reduced profitability.

Principal risk - GI	Principal risk – PHI	Comment
Catastrophic events	No	Primary and public healthcare would absorb most of the cost of a catastrophic health event (such as a pandemic).
Inadequate provisions	No	Provisions represent a small proportion of annual claim costs.
Inadequate premiums (for product design)	Yes	However, PHI under-pricing should become apparent quickly, allowing corrections to be made.
Rapid growth	Yes	Combining rapid growth with inadequate premiums means private health insurers may become insolvent before corrective action can be taken.

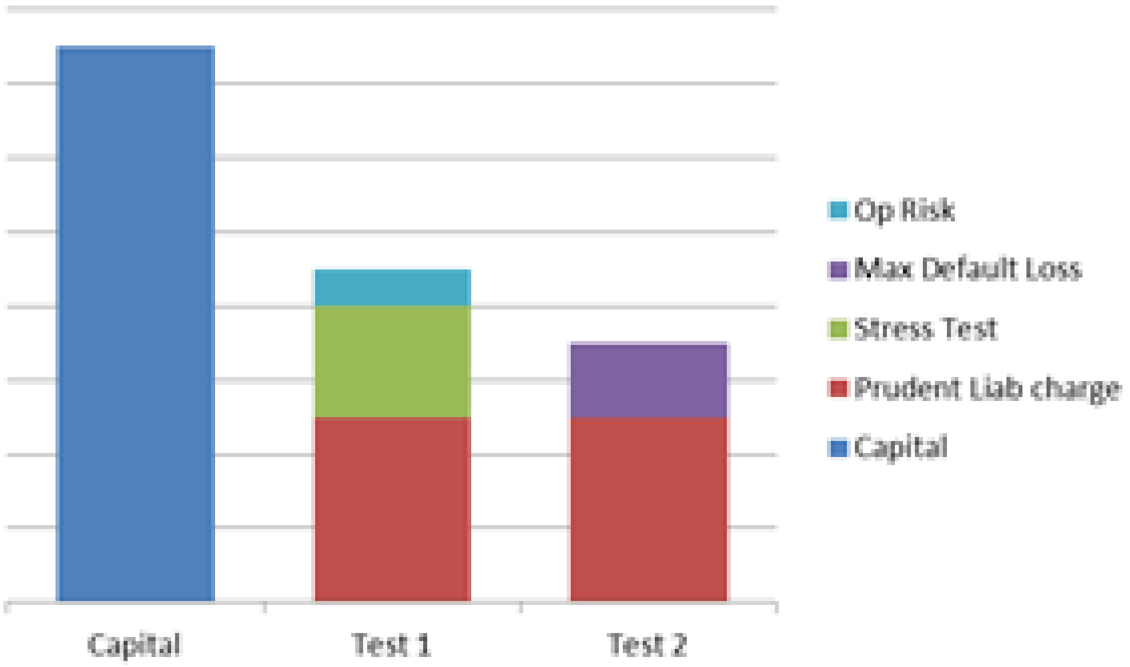
Principal risk - GI	Principal risk – PHI	Comment
Significant change in business	No	Most PHIs are monoline Although membership/product mix can change
Mis-stated accounts / fraud	Yes	Short-tailed nature of PHI means that there is less scope for mis-statement of outstanding claims or unearned premiums.
Impaired affiliate	No	Most PHIs are monoline, stand-alone
Reinsurance failure	No	Private health insurers cannot reinsure

Risk, capital and reward

- Clear link between riskiness of line of business, the capital requirements, and the required level of profit on that capital

Type of insurance	Capital (% of premium)	Profit margin (actual)	Profit margin (target/required)
Liability	80-90	20%	20%
CTP	80-90	10-12%	10-12%
PI	80-90	20%	13%
D&O	80-90	-10%	13%
Commercial Property	30-40	-15 to -10%	5-7%
Home	25-30	7%	5+%
Motor	20-25	3-4%	5%
PHI (large for-profits)	13*	7%	

Regulatory Minimum Capital Requirement



Capital management

- Capital in excess of regulatory requirement reflects:
  - APRA requirement to have a CMP, with targets, trigger points and corrective actions above target
  - Risk appetite, which varies significantly between insurers
- Potentially more important than the amount of capital held is the management response to a challenging capital situation
  - Including the discipline of the monitoring processes
  - Whether or not the corrective actions included in the plan are followed effectively.

Conclusion

Drivers of failure in PHI

- A consistent set of risk factors—pricing, growth and capital management
- Government decisions have sometimes played a significant role

Comparison to GI

- Many significant issues (catastrophes, reserves, etc) have not been experienced in PHI

Implications

- Forward-looking tools are required in order to set capital targets and triggers
- These are inherently subjective in nature
- And will result in capital targets significantly in excess of the regulatory minimum

Let's discuss:

What drives pricing errors?

- Lack of technical ability/resource?
- Inherent bias (e.g. management incentives)?

What drives capital problems?

- Poor CMP?
- Failure to follow CMP?

Key relationships

- Is there any correlation between weaknesses in key relationships (e.g. CEO-Board, CEO-Appointed Actuary, pricing team-sales team) and instances of financial distress?

Move to APRA

- Will the move from PHIAC to APRA change capital management over time?
- Will improved risk management mitigate the drivers of failure?