



Getting to know ICAAP

Making the capital management switch

APRA's recently released draft capital standards confirm, from 1 July 2023 all Private Health Insurers will be required to have an Internal Capital Adequacy Assessment Process (ICAAP). This d'finitive provides an introduction to ICAAP and outlines what health insurers need to do to prepare.



This d'finitive outlines the purpose of ICAAP, reporting requirements and potential gaps and opportunities PHI insurers should be aware of as they get ready for ICAAP.

What is ICAAP?

ICAAP integrates the key elements of an insurer's risk management, business plans and capital management framework. It replaces capital management plans with a defined annual process that links with other regulatory requirements.

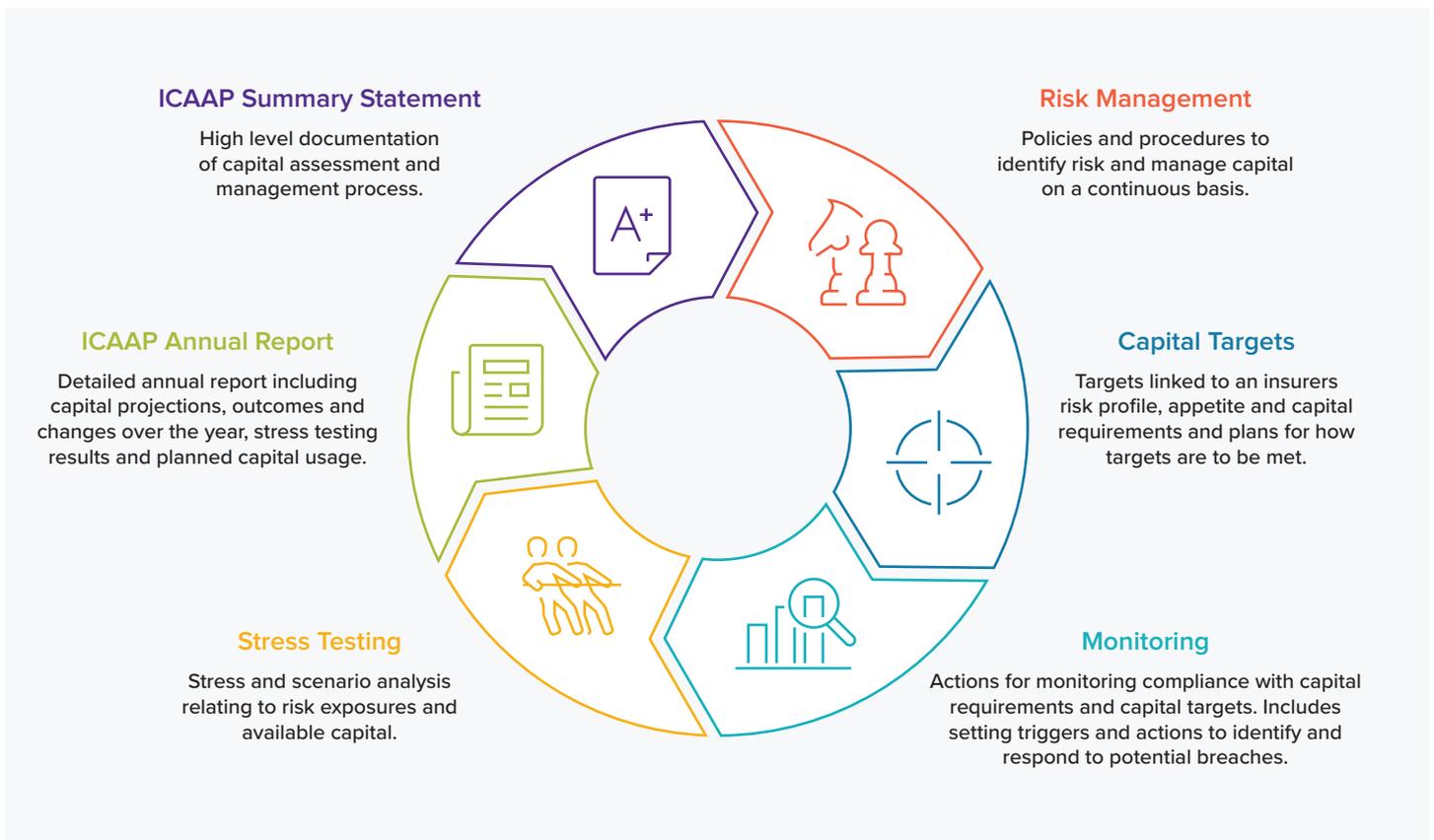


Figure 1 – Key elements of ICAAP

While new to PHI, ICAAP has been a requirement for ADIs and general insurers for a number of years. Senior management and the Board must ensure that the ICAAP is considered in making business decisions. There is also a formal requirement for the ICAAP to be independently reviewed no less than every three years.

"A private health insurer's ICAAP must be appropriate to its size, business mix and the complexity of its operations" – HPS 110 Capital Adequacy.



**An ICAAP report
must be submitted
to APRA annually.**

ICAAP Annual Report

An ICAAP report must be submitted to APRA annually. It is one of the key documents APRA will use to determine whether a supervisory adjustment to the insurer's prudential capital requirements is required. Among other things, the ICAAP annual report must include:

- A three-year projection of capital levels relative to minimum requirements and target levels
- A comparison of the ICAAP outcomes achieved over the year, relative to the projections in the previous ICAAP report
- A description of changes to the ICAAP over the year
- Details and outcomes of stress testing and scenario analysis
- A breakdown of plans for the use of capital over the planning horizon (for example to support existing business or to fund growth seeking initiatives)
- An assessment of anticipated changes in risk profile or capital management processes (for example expected changes in insurance or investment risk or planned revisions to capital targets)

ICAAP Summary Statement

The ICAAP summary statement outlines at a high level an insurer's capital assessment and management process. Among other things the summary statement must include:

- A statement of objectives and a description of the key assumptions and methodologies used in the ICAAP including stress testing and scenario analysis
- Triggers for reviewing the ICAAP (i.e. changes to operations, regulation and market conditions)
- The insurer's policy for reviewing the ICAAP including detail of the mechanisms to report review outcomes to the Board and senior management.

While the ICAAP annual report assesses the implementation of ICAAP over the last 12 months, projects capital outcomes into the future and is required to be updated each year, the ICAAP summary statement describes the capital management processes of the insurer at a point in time and may have a longer life. APRA does not mandate a particular format for either the ICAAP annual report or ICAAP summary statement.

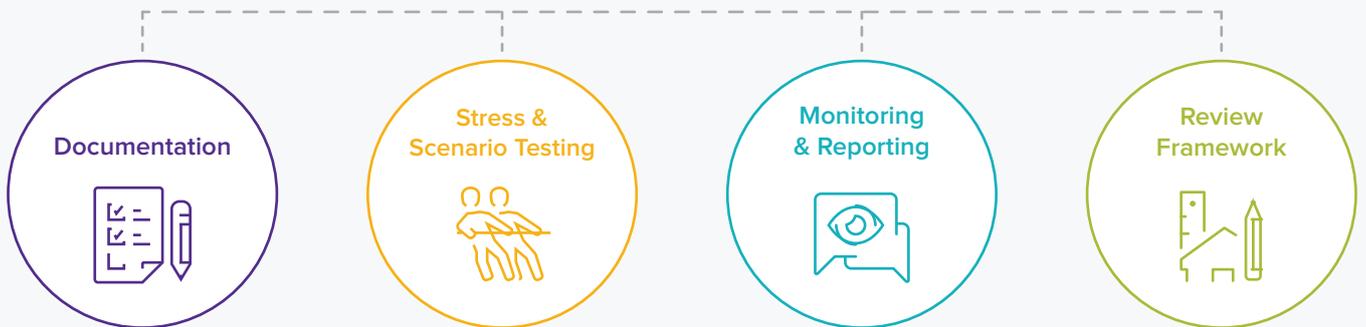


Identifying gaps

We expect that some of the work currently undertaken in preparation for the Financial Condition Report (FCR) will shift to the preparation of the ICAAP Report. The ICAAP documentation will likely include all of the content in existing capital management plans and some of the current Business Plan content.

The introduction of ICAAP, however, is not simply a re-orientation of existing processes and there are a number of gaps that insurers will be expected to close as part of the ICAAP implementation. We expect the following areas may require further development for many insurers (these examples are not exhaustive):

Potential Gaps



ICAAP documentation requirements are unlikely to be met by existing policies. Potential gaps include defining the time horizon of capital management processes, documentation of strategies to maintain or access new capital and identification of links between key policies (risk management framework, risk appetite statement, Business plan and ICAAP among others).

Most insurers already conduct stress and scenario analysis in some form, though there may be gaps in process under ICAAP. This may include integration of stress testing into decision making and setting of capital triggers or whether there is broad consultation and challenge in their development. The required degree of variation in stress testing, use of reverse stress testing and of mitigating actions in scenarios may also require improvement.

Most insurers will have triggers and actions in place in capital management plans to identify breaches of capital requirements. However many will not have a monitoring and reporting framework for the process of managing capital itself. This particularly includes the documentation required in the ICAAP annual report which provides details on the outcomes of the ICAAP over the previous 12 months, as well as covering detailed information on current and three year capital forecasts.

A specific requirement of ICAAP is the development of a review framework which includes an operationally independent review on the adequacy and effectiveness of ICAAP at least every three years. Insurers will need to determine the appropriate internal and external review responsibilities, policies and triggers.

Who can be an independent reviewer?

APRA requires an insurer's ICAAP be reviewed at least every three years by 'appropriately qualified persons who are operationally independent of the conduct of capital management'. In General Insurance, this role is typically held by an external audit firm. The Appointed Actuary for an insurer (either internal or external) is generally not considered adequately independent.

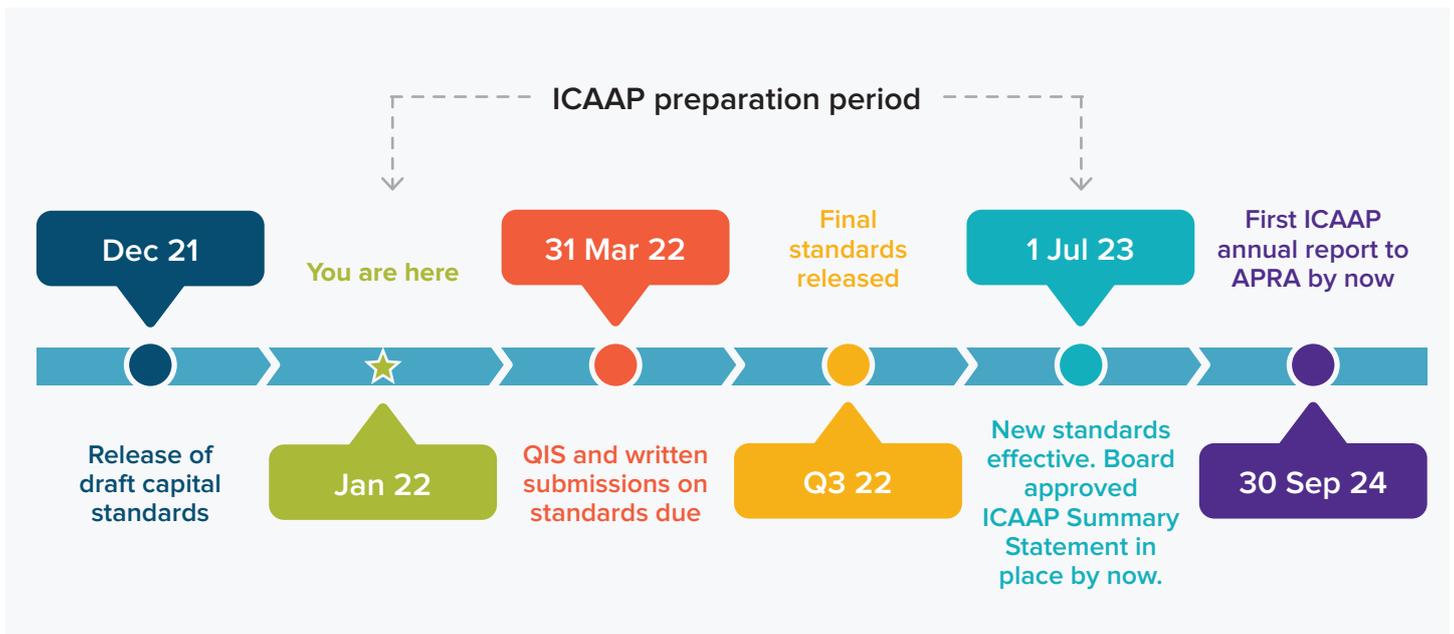


Taking things to the next level: ICAAP and DFA

Dynamic Financial Analysis or DFA, while not formally required under ICAAP, is a helpful tool commonly used by General Insurers under ICAAP to support capital management and planning. Stress and scenario testing considers future financial and capital outcomes under a base case and then estimates the impact of various alternative scenarios and stresses by changing individual assumptions and estimates (deterministic analysis). DFA on the other hand models the distribution of individual risks impacting an insurers financial and capital position and combines these to estimate the full range and likelihood of potential outcomes (stochastic analysis).

DFA is particularly helpful in quantifying earnings and capital risk impacts when an insurer's risk appetite and tolerances are articulated in a probabilistic way. For example an insurer may express an appetite for capital adequacy risk in the form of 'a risk of no more than 1% that the capital ratio will reduce below 1.2 times the prudential capital requirement (PCR). DFA can assess this risk and determine an estimated likelihood of specific financial and capital outcomes.

When will I need to act?



With the standards coming into effect 1 July 2023, health insurers should start planning for and developing the relevant ICAAP processes and documentation well in advance to avoid getting caught unprepared.

How Finity can help

With over 25 appointed actuary roles in General Insurance, Finity has supported many insurers through the ICAAP development, implementation and review process since its introduction to General Insurance in 2013 and we bring this knowledge and experience to our clients in the PHI sector. We can work flexibly with you through the ICAAP process and provide services ranging from full outsourcing of the development of your process to working with your in-house team on some or all aspects of the ICAAP including:

- Gap analysis
- Facilitating board discussions
- Risk analysis including stress testing, scenario analysis and DFA modelling
- Capital strategy
- ICAAP reporting templates

For more information about ICAAP and how Finity can work with you, have a chat with your Finity consultant.

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