Regulation Impact Statement

Outsourcing Standard
for Private Health Insurers

1. Executive Summary

1. The Private Health Insurance Administration Council (PHIAC) is an independent Statutory Authority that is the prudential regulator for the Australian private health insurance industry. PHIAC was established in 1989 as a body corporate under section 82B of the National Health Act 1953 (the NHA) and continues in existence by force of section 264-1 of the Private Health Insurance Act 2007 (the PHI Act).

2. Under section 264-5 of the PHI Act, PHIAC is required to take all reasonable steps to perform its functions and exercise its powers with a view to achieving an appropriate balance between:

   - fostering an efficient and competitive health insurance industry
   - protecting the interests of consumers
   - ensuring the prudential safety of private health insurers.

3. PHIAC's strategic vision is to protect consumers of private health insurance by ensuring a well-run and competitive industry. This is achieved by addressing challenges proactively and preventatively as well as directly when they arise. In responding to issues PHIAC has the ability to establish whole-of-industry regulatory settings, primarily in the form of new or updated prudential standards.

4. As well as taking service delivery, financial and demand pressures off the public health sector, private health insurance is a vital means by which a large proportion of the Australian population accesses health care. It is on this basis that the Australian Government has made a considerable investment in maintaining the industry.

5. In light of this, PHIAC has been charged by the Government, via the PHI Act, with the important task of regulating the private health insurance industry in a way which proactively identifies risks and responds preventatively. This is done with the goal of protecting consumers through the promotion of a viable, competitive private health insurance industry, and on the basis that the Government's appetite for an insurer's operational failure or collapse, including by poor outsourcing practice, is nil.

6. Outsourcing is common practice in the private health insurance industry. There are currently significant functions being performed by third parties and entities within insurers' corporate groups, including 25 of the 34 private health insurers using the same provider for their negotiation of contracts for hospital treatment and general treatment. There is a similar level of outsourcing of claims processing services in the industry, a key interface between consumers and private health insurers.

7. In its role as a proactive prudential regulator, PHIAC is proposing to exercise its powers under Division 163 of the PHI Act and make a prudential standard in relation to outsourcing (the Outsourcing Standard). Through this proposed Outsourcing Standard, PHIAC seeks to address the significant (potential or real) risks associated with insurers outsourcing material business activities. These are outsourcing arrangement which can be described as activities which have the potential, if disrupted, to have a significant impact on the insurer's business operations and / or

the insurer's ability to manage risks effectively. This significant impact can include impacts on third parties such as policy holders and service providers.

8. With the instigation of its proposed Outsourcing Standard (which, notably, is reflective of those imposed by PHIAC's domestic and international regulatory peers), PHIAC does not seek to restrict existing or future outsourcing arrangements. Rather, PHIAC aims to ensure that insurers meet minimum best practice requirements in outsourcing and are positioned to control the risks associated with outsourcing material business activities.

9. It is not PHIAC's intention in introducing the Outsourcing Standard to burden insurers with arbitrary or unnecessary regulation or intervention, nor to prejudice particular business structures or geographical locations. The Outsourcing Standard will encourage self-governed, principles-based best practice. Subject to the requirements of the Outsourcing Standard, insurers will have the flexibility to manage their outsourcing arrangements in the way most suited to achieving their distinct business objectives.

10. PHIAC acknowledges the important role outsourcing plays in the administrative arrangements of private health insurers, in particular, that it may result in efficiencies and cost savings. PHIAC does not seek to restrict existing or future outsourcing arrangements, but aims to ensure that insurers meet minimum best practice requirements and are positioned to adequately control the potentially significant myriad of risks associated with outsourcing material business activities.

11. PHIAC acknowledges that many insurers conduct themselves and their outsourcing arrangements in a risk conscious manner, and for these parties, the proposed Outsourcing Standard will necessitate minimal adjustment. Nevertheless, having regard to actual regulatory experience some insurers will need to significantly modify their arrangements to meet the proposed Outsourcing Standard and to appropriately protect their businesses and policy holders.

12. PHIAC has conducted two rounds of extensive consultation with the private health insurance industry and stakeholders, and has received broad support for the proposed Outsourcing Standard. Some issues raised during consultation relate to the proposed Outsourcing Standard's consistency with the equivalent standards for the banking and general insurance industries. These include: proposed requirements for around offshore outsourcing and vetoing powers and grandfathering existing outsourcing arrangements. These issues have been addressed through the re-drafting of the Outsourcing Standard and communicated to the industry.

13. PHIAC plans to continue in its collaborative regulatory approach, to educate the private health insurance industry about the key focus of the proposed Outsourcing Standard and to engage with insurers who seek guidance about how they may best implement the requirements of the Standard.

2. Introduction

14. This Regulation Impact Statement (RIS) considers options in relation to the establishment of minimum best practice requirements for outsourcing arrangements for registered private health insurers.

15. The private health insurance industry in Australia comprises 34 private health insurers registered under the PHI Act. In 2010-11, premium revenue for the industry totalled $15.42 billion, a significant jump from 2000, where premium revenue was only $5.46 billion. This increase reflects the maturation of the industry - not just the private health insurers themselves - but also the significance of private health insurance to the broader Australian health system. As at 30 June 2011, 11.89 million people in Australia, or 52.5% of the population, held some form of private health insurance.

16. The Australian Government supports the private health insurance industry through a range of measures and policies to maintain the affordability and access of private cover. To assist Australians with the cost of private health insurance premiums, since 1999 the Government has provided a rebate directly to consumers. In 2011-12 the private health insurance rebate totalled $4.95 billion.

17. An important feature of private health insurance is that it is ‘community rated’ as opposed to ‘risk rated’. The principle of this policy is that private health insurers have to base their prices on the type of policy only and not according to the risks attached to a particular policy holder. This means that every person purchasing the same policy will be charged the same price, regardless of their age or health condition. This is a major difference compared to other types of insurance where the price structure reflects the risks represented by a particular insured person.

18. Furthermore, in support of community rating, and to ensure that no insurer is unduly impacted by costly claims because of the risk profile of their members, the PHI Act provides that the costs of certain types of claims should be pooled and shared amongst all insurers. This practice is called risk equalisation and in 2010-11 PHIAC this resulted in $316,053,054 in Risk Equalisation Trust Fund payments to the industry.

19. There are also dual incentives for consumers to take out private health insurance and maintain cover for life, in the form of the Medicare levy surcharge and the life time health cover loading. The PHI Act also provides for portability, allowing insured persons to switch easily between insurers without having to re-serve waiting periods.

20. With the important role of private health insurance (and the private health sector) in the Australian health sector and the significant support from the Government comes commensurate regulation - with the Minister for Health, the Private Health Insurance Ombudsman and PHIAC all having specific regulatory roles under the PHI Act. All of these regulatory roles are in place to protect consumers and insure the industry’s ongoing viability. Additionally, all insurers are companies under the Corporations Act 2001.

21. PHIAC is an independent statutory authority and is the prudential regulator of the private health insurance industry and oversights a range of regulatory elements of the private health insurance industry under the PHI Act. Since it was established in 1989, PHIAC has worked diligently to become an effective industry regulator and trusted adviser to government. In so doing, it has ensured that no consumers of private health insurance in Australia have been disadvantaged or left out-of-pocket because of the prudential failure of a private health insurer. PHIAC has also managed insurer failures proactively by ensuring consumers transfer to equivalent policies during a facilitated merger or takeover.

22. In 2007, through the implementation of the PHI Act, the Government significantly increased the role and powers of PHIAC. In particular, PHIAC's oversight was extended beyond financial regulation to include oversight of "Council-supervised obligations", which includes the Risk Equalisation arrangements, prudential standards and the day to day operations of health benefits funds. This oversight extends from registering new entrants to the market, assessing applications for mergers and changes to for-profit status, oversighting complying health insurance policies, reviewing the expenditure and use of assets and compliance with industry standards, including the capital adequacy, solvency and prudential standards.

23. PHIAC has a range of enforcement powers including the ability to seek injunctions, to require the provision of information, to seek enforceable undertakings, to issue directions, to seek the application of criminal provisions and the orders from the Federal Court.

24. Under the PHI Act, PHIAC was given the power to make prudential standards (to make law via subordinate legislation). The prudential standards may be made in relation to the conduct by private health insurers of any of their affairs in such a way as to keep themselves in a sound financial position, not to cause or promote instability in the Australian private health insurance system or the conduct by private health insurers of any of their affairs with integrity, prudence and professional skill.

25. PHIAC has utilised the power to date to make prudential standards in relation to appointed actuaries, governance and disclosure requirements. These standards were made to address concerns identified by PHIAC in the operation of private health insurers, but also in response to lessons learnt in other jurisdictions including in Australia (experiences in particular of the Australian Prudential Regulation Authority [APRA]) as well as international experience in particular as reflected in core best practice regulation identified by the International Association of Insurance Supervisors [IAIS]).

26. PHIAC is now considering the regulation of outsourcing arrangements by private health insurers. Outsourcing of functions can be an important way of increasing efficiency and reducing cost pressures. Failures in outsourcing arrangements either by poor management or poor provision of services can have significant impacts on insurers, policy holders, health service providers and the industry as a whole. Principle-agent problems, regulatory failure and negative impacts on insurers or third

parties are important issues in considering whether or not to respond to outsourcing with formal regulation.

3. Background

27. While PHIAC has a well-developed regulatory framework in a range of areas (as noted above) including in particular for controlling the financial stability of insurers through the Capital Adequacy and Solvency Standards, the regulatory levers available to PHIAC to control risks associated with outsourcing are absent and hence the need to consider additional regulation, in particular via the power to make prudential standards.

28. The first prudential standard made by PHIAC was the Appointed Actuaries Standard in 2007. This Standard supports the PHI Act requirement for insurers to have an Appointed Actuary, and that they must be involved in or notified of:

    - pricing
    - new product development
    - monitoring and adhering to financial standards
    - application of certain Australian equivalents to International Financial Reporting Standards
    - preparation of the insurer's annual financial condition report.

29. The role of the Appointed Actuary is important for both the insurer and PHIAC. In particular, the Appointed Actuary provides additional support and technical advice to insurers while operating as an element of the prudential oversight of the industry by PHIAC.

30. In 2009, PHIAC introduced a Governance Standard for private health insurance, which set out minimum requirements for good corporate governance, in line with Australian Stock Exchange and APRA best practice, to mitigate the risks of an insurer failure associated with poor governance.

31. In 2010, PHIAC introduced a prudential standard relating to disclosure of information, to better position PHIAC to understand the business operations and risk profile of private health insurers. Both of these existing prudential standards are principles based, as opposed to rules based standards. They provide firm guidance, but importantly allow insurer's requisite flexibility to manage their affairs, and also allow PHIAC to engage early with insurers and seek resolutions before a crisis eventuates.

32. Outsourcing involves an insurer entering into an arrangement with another party (including an entity within a corporate group) to perform a business activity which currently is, or could be, undertaken by the insurer. Effective outsourcing allows arrangements to be put in place more quickly and potentially at a lower cost than would be the case if the service was provided in-house.

33. PHIAC is generally supportive of industry outsourcing, as in many instances the practice provides economies of scale and cost efficiencies to insurers. PHIAC has no preconceived views as to whether or not outsourcing should occur and whether or not such arrangements should be domestic or offshore. Outsourcing does, however, create the potential for the transfer of risk along with the management of that risk to third parties, and this may impact on insurers to adequately manage, control or monitor risks for which they are ultimately responsible.

34. There are, in essence, no regulatory controls under the PHI Act around the outsourcing of material business activities by private health insurers. This is despite the fact that prudential standards relating to outsourcing exist in comparable Australian financial sector industries including general insurance, life insurance, superannuation and authorised deposit institutions (which include banks and credit unions). Controls in relation to outsourcing risks are also articulated through the international best practice regulation of insurance markets.

4. Problem identification

Context

35. Private health insurers have historically outsourced a range of business activities, including administrative functions, claims processing functions and group negotiations for private hospital contracting. Through PHIAC's fund review process, and in receiving industry feedback about the proposed outsourcing regulation, PHIAC has identified that industry wide, there are currently significant functions being performed by third parties and entities within insurers' corporate groups.

36. For example, 25 of the 34 registered private health insurers operating in Australia outsource their negotiation of contracts for hospital treatment and general treatment to only one service provider. This almost monopolistic arrangement is an example of the concentration risk that the industry is exposed to. There is a similar level of outsourcing of claims processing services in the industry, a key interface between consumers and private health insurers.

37. Furthermore, two insurers outsource the entirety of their business operations, including the position of CEO, to a third party outside of their corporate group. Essentially, these insurers operate as nothing more than a brand, and yet have to meet all relevant regulatory requirements required of a registered private health insurer. There are examples of insurers outsourcing a similar level of management functions to entities within their corporate group.

38. An example of this was when one private health insurer outsourced most of its material business activities to entities within its own corporate group, and for that matter, a corporate group whose overall business operations, it was essentially funding. This arrangement – riddled with a number of conflicts, and subject to significant risk creep – led to significant internal instability and uncertainty.

39. Past examples of insurer failures, including Goldfields Medical Fund in 2001 and the Independent Order of Rechabites in 2002, were primarily due to poor management, however, poor selection and oversight of outsourcing arrangements were a contributing and exacerbating factor. PHIAC's intervention during these failures, and its and management of the subsequent mergers, enabled the identification of the absence of a selection process for service providers, adequate risk assessments or monitoring of material arrangements as issues of concern.

Regulatory failure

40. PHIAC considers that there is a regulatory gap in terms of its current capacity to oversee the outsourcing practices of the private health insurance industry. This may in fact be characterised as a "regulatory failure".

41. As the regulatory framework now operates, if a significant business function of an insurer is outsourced to an entity that is not a registered private health insurer, PHIAC's regulatory options and powers in relation to that insurer are limited.

42. In PHIAC's experience (and reflecting other domestic and international experience), the absence of a clear articulation of industry-wide expectations with regard to the best practice requirements for managing outsourcing, some private health insurers do not adequately manage risks associated with outsourcing. PHIAC knows this because it has observed that elements of the industry as it stands do not proactively guard against outsourcing risk, as is currently required by PHIAC's domestic and regulatory peers, such as the Australian Prudential Safety Authority (APRA) and Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS).

43. Outsourcing material business activities to a service provider outside of Australia adds additional layers of complexity, risk and increased potential for failure.

44. PHIAC monitors the operations of private health insurers through its informal rolling program of fund reviews. Fund reviews involve PHIAC officers conducting site visits voluntarily acceded to by insurers which include interviews of key staff, physical audits, analysis of Board papers and evaluation of business systems. In relation to specific areas of industry compliance, PHIAC may conduct fund reviews through desktop analysis.

45. Through conducting targeted reviews and analysing quarterly and monthly financial reports, PHIAC is able to monitor key areas of risk including:

- failure to have a strong, effective and diversely skilled board;
- ineffective management;
- weak governance structures with poor risk, compliance and assurance functions;
- poor strategic planning;
- failure to meet operational cash flow requirements;
- poor internal control and business operations;

- failure to adequately respond to the inherent volatility of the share market and other investment options;
- insufficient insurance coverage; and
- failure to maintain sufficient capital to ensure long term viability.

46. Regular monitoring of these risk areas allows PHIAC to identify trends and to develop and implement strategies (including prudential standards), to reduce the likelihood of these risks having an adverse impact on policy holders.

47. This monitoring can lead to PHIAC utilising its powers to respond to a breach, or potential breach of the regulatory requirements by an insurer. The potential breach of the PHI Act will depend upon a number of factors, including the nature and severity of the alleged breach or potential breach of the PHI Act, and an insurer's responsiveness to PHIAC's investigation of an issue.

48. As mentioned above, PHIAC's associated enforcement powers include:

- giving notices or directions;
- seeking injunctions;
- requiring the provision of information;
- seeking enforceable undertakings; and
- seeking the application of criminal provisions and the orders of the Federal Court.

49. While the fund review program is an effective monitoring tool, unless a prudential standard or other regulatory power exists relating to a finding in the fund review, and PHIAC is empowered to take action, PHIAC can only issue non-binding recommendations to insurers relating to their conduct. While the fund review program is generally a voluntary arrangement between the parties whereby PHIAC is able to form a view as to the appropriateness of insurers' outsourcing processes, it cannot institute a formal remedial requirement.

50. There is currently no regulator-articulated obligation for private health insurers to develop and implement their outsourcing practices in a risk conscious or best practice manner. This not only creates inconsistency of industry practices, but it could also potentially put consumers and the stability of the private health insurance system at risk.

51. PHIAC's inability to either directly or indirectly regulate the performance of outsourced material business activities is not the problem PHIAC seeks to address through future regulation. Rather, PHIAC aims to ensure that private health insurers plan for, develop and implement their outsourcing arrangements in a way which will eliminate the need for regulatory intervention – by PHIAC, or other regulators for that matter – by adopting more rigorous process for identifying and addressing the key risks associated with outsourcing significant functions.

52. PHIAC is keen to learn from, and ensure consistency with, other Australian and international regulatory regimes. As well as meeting best practice regulation to the extent that this is appropriate, the proposed prudential outsourcing standard

responds to PHIAC experience and the experience of other jurisdictions. Accordingly, in developing this RIS, PHIAC has considered the following sources and events:

- **PHIAC's supervisory experience:** PHIAC's oversight of the private health insurance industry has highlighted the variability of insurers' outsourcing arrangements, identified associated risks (for private health insurers, the industry as a whole, and policy holders) and established the need to consider having industry-wide minimum standards in place.
- **Enactment of the PHI Act:** the PHI Act was enacted in 2007. As noted earlier, the legislation contains provisions which specifically empower PHIAC to make prudential standards addressing "the conduct by private health insurers of any of their affairs with integrity, prudence and professional skill".
- **APRA Prudential Standards.** An outsourcing standard has been in place for authorised deposit-taking institutions since 2002, and general insurers since 2007. APRA has also recently standardised outsourcing arrangements across all institutions regulated by APRA.
- **International principles on outsourcing** issued by the Joint Forum in 2005, comprising the Basel Committee on Banking Supervision, the International Organisation of Securities (the IOS) Commissions and the International Association of Insurance Supervisors (the IAIS). These principles outline internationally accepted benchmarks for minimum supervisory standards, against which the quality of a country's prudential supervision of outsourcing arrangements can be measured and assessed.
- **International prudential regulators.** In recent years, many overseas prudential regulators have introduced comprehensive guidance material and institutions relating to outsourcing, including the Office of the Superintendent of Financial Institutions in Canada and the Financial Services Authority in the United Kingdom.

53. All of the above is evidence of how without a clear and consistently articulated standard set by its regulator, the industry may be unable to adequately manage risks associated with outsourcing. It is also clear evidence of how failure of an insurer's material business activity imposes unacceptable negative impacts on third parties.

Principle-agent problem

54. Private health insurers take premiums from policy holders and manage their resources to meet future benefit claims of policy holders and other financial obligations. This opens the private health insurer up to a range of risks that, if not appropriately managed, could lead to the private health insurer failing to meet insurance and other obligations. For example, a private health insurer's management may take undue risks with policy holder funds.

55. Appropriate risk-based outsourcing requirements increase the likelihood that obligations to policy holders can be met and they provide some protection where

management may take undue risks with policy holder funds. Where outsourcing requirements are both adequate and risk conscious, sound risk management can also be encouraged, helping to reduce the potential for insurers to take on excessive exposure to risks.

56. The likelihood of adverse events such as those outlined above occurring is high, as there is currently no articulation of requirements (industry standards) or expectations (practice notes or self-regulation) within the private health insurance industry as to what constitutes economic and risk conscious outsourcing.

57. The question may be asked: why is this a bad thing? And the suggestion may be made: won't market forces inform a kind of intrinsic self-regulation of the industry? As explained earlier, the Australian private health insurance industry is a unique and vital feature of the Australian healthcare system as a whole. For more than 50% of the Australian population, it means the ability to receive necessary and urgent medical care.

58. Accordingly the Australian Government's and PHIAC's appetite for risk and the preparedness to accept operational failure or the collapse of an insurer is low, as evidenced by the proactive and preventative approach to regulation PHIAC is charged with protecting consumers. The possibility that policy holders or other third parties may suffer loss as the result of poor risk controls is considered to be an unacceptable risk that should be treated.

Failure of a material business activity

59. If a private health insurer outsources a material business activity, the stability of its operations could potentially be at risk. For example, if a private health insurer were to outsource its claims processing function, the means by which a large amount of the insurer's liabilities are administered, would be left in the hands of an unregulated entity. If that unregulated entity, for whatever reason, failed to perform that material business activity, or failed to perform it to service level standards, two possible problems could result:

    1) private health insurance policy holders would be provided with inaccurate (and possibly, deficient) claims payments; and
    2) if through maladministration, the insurer was liable for policy holder losses and the costs associated with fixing the problem, the insurer would suffer losses, and could potentially look to pass these on to policy holders through premium increases.

60. Using a Qualitative Risk Analysis, while the above scenario may be assessed as unlikely, the impact can be severe, as it could potentially threaten or necessitate the need for significant adjustment to the operations of individual insurers or to the overall goals and objectives of the private health insurance industry as a whole if a large insurer is impacted.

61. Potentially, if one or more private health insurers fail due to the implementation of risky and poorly-managed outsourcing practices, private health insurance policy

holders receiving health services at the time could find their policies are not able to cover the costs of the service, and the value and stability of the private health insurance industry may be brought into question.

Third party impacts

62. While outsourcing of any type changes the risk profile of an insurer, PHIAC's particular concern is with the significant risks (real or potential) associated with insurers outsourcing material business activities, which can be described as activities which have the potential, if disrupted, to have a significant impact on the insurer's business operations and / or the insurer's ability to manage risks effectively. This significant impact can include impacts on third parties.

63. This concern is raised on the back of PHIAC's experience in oversighting the industry as its source prudential regulator.

64. A recent example is of a private health insurer that outsourced a function to an offshore service provider, which was unable to perform the function appropriately. In particular, the service provider was found to be providing incorrect advice to policy holders, contrary to the insurer's specified service levels. This led to the exposure of policy holders to unexpected liabilities, and complaints to the regulators, including PHIAC and the Private Health Insurance Ombudsman (the PHIO).

65. The effect of this was a negative impact:

- on specific policy holders (with exposure to potential unexpected liabilities)
- on the reputation of the insurer, health service providers and the industry as a whole, and
- on the value proposition of private health insurance.

66. To remedy this situation the insurer was forced to:

- return the performance of the function in-house (at considerable additional expense)
- meet the liabilities of the policy holders
- manage complaints from consumers, health services providers, and
- respond to investigations by industry regulators.

67. In the context of failures such as those mentioned above and in reference to the externality problem created by outsourcing, Australian consumers may lose confidence in a private health insurer or the private health insurance industry as a whole. In the event of this happening, it is plausible that consumers may move on mass (creating significant churn and consequential risk within the industry) and / or could drop their cover and rely solely on the public health care system.

68. The health service providers funded by private health insurance would be likely to suffer losses and potentially fail themselves, in the context of such collapses.

69. The abovementioned scenarios are a glimpse at the variety of actual, or hypothetical, forward-thinking situations in which third parties suffer unexpected loss or costs as the result of failed outsourcing practices.

Potential for failure

70. There is significant potential for failure of outsourced material business activities, some of which PHIAC has observed in its ongoing supervision of the industry. Through its fund review program, PHIAC has observed:

    - That the relationship of insurers with the industry owned service providers is not the same as the usual customer / provider relationship in other industries. There is little competitive pressure on these providers as the ownership arrangements provide an incentive to remain using the services. The governance arrangements of these providers are such that the directors of the companies are also their customers and owners. For reference, PHIAC's best practice Governance Standard requires insurers to have a minimum number of independent directors.
    - Situations in which an insurer operates as part of a larger corporate group and by nature, reactively defaults to outsourcing within that group. Such outsourcing arrangements are on occasion, entered into to the detriment of the insurer, as the subject service may be underperformed and /or provided at a cost which may not be in line with competitive market rates. This ineffective selection process can lead to poor monitoring, deficient risk controls and associated cost increases. As such poor selection processes represent a risk of failure.
    - More generally, because insurers aren't turning their collective minds to the risks associated with the practice of outsourcing, the risks themselves are heightened and more likely to be realised.

71. In explaining the forward-thinking hypothetical scenarios outlined above, PHIAC is mindful of the probability of risk, or how common each risk is within the industry as it operates today.

72. Following on from its oversight of the industry, PHIAC has identified potential reasons for the failure of an outsourcing arrangement, including:

    - **Tendering process not effectively employed.** There is potential for failure if the insurer does not select the most appropriate supplier to deliver the service. Competitive tender and selection processes are vital for appropriate appointment of service providers, and form a part of best practice outsourcing.
    - **Upfront risk assessment not performed.** If an insurer has not fully considered the risks of the outsourcing it is easy to make poor outsourcing decisions, even when the right provider is chosen. Best practice outsourcing requires a due diligence process, which minimises this risk.
    - **Effective monitoring process not used.** After establishment of an outsourcing arrangement, effective, ongoing contract management processes are not always employed. Risk of failure decreases dramatically if the outsourcing arrangement

is appropriately managed and controlled. Best practice suggests monitoring of outsourcing arrangements should be comprehensive and well resourced.

- **Misunderstanding the service levels.** Requiring outsourcing arrangements to be in writing reduces the risk that arrangements are misunderstood by both parties. PHIAC is aware of a number of examples of this occurring in the industry.
- **Outsourcing a function that is underperforming.** It is possible that an insurer will tend to outsource a function that is not performing well internally. Business requirements are difficult to communicate when the process in question is failing or underperforming. Effective management of an outsourcing arrangement requires an understanding of how the process is supposed to work and needs to be detailed on the agreement.

Offshore risk

73. PHIAC has no preconceived issues with the location of an outsourced service provider. Locations other than Australia may offer significant cost efficiencies and skills concentration. The practice of offshore outsourcing is indicative of the globalisation of markets. PHIAC will not oppose insurers from accessing the opportunities available in international markets. However, the offshore outsourcing of material business activities carries with it additional risks for the insurer, as there is far less effective control over the service provision. Specific risks associated with offshore outsourcing include:

- privacy obligations for overseas providers that may be inconsistent with Australian standards.
- the ability to enforce a contract in a different jurisdiction;
- choice of applicable laws in the contract (including in relation to privacy or dispute resolution);
- the political, social and legal climate in the other country; and
- ability to return the activity to be performed in-house if required.

74. These offshore risks are in addition to the generic outsourcing risks identified below, and are of sufficient significance to warrant additional consideration and treatment by insurers. Notably, international and Australian best practice provides that offshore outsourcing should be subject to a higher level of risk assessment.

Risk Identification

75. The specific and potential risks associated with the outsourcing of material business activities are diverse, and pose potential threats to individual private health insurers as well as the stability of the Australian private health insurance industry. Problems identified with regard to the outsourcing are considered by PHIAC to have the potential to be key risks to private health insurers. These include but are not limited to:

    1) **Strategic risk,** if the outsourced service provider conducts activities on its own behalf which are inconsistent with the overall strategic goals of the insurer; or if

the insurer has inadequate expertise to oversee the service provider, or fails to monitor the outsourcing arrangement appropriately;

2) **Compliance and Privacy risk,** should prudential, consumer or privacy laws not be complied with, due to the outsourced service provider having inadequate compliance systems and controls;
3) **Legal and reputational risk,** stemming from poor service or a failure to deliver from a service provider. Customer service may not be consistent with the overall standards of the insurer, due to the service provider's practices not being in line with stated practices (ethical or otherwise) of the insurer;
4) **Operational risks** such as significant loss of control, reliability and responsiveness throughout the term of the outsourcing arrangement; fraud or error; risk that PHIAC or other external auditors find it difficult or costly to conduct inspections; technology failure; or other hidden or uncertain costs;
5) **Access risk,** if an outsourcing arrangement hinders the ability of an insurer to provide timely data and other information to PHIAC and other regulators. Instigation of an outsourcing arrangement may hinder PHIAC's ability to properly oversee the operations of the insurer;
6) **Business continuity risk,** in the event that appropriate exit strategies are not in place and the service provider no longer proves to be a viable entity, including contracts which make a timely exit prohibitively expensive;
7) **Loss of internal capacity** as the ability to perform the outsourced function in house is reduced or removed, due to the loss of relevant skills and corporate history from the insurer; and
8) **Concentration and systemic risk,** including the overall exposure the industry has to one or more outsourced service providers, and the potential for those service providers to refuse to cooperate with PHIAC.

76. While all of the risks identified above relate to outsourcing of material business activities, as a prudential regulator, PHIAC is particularly concerned with concentration, contagion, and systemic risk. This is the risk that a service provider that is essentially monopolistic and systematically important to the industry is not appropriately reviewed by insurers, and / or refuses to cooperate with PHIAC.

77. There have been cases where the selection process, contracts and / or monitoring procedures relating to outsourcing arrangements were poor, or could have been improved. Situations in which failures by insurers to effectively manage their outsourcing arrangements has the potential to impact on consumers.

5. Objectives

78. Private health insurance is a fundamental element of the Australian health system, in that it provides for a large proportion of Australians' access to health services and reduces pressure on the public health system. PHIAC focuses in its role as a risk-based preventative prudential regulator, on monitoring and regulating the industry, maintaining its prudential standing, protecting consumers, and increasing consumer participation in private health insurance.

79. PHIAC plays an important role in fostering an efficient and competitive industry, and protecting and supporting consumers. A vital aspect of its risk-based prudential role is ensuring that private health insurers conduct themselves in a prudent and risk

conscious manner. PHIAC's aim is to avoid the possibility of operation failure of an insurer, insurer collapse, and any consequent industry instability. PHIAC also seeks to protect consumers of private health insurance from the negative impacts of any level of failure. To date, no such event has occurred, and this is due in large part to PHIAC's preventative, pro-active approach to regulation.

80. Specifically, PHIAC's objective is to improve the business and risk management practices of insurers in relation to outsourcing. This objective stems from PHIAC's statutory objectives under section 264-5 of the PHI Act and the power and intent of Division 163 of the PHI Act. In particular, PHIAC seeks to appropriately respond to identified regulatory issues (identified from PHIAC's oversight or experiences in other jurisdictions both domestic and overseas) while achieving a balance between fostering an efficient and competitive health insurance industry, and protecting the interests of consumers of health insurance.

6. Options

Option 1 – retain status quo: no specific requirements regarding insurer outsourcing arrangements

81. Under this option, there would be no change to current arrangements, and PHIAC would continue to review outsourcing arrangements in the context of its program of fund reviews. PHIAC would continue to provide recommendations on proposed improvements in outsourcing practices on an individual, fund-by-fund basis.

82. Where necessary, PHIAC would hold direct discussions with third party service providers who are willing to cooperate with PHIAC, although they would be under no legal obligation to do so. Where a service provider refused to cooperate, PHIAC would have to rely on its relationship with the insurer to ensure resolution of any issues.

83. This option is not preferred as it does not address the identified risks in the private health insurance industry. There is currently no requirement for third parties to cooperate with PHIAC and no requirement for insurers to implement better practices in undertaking outsourcing arrangements. This limits PHIAC's regulatory ability and increases the risk of the continuation of poor practice in the industry.

Option 2 – provide guidance and information to insurers in relation to outsourcing arrangements

84. This option involves the development of guidance material to educate the industry and encourage it to adopt best practice arrangements for outsourcing. This approach largely relies on the good intentions of the insurer to improve its outsourcing practices and does not provide PHIAC with any formal capacity to address concerns as they arise.

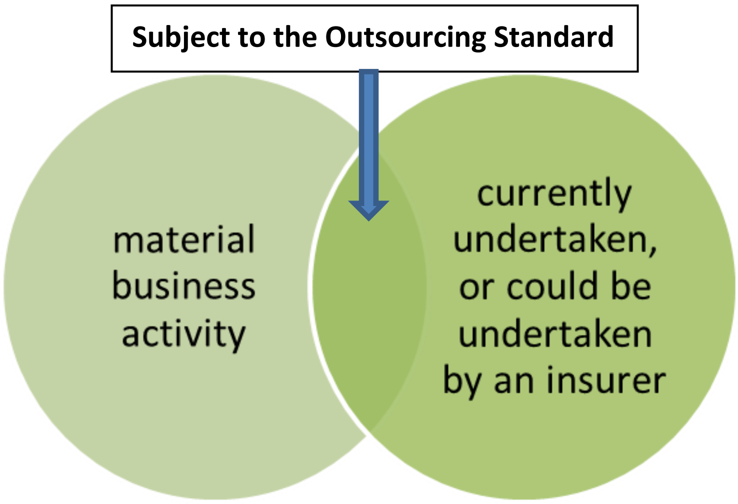
85. While there may be some improvements in individual insurers, this approach is subjective and would leave it to each individual insurer to interpret their obligations. This would likely lead to the continuation of inconsistent approaches to outsourcing being taken across the industry.

Option 3 – establish principles-based regulation in the form of a best practice prudential standard to ensure that insurer outsourcing arrangements adopt minimum requirements (preferred option)

86. Under this option, PHIAC would exercise its legislative powers under Division 163 of the PHI Act to introduce a new industry-wide prudential standard relating to outsourcing (the Outsourcing Standard). The Outsourcing Standard would appear as a new Schedule to the Private Health Insurance (Insurer Obligations) Rules 2009 (the Rules).

87. Notably, if an activity is not currently undertaken, or could not be undertaken by an insurer itself and is not a material business activity, it will not be subject to the Outsourcing Standard (see Figure 1). This being said, all insurers will be encouraged to use the Standard's framework for all outsourcing arrangements and are required to have an Outsourcing Policy.

Figure 1: venn diagram identifying arrangements which will be subject to the Outsourcing Standard



Caption: The above diagram identifies which arrangements will be subject to the Outsourcing Standard. As indicated, the Outsourcing Standard is seeking to govern outsourcing arrangements which involve a material business activity of an insurer, which is currently undertaken, or could be undertaken by an insurer itself.

88. A material business activity will be described in the Outsourcing Standard as an activity that has the potential, if disrupted, to have a significant impact on the insurer's business operations and / or the insurer's ability to manage risks effectively.

89. The Outsourcing Standard will set out the best practice principles private health insurers will need to comply with in relation to the selection, engagement and monitoring of outsourcing arrangements and the associated risk management practices. Importantly, it will be a principles based best practice standard and no more onerous than the comparable APRA standard. It will set minimum requirements to aid the effective operations of insurers and impose accountabilities on insurers to comply. The requirements of the standard will include:

Outsourcing policy

90. Under the best practice standard, all private health insurers will be required to have a Board-endorsed outsourcing policy that sets out its approach to outsourcing and describes how the insurer will conduct its selection process for outsourced service providers of material business activities.

91. The policy must be followed by the insurer and insurers must be able to demonstrate to PHIAC that it is being followed. The policy and will describe the different requirements when outsourcing a material business activities to entities within its corporate group (related bodies corporate) and to unrelated third parties.

92. When outsourcing to a third party, insurers will be required to prepare a business case, conduct a selection process, prepare a due diligence review of the chosen provider, and develop contingency planning, dispute resolution procedures and appropriate monitoring arrangements. When outsourcing to a related body, insurers will have lessened requirements.

93. This requirement to conduct selection processes is likely to increase the level of competition for certain types of service providers.

Risk management

94. For all outsourcing arrangements, the insurer is to conduct a risk assessment, develop and implement risk controls and regularly report to its board in relation to their effectiveness. The insurer is also to stay in regular contact with the outsourced service provider and monitor the outsourcing arrangement against the agreed service levels.

PHIAC access

95. Insurers will be required to ensure PHIAC has access to the documentation and information held by the outsourced service provider, including making site visits to the service provider when necessary, although this would only be in cases where the insurer has failed to provide requested information. This requirement reflects an extant APRA requirement and is not expected to impact on competition (please see a further discussion of competition below at “Offshore outsourcing – competition issues”).

Offshore outsourcing

96. In addition to the requirements of the outsourcing policy, insurers that are intending to enter into an outsourcing arrangement to be performed outside of Australia will be required to notify PHIAC before they enter into the arrangement, and to provide PHIAC with the associated risk assessment and risk controls.

97. If PHIAC is not satisfied that the insurer's risk management is adequate to manage key risks that might arise from the outsourcing arrangement, PHIAC may require the insurer to review the arrangements. This may include:

- requiring the insurer to reconsider its risk management analysis and control framework in relation to a particular outsourcing arrangement; or
- requiring the insurer to reinforce an existing outsourcing arrangement with a specific policy or schedule outlining further terms and / or conditions; or
- requiring the insurer to break an existing outsourcing arrangement and then make an outsourcing arrangement with an alternative service provider.

98. PHIAC will have regard to the privacy implications in relation to the personal information of consumers of private health insurance in its appraisal. If a potential breach of privacy law is identified, PHIAC would refer this to the appropriate authority.

99. PHIAC's inclusion of an offshore outsourcing provision in its proposed Outsourcing Standard is to reduce the risk of interruption or failure of the material business activities of insurers, to protect policy holders, the reputation of the particular private health insurer, and the private health insurance system as a whole.

100. It is not the intention or the effect of the proposed Outsourcing Standard to restrict industry competition, or to "veto" or "override or block" offshore outsourcing arrangements.

Offshore outsourcing – competition issues

101. The aim of the proposed Outsourcing Standard is not to require insurers to seek PHIAC's permission before outsourcing. Only after notification of an offshore outsourcing arrangement, if PHIAC assesses the risk management analysis associated as being inadequate, could PHIAC require the insurer proposing the arrangement to review its analysis or make other arrangements for the performance of the service. Such an assessment would not be intended to, or have the effect of restricting the type of business structure or location an insurer outsourced through or to. Any such assessment would be conducted on a case-by-case basis, and would not prejudice any particular proposed business structure or geographic location.

102. A core focus of the proposed Outsourcing Standard is to encourage insurers who utilise particular service providers for performance of their material business activities, to reflect on these existing arrangements and place them under the same scrutiny as outsourcing arrangements which are being newly considered. The

proposed Outsourcing Standard clearly articulates the extensive measures insurers should take when assessing options to enter into, renew or renegotiate an outsourcing arrangement.

103. As such, the proposed Standard in fact in PHIAC's view promotes and fosters an environment of competition within the potential service provider market.

Notification

104. Insurers would be required to notify PHIAC of outsourcing arrangements within 28 days after the execution of the agreement (other than for offshore arrangements which require notification in advance), and to notify PHIAC of any problems being encountered, which may significantly impact on an outsourcing arrangement.

105. Subject to the requirements of the Outsourcing Standard, insurers will have the flexibility to manage their outsourcing arrangements in the way most suited to achieving their distinct business objectives.

106. PHIAC recognises there is a broad continuum in outsourcing arrangements. In this context many insurers already have high standards for managing outsourcing arrangements across business operations. In many cases insurers will not have to change processes significantly to meet the outsourcing standard. So saying, there are insurers who will need to take significant action to bring their processes in line with the new requirements.

107. It is noted that the proposed outsourcing requirements are, where appropriate, in line with the APRA cross-industry outsourcing standard, CPS 231.

108. PHIAC acknowledges the important role outsourcing plays in the administrative arrangements of private health insurers, in particular, that it may result in efficiencies and cost savings. PHIAC does not seek to restrict existing or future outsourcing arrangements, but aims to ensure that insurers meet minimum best practice requirements and are positioned to adequately control the potentially significant myriad of risks associated with outsourcing material business activities.

7. Impact Assessment

Industry

Option 1

109. As there would be no changes to the current arrangements for managing outsourcing arrangements by private health insurers, oversight by PHIAC would remain subject to the informal fund review process, with no recourse to formal regulatory options.

110. This approach would impose no additional compliance burden or cost on the industry. The benefits to the industry may be no additional regulation and reliance on

self-regulation. Noting that the risks associated with outsourcing material business activities would continue to be managed by insurers on an ad hoc basis.

111. Insurers and the industry as a whole would not necessary see any improvement in the management of outsourcing arrangements and the risks would in all likelihood remain, in essence, unchanged. In particular, no formal regulatory options would be available to address any concerns that may accrue from the establishment of outsourcing arrangements and hence there would be no additional protections in place.

Option 2

112. Option 2 may impose some costs on the industry, as those insurers that wish to change their practices to adopt the optional information material would amend their policies and practices to align with the best practice model. For those insurers' adopting the best practice model, the costs involved would be very similar to those associated with option 3, the establishment of an outsourcing standard, as it prescribes a best practice approach. Accordingly, the benefits involved for this group of insurer's would be very similar to option 3.

113. For those insurers not willing, however, to change their practices and processes to align with accepted best practice, the initial costs would be nil. However, by not following the best practice approach to outsourcing, those insurers would continue to be at greater risk of suffering potentially significant losses due to the poor selection, oversight and / or management of an outsourcing arrangement involving a material part of their business. The benefits to this group of insurer's would be nil, as they have not realised the potential benefits of a best practice approach.

114. While this option may see some additional self-regulation, PHIAC's regulatory tools would remain on the current settings of oversight via informal review and no formal capacity to respond to risk or failures. As such, the industry and some individual insurers may still be exposed to risk and failure arising from the poor management of outsourcing arrangements.

Option 3

115. PHIAC is of the view that the costs associated with Option 3 - the introduction of the Outsourcing Standard - will not be significant. A good proportion of insurers already meet some or a majority of the proposed requirements and would therefore face little or no additional costs in relation to these proposals – this has been confirmed by industry consultation.

116. The Outsourcing Standard would establish a requirement to meet minimum levels of best practice and should therefore only have a significant impact on those insurers who do not currently have these practices in place.

117. Enhancements to current systems arising from the Outsourcing Standard may result in minor increased costs for insurers. This could result from improvements to internal processes or additional costs imposed by a service provider for increased monitoring arrangements. Implementation costs may be carried by insurers or the outsourced service providers they use.

118. Possible changes to the internal processes of insurers are outlined above, under “Options - option 3”.

119. Neither PHIAC nor private health insurers have direct control over the prices outsourced service providers may charge for their monitoring arrangements. As such, and owing to a number of variables, including PHIAC’s uncertainty as to whether all private health insurers will in fact outsource, to what extent and how, PHIAC is unable to accurately indicate compliance and other costs involved. PHIAC has received limited feedback (despite asking) with regard to the impact of the outsourcing standard through the industry consultation process, but this feedback is not indicative of industry costs as a whole.

120. Potential advantages to the industry and to individual insurers of the better outsourcing practices prescribed by the Outsourcing Standard include:

- **better selection of outsourced service providers,** leading to more competitive, efficient and cost effective services being provided within the industry.
- **better identification and resolution of service delivery issues** where an insurer has adequate monitoring procedures. For example, any potential service delivery issue will be detected and addressed before it becomes costly or dysfunctional.
- **better understanding of services being delivered and contractual arrangements** leading to decreases in other costs such as those associated with a change in service providers due to poor performance or other issues.

121. In PHIAC’s view, the benefits of the Outsourcing Standard to individual insurer’s risk profile and consumer protections outweigh any costs that may be incurred by individual insurers in improving their business practices.

122. In particular, grounding oversight of outsourcing arrangement in formal regulation with associated formal regulatory options enables PHIAC to take proactive preventative action, as well as direct action on a case by case basis, to respond to any risk or to actual failure.

Consumers

Option 1

123. The costs and benefits to consumers under this option would remain unchanged from current arrangements. Consumers are currently unaware of what, if any, part of their insurer’s material business activities are outsourced, or whether or not the associated risks are well managed.

124. In essence consumers would remain exposed to potential risk and failure of outsourcing arrangements as oversight would be via informal review with no recourse to formal regulatory options.

Option 2

125. For policy holders of the insurers that adopt the best practice outsourcing approach, there will be short, medium and long term benefits in the form of greater protection from failure of a material service provider to their insurer, a reduced risk of a significant impact on their fund's ability to meet its insurance liabilities and greater stability in their fund of choice. The costs to this group of policy holders will be imperceptible. Due to the Government's price control of private health insurance, there is little ability for insurer's to transfer the costs to insurers in the form of increased premiums.

126. The benefits for consumers who are policy holders with insurers who do not adopt the recommended best practice approach to outsourcing are negligible. The costs to this group of consumers are in the form of increased risk of an impact on their insurer

127. The costs and benefits to a more broadly defined group of consumers, being those people already covered by private health insurance and those considering purchasing, are far more variable. An inconsistent approach to outsourcing that has no regulatory boundaries will not adequately protect consumers as a whole from the significant risks associated with outsourcing material business activities of private health insurers.

128. While this option may result in some increased protections for consumers via industry adoption and self-regulation consumers would remain exposed to potential risk and failure of outsourcing arrangements as oversight would be via informal review with no recourse to formal regulatory options.

Option 3

129. Option 3 is expected to benefit consumers the most. The benefits of more efficient and better management of outsourced services is likely to flow through to consumers of private health insurance, as a result of improved stability, better services and the passing on of savings.

130. Option 3 will protect consumers by reducing the risk of failure of an outsourcing arrangement, and the potential impact on the prudential position of the insurer by requiring formal compliance with best practice requirements. The benefits of this reduced risk of failure, however, are not readily quantifiable.

Government

Option 1

131. Option 1, maintaining the status quo, has the greatest potential costs to government in both the short and long run. In the short term, those insurer's that have identified high risk outsourcing arrangements which are not being appropriately managed will draw the oversight focus of PHIAC, requiring the re-allocation of resources from other types of monitoring or proactive regulation. Over the longer term, should a significant outsourcing arrangement fail and cause the collapse of an insurer, the cost to the government could be significant, as managing the wind up and exit from the industry is a costly process. There is no benefit to government in maintaining the status quo.

Option 2

132. An inconsistent adoption of best practice outsourcing processes is of little benefit to government. While some insurers would improve their practices, others would not, this would lead to unnecessary variability in the practices of what are otherwise highly regulated businesses. PHIAC benefits from conducting fund reviews against set minimum standard against which PHIAC can measure an individual insurer's compliance.

133. An industry that adopts best practice outsourcing on an ad-hoc basis therefore has some exposure to significant outsourcing risk, and the costs to PHIAC and the government of inconsistency takes the form of increased potential for realisation of these significant risks. Potential impacts on government should these risks eventuate and impact the industry may take the form of diminished reputation, as private health insurance receives significant support, or in the form of policy holder movements out of the industry as the value proposition of private health insurance is tarnished.

Option 3

134. The introduction of an Outsourcing Standard under Option 3 is expected to strengthen PHIAC's supervisory functions and assist its proactive and preventative approach to the regulation of the industry. It would reduce the risk of an insurer experiencing a significant adverse impact, due to the failure or underperformance of an outsourcing arrangement, thereby potentially reducing the cost to government in supporting regulatory action or the diminution of the reputation of the value proposition of private health insurance, thus promoting stakeholder confidence in the industry.

135. The Outsourcing Standard would provide PHIAC with enhanced regulatory powers and the ability to access the premises and records of a service provider that manages significant parts of an insurer's business. Enhanced regulatory oversight would, in turn, improve the soundness and safety of the industry, thus enabling

PHIAC to meet its statutory mandate to protect consumers and ensure a well-run and competitive industry.

136. Option 3 would reduce PHIAC‘s concerns about the risks associated with the current variability in the industry’s application of outsourcing best practice principles. It will allow insurers to have greater clarity about the government’s and PHIAC‘s expectations and requirements, and help to ensure that PHIAC’s regulatory framework keeps pace with other insurance industry practices. Pursuit of Option 3 will also increase stakeholder confidence in the industry’s ability to meet financial obligations.

Conclusion

137. Options 1 and 2 are not considered to be sufficiently viable options to address and manage the issues surrounding poor outsourcing practices. Option 1 sees the status quo maintained and does not facilitate any beneficial change either to industry practice or regulatory response capacity. While option 2 has some potential benefits, with some insurers likely to respond to information around best practice, at the end of the day the self-regulatory approach does not sufficiently mitigate the risks and does not provide PHIAC with any tools to formally respond to failure.

138. Option 3’s short term impact, being the initial cost involving the establishment of a board endorsed outsourcing policy by insurers and the commensurate changes to business systems will be more than offset in the medium to long term by the increased efficiencies gained by the better selection processes for material service providers.

139. The greater surety of service delivery, through the increased monitoring and agreed service levels as required by the Outsourcing Standard, and decreased risk of failure of material service providers, are benefits that outweigh the initial burden on insurers of complying with the proposed Outsourcing Standard.

8. Consultation

140. PHIAC is in constant contact with the private health insurance industry regarding its overall regulatory stance, and its approach to specific areas of concern. As early as 2009, in response to the growing prevalence of outsourced service providers in the private health insurance industry, PHIAC indicated a desire to institute adequate controls in relation to outsourcing risks.

141. In August 2011, PHIAC released to the industry and stakeholders a discussion paper setting out its aspiration to introduce a prudential standard relating to outsourcing. Of the 15 responses to this first round of consultation, most were broadly supportive of the proposed framework.

142. Following the initial round of industry consultation, on 2 March 2012, PHIAC released to the private health insurance industry a second consultation package for

comment. This package contained a draft legislative instrument, an outsourcing policy guide and an explanatory discussion paper.

143. The second consultation period closed on 6 April 2012, with 23 submissions received - 17 from private health insurers and six from industry stakeholders. Two main themes came through in the submissions:

1) PHIAC's Outsourcing Standard should be more closely aligned with APRA's cross industry prudential standard on Outsourcing, CPS 231; and
2) insurers' relationships with certain industry owned service providers should be treated differently to other types of outsourcing.

Alignment with CPS 231

144. In response to the numerous submissions calling for greater alignment with the APRA prudential standard on outsourcing, PHIAC made a number of consequential changes to its proposed prudential standard. Acknowledging that without a strong reason to do so, PHIAC's regulatory regime should not deviate significantly from that of APRA. Specifically, PHIAC made the following changes to its prudential standard in response to its consultation to achieve greater alignment with CPS 231:

- **Outsourcing Policy.** PHIAC amended the proposed Outsourcing Standard to allow insurers to engage in a broadly defined "other selection process" rather than a tender or competitive procurement process when outsourcing a material business activity to a third party. This approach creates additional scope for direct sourcing which can be an appropriate procurement strategy in some cases, and aligns with the approach in the equivalent APRA standard.
- **Outsourcing Decisions.** PHIAC extended the ability of appropriately authorised officers of insurers to be involved in the decision to outsource a material business activity to reflect common business practices and the intention of Section 6 – Delegations within the Governance Standard. It also accords with APRA's practice.
- **Third Party Outsourcing.** PHIAC changed the Standard to provide a clearer differentiation of the requirements of outsourcing to a third party as opposed to outsourcing to an entity within a corporate group, in response to recommendations by a number of insurers.
- **Offshore Outsourcing.** Three insurers provided submissions critical of the Outsourcing Standard's requirements that insurers seek prior written approval for any offshore outsourcing. The submissions cited the onerous nature of this proposed requirement for little regulatory gain, and its lack of alignment with APRA's CPS 231. PHIAC reviewed its objectives in relation to controlling the risks associated with offshore outsourcing and amended the Outsourcing Standard to allow insurers to enter into offshore outsourcing arrangements, provided notification and a risk assessment are submitted to PHIAC prior to entering into the arrangement. This requirement is notably less obstructive than the APRA framework, which instructs regulated entities to consult with APRA

prior to entering into an offshore outsourcing arrangement. Like the APRA requirement, PHIAC reserves the power to instruct the insurer to make other arrangements if the risk controls related to the outsourcing arrangements can be demonstrated to be less than adequate.

- **Transitional Arrangements.** While it was always PHIAC's intention for the Outsourcing Standard to only apply to new or renegotiated outsourcing agreements, many insurers sought an explicit exemption provision for existing arrangements. Accordingly, PHIAC inserted a provision into the Outsourcing Standard which clearly states its aim of effectively "grandfathering" existing arrangements from the Outsourcing Standard's operation, until such time that they are renewed or renegotiated. This was to address any residual concern that existing outsourcing arrangements require renegotiation on commencement of the Standard. A similar transition provision appeared when APRA first introduced its Outsourcing Standard to Authorised Deposit-taking Institutions in 2002, with APS 231.

Special treatment

145. Importantly, the majority of responses from insurers, peak bodies and industry owned service providers sought to have insurers' outsourcing arrangements with the industry owned service providers receive special treatment under the proposed Outsourcing Standard. All submissions argue that this would be appropriate because of the unique ownership arrangements of organisations, being companies limited by guarantee with membership only held by the registered private health insurers that use their services.

146. The suggested treatment of the industry owned service providers can be grouped into three different categories:

1) **Arrangements with industry owned service providers should be exem**pt from all provisions of the Outsourcing Standard.

PHIAC was of the view that this requested exemption is not appropriate. The industry owned service providers are two of the largest outsourced service providers in the private health insurance industry, and an Outsourcing Standard that does not capture these arrangements would limit PHIAC's intended capacity to oversee risks associated with industry outsourcing.

2) **Industry owned service providers should be considered part of the member funds 'corporate group',** and accordingly, insurers utilising their services should not be required to prepare a business case, due diligence assessment or conduct a tender or other selection process.

PHIAC has considered this view, and understands its main points, namely:

- such an understanding would reduce regulatory burden on the industry owned service providers and their member funds; and

- such an understanding would still require heightened monitoring of the arrangements, by way of provisions being inserted in outsourcing agreements, thus allowing PHIAC access to relevant documents and records.

Despite this, PHIAC considers that the industry owned service providers cannot reasonably be considered a part of any member insurer's corporate group.

The Private Health Insurance (Insurer Obligations) Rules 2009, which the Outsourcing Standard would form a schedule of, uses the Corporations Act 2001 (the Corporations Act) definition of a 'corporate group'. The Corporations Act makes clear that a 'corporate group' is made of 'related bodies corporate', which are defined as either subsidiaries or holding companies, or subsidiaries of a common holding company.

The question of a subsidiary relationship rests on the question of control of that subsidiary body. Section 46 of the Corporations Act states three, independent tests of whether a corporation is a subsidiary of another. One, if a corporation controls the composition of the board of another corporation. Two, if a corporation has more than 50% of voting power in another corporation. And three, if a corporation holds more than 50% of issued shares in another corporation. Relevant case law that confirms these tests include *NSAC v Brierley Investments Ltd (1988) 14 ACLR 177* at 184.

As both the industry owned service providers in question have 25 member funds, and each fund is an equal member under their constitutions, each fund is only able to exercise 1/25 or 4% voting power. This is significantly below the 51% control needed under the Corporations Act to claim a subsidiary relationship.

This cuts against the arguments put forward from the submissions that argue funds (collectively) exercise sufficient control over both organisations and therefore the industry owned service providers are part of the member funds corporate group.

Because existing arrangements between insurers and the industry owned service providers fall within the definition of an outsourcing arrangement to a third party (that is, to a party not within the corporate group) the Outsourcing Standard would require them to be subject to the additional requirements outlined in the Standard.

3) **Arrangements should be 'grandfathered'.** The joint submission of industry owned service providers as part of the initial round of consultation supports this approach, as did second round submissions from other insurers.

The recommendation from insurers is to allow a roll-over of existing arrangements with the industry owned service providers so long as the substantive parts of the arrangement are not altered and the industry owned service providers ownership arrangements or corporate structure do not change. This would essentially mean result in an indefinite exemption of these arrangements from the Outsourcing Standard.

The recommended transition provisions in the final Outsourcing Standard go some way in satisfying this request, without providing an indefinite exemption for contract roll-overs.

The Outsourcing Standard will not apply to outsourcing arrangements in place at the commencement of the standard, and insurers will only be required to apply the Standard to those arrangements when they are renegotiated or renewed.

9. Conclusion and Recommended Option

147. Option 1, maintaining the status quo, falls short of meeting all of the previously stated objectives, as it would neither address current deficiencies identified in the industry, nor would it enhance industry practice and consumer confidence. The absence of an outsourcing standard would inhibit PHIAC's regulatory ability, and it would limit PHIAC's ability to effectively protect policy holders.

148. Option 2, the provision of guidance material, is not preferred as this would not adequately meet PHIAC's policy objectives of protecting consumers and fostering an efficient and competitive private health insurance industry. While the provision of guidance material is a core component of PHIAC's preferred option, PHIAC does not consider taking this step alone, is adequate in providing benchmarks or regulatory response options for best practice outsourcing processes in the industry. The provision of guidance material needs to relate to and be based in a rigid regulatory framework in order for it to ensure the consistency it seeks to create. Having a clear Standard available for insurers to measure their compliance against will ensure that PHIAC's requirements for outsourcing best practice is not overly subject to the interpretation of each individual insurer.

149. Option 3 - the introduction of a prudential standard relating to outsourcing - is the preferred option as it will enable the effective identification, management and treatment of risks to the stability of the private health insurance industry.

150. Option 3 is the preferred option as it:

- Establishes formal requirements for minimum levels of best practice in outsourcing arrangements
- Reflects an appropriate level of regulation having regard to PHIAC's regulatory experience, as well as experience of other insurance regulators (both domestic and international)
- Enables access by PHIAC to formal regulatory tools to enable PHIAC to respond to unacceptable risk and failure
- Accrues the most benefit to insurers, the broader industry, consumers and government
- Has a demonstrable benefit which is considered to be in excess of the expected costs.

151. As the regulatory framework now operates, if a significant business function of an insurer is outsourced to an entity that is not a registered private health insurer, PHIAC's regulatory options and powers in relation to that insurer are significantly reduced. The Outsourcing Standard aims to facilitate PHIAC's regulatory ability by allowing access, through required contractual provisions, to those records and operations of the outsourced service provider which relate to the insurer.

152. The Outsourcing Standard will also require insurers to have in place an effective control framework in relation to implementing and managing the outsourcing arrangements of material business activities. Through implementation of the Outsourcing Standard, PHIAC will be better enabled to regulate the risks associated with this by requiring insurers to follow minimum levels of best practice when outsourcing.

153. PHIAC notes that many insurers already have high standards for managing outsourcing arrangements across business operations. Cases have been identified, however, where the selection process, contracts and/or monitoring procedures put in place by some insurers are poor, or could be improved.

154. The Outsourcing Standard will align as far as appropriate the private health insurance industry with the general insurance industry and it will ensure that practices across the industry are reflective of domestically and internationally accepted practices. Importantly, enactment of the Outsourcing Standard is expected to prevent the problem scenarios envisaged in our "Problem Identification" discussion.

155. Consumers will benefit from the enhanced supervision framework and the associated increase in consumer confidence. This will in turn promote the long-term stability of many insurers.

156. It is considered very unlikely that transitional costs incurred by insurers will be of a magnitude that will translate into increased premiums for consumers.

10. Implementation and Review

157. The date of effect for the Standard is planned to be 1 October 2012.

Transitional Arrangements

158. All outsourcing arrangements in place at the time of commencement of the Outsourcing Standard will not be subject to its requirements until the outsourcing arrangement is renewed or renegotiated.

159. Where an insurer is not able to comply with requirements in the Outsourcing Standard on commencement, the insurer may seek additional time in which to comply.

160. The Outsourcing Standard will be subject to the standard 10 year sun-setting provisions pursuant to Part 6 of the Legislative Instruments Act 2003. The

Outsourcing Standard will also be reviewed after 24 months of operation and again after five years, to ensure that it continues to reflect good practice, remains relevant and effective, and to meet the Government's five yearly review process.

161. As part of these reviews, PHIAC will liaise with other regulatory bodies to ensure that its governance requirements remain consistent with domestic and international best practice, and that they remain relevant.

Industry Training

162. PHIAC will provide industry training via seminars in capital cities, before the Outsourcing Standard comes into effect on 1 October 2012. The purpose of the training seminars will be to explain the operation of the Standard in detail prior to its commencement, and to provide the industry with a forum to discuss implementation issues.