PRIVATE HEALTH INSURANCE ADMINISTRATION COUNCIL

Reform of Capital Adequacy and Solvency Standards

REGULATION IMPACT STATEMENT

(Office of Best Practice Regulation ID No 2012/ 14174)

August 2013

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GLOSSARY

AA	Appointed Actuary
AASB	Australian Accounting Standards Board
Act	Private Health Insurance Act 2007
ADIs	Authorised Deposit-taking Institutions are corporations which are authorised under the *Banking Act 1959*
APRA	Australian Prudential Regulation Authority
Board	means the Board of Directors of a private health insurer
Business funding amount	means the amount calculated in accordance with Part 8 of Schedule 3 of the Rules
Capital adequacy insurance liabilities amount	means the amount calculated in accordance with Part 6 of Schedule 3 of the Rules
Central estimate	if all the possible values of the liability being estimated are expressed as a statistical distribution, the mean of that distribution.
CMP	Capital Management Policy
Expense amount	means the amount determined in accordance with Part 5 of Schedule 2 of the Rules
Inadmissible assets amount – capital adequacy	means the amount calculated in accordance with Part 9 of Schedule 3 of the Rules
Inadmissible assets amount – solvency	means the amount calculated in accordance with Part 7 of Schedule 2 of the Rules
insurer	means a private health insurer registered under the *Private Health Insurance Act 2007*
OLDP	Office of Legislative Drafting and Publishing
ORCR	Operational Risk Capital Requirement
PHIAC	Private Health Insurance Administration Council
QIS	Quantitative Impact Study
Resilience Amount – Capital Adequacy	means the amount calculated in accordance with Part 10 of Schedule 3 of the Rules
Resilience Amount	means the amount calculated in accordance with Part 8 of Schedule 2 of the

– Solvency	Rules
Renewal option amount	means the amount calculated in accordance with Part 7 of the Capital Adequacy Standard.
Requirements	The Capital Adequacy and Solvency Requirements as defined in the Standards
the Rules	Private Health Insurance (Health Benefits Fund Administration) Rules 2007
SEU	means single equivalent unit and has the same meaning as in the *Private Health Insurance (Risk Equalisation Policy) Rules 2007*
Standards	means the Capital Adequacy and Solvency Standards
Subordinated debt	For Solvency is defined in Item 3 of Schedule 2 of the Rules and for Capital Adequacy in Item 3 of Schedule 3 of the Rules
Expense Amount	is defined in Item 3 of Schedule 2 of the Rules
Solvency Insurance Liabilities Amount	is defined in Item 3 of Schedule 2 of the Rules

INTRODUCTION

This Regulation Impact Statement (RIS) considers options to reform the Solvency and Capital Adequacy Standards (the **Standards**) governing registered private health insurers and administered by the Private Health Insurance Administration Council (**PHIAC**). In doing so, it presents background information about the industry and PHIAC, presents problems with current Standards, discusses the objectives of and options for reform, discusses the consultation processes undertaken, and provides information on implementation and review.

This single-stage RIS has been prepared in accordance with the new Regulatory Impact Analysis process which commenced on 8 July 2013. As no decision had previously been announced, an options-stage RIS is not required. It is also noted that the process for considering reforms to the current Standards commenced well before 8 July 2013, and that this RIS is about assessing options to improve the current regulatory regime rather than about assessing the need for a regulatory intervention.

PHIAC considers that this RIS, and the process leading to this RIS, fully meets all the requirements of the new Regulatory Impact Analysis process.

BACKGROUND

The Industry

The private health insurance industry in Australia comprises 34 private health insurers registered under the *Private Health Insurance Act 2007* (**the Act**). The five largest private health insurers account for 82 per cent of the market and for-profit insurers account for 69 per cent of the market. The industry's total assets were $11.1 billion at 30 June 2012. As at 30 June 2012, around 12.3 million people in Australia, or 54.4 per cent of the population, held some form of private health insurance.

In 2011-12, premium revenue for the industry totalled $16.7 billion; a significant jump from 2000-01 when premium revenue was only $5.5 billion. This represents an average growth rate of 10 per cent per annum. Total benefits paid were $14.4 billion in 2011-12 compared with $4.5 billion in 2000-01, an average growth rate of 10 per cent per annum. These strong average annual growth rates reflect the maturation of the industry both in terms of the private health insurers themselves, and in terms of the significance of private health insurance industry to the financing of the Australian health care system. In particular, the industry contributed around 11 per cent of Australia's total health expenditure in 2010–11.

Government support

The Australian Government supports the private health insurance industry through a range of policies directed at maintaining the affordability of and access to private health insurance cover. The Government has provided a 30 per cent rebate directly to consumers since 1999 to assist them with the cost of private health insurance premiums and to increase the coverage of private health insurance. In 2011-12, the cost of the private health insurance rebate was around $5 billion.

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 they offer only, and not according to the risks attached to a particular policyholder. This means that every person purchasing the same policy is 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 or asset.

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 Act provides that the costs of certain types of claims should be pooled and shared amongst all insurers. This is known as risk equalisation. It involves lower risk profile health insurers making payments to the Risk Equalisation Trust Fund and these funds are distributed to higher risk profile insurers as a cross subsidy. In 2011-12, this resulted in $393 million in Risk Equalisation Trust Fund payments across the industry.

There are dual incentives to encourage 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 Act also provides for portability, allowing insured persons to switch between insurers without having to re-serve waiting periods.

With the important role of private health insurance (and the private health sector) in the Australian health sector, the significant support from the Government and the Parliament's desire to ensure that consumers interests are paramount, comes commensurate regulation of the industry. In particular, the Minister for Health, the Private Health Insurance Ombudsman and PHIAC have specific regulatory roles under the Act. Each of these regulatory roles are in place to provide a protective framework for consumers and to ensure the industry's ongoing viability as a key pillar of the health sector. Additionally, all private health insurers are companies, so they are subject to regulation under the *Corporations Act 2001*.

Private Health Insurance Administration Council

PHIAC is an independent statutory authority accountable to the Parliament through the Minister for Health, and is the prudential regulator of the private health insurance industry. PHIAC oversees a range of regulatory elements of the private health insurance industry under the Act.

Under section 264-5 of the 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; and
- ensuring the prudential safety of private health insurers.

PHIAC's strategic vision is to protect consumers of private health insurance by ensuring an industry which is competitive, efficient and financially sound. This is achieved by addressing regulatory challenges proactively and preventatively as well as directly when they arise. In establishing an effective prudential framework for the industry, PHIAC has the ability to implement whole-of-industry regulatory settings, primarily in the form of new or updated capital and prudential standards.

Since it was established in 1989, PHIAC has worked diligently to be 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. Early last decade, when PHIAC operated under the *National Health Act 1953*, PHIAC managed insurer failures proactively by ensuring consumers transfer to equivalent policies during a facilitated merger or takeover.

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

PHIAC has utilised its powers to make standards in relation to capital adequacy and solvency, as well as prudential standards relating to appointed actuaries, governance, disclosure requirements and outsourcing arrangements. These standards were made not only to proactively address concerns identified by PHIAC in the operation of private health insurers, but also in response to lessons learnt in Australia (through APRA's experiences) as well as international experience, as reflected in core best practice regulation identified by the International Association of Insurance Supervisors (IAIS).

Importantly, PHIAC is authorised under the Act to act on a preventative, forward-thinking basis. Accordingly, PHIAC views the design, promulgation and review of appropriate capital and prudential standards as a key tool for use in PHIAC's proactive oversight of the industry's prudential affairs.

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, and to seek the application of criminal provisions and orders from the Federal Court.

PHIAC is now considering options to reform the Capital Adequacy and Solvency Standards for registered private health insurers.

CURRENT LEGISLATIVE FRAMEWORK

Private health insurers are subject to a range of regulatory requirements under the Act. Of relevance to this RIS are the legislative requirements to have an Appointed Actuary, and the setting of, and compliance with, Capital Adequacy and Solvency Standards.

Appointed Actuaries

Private health insurers operate in an environment with large cash flows and small margins relative to other types of insurance. Like a large part of the general insurance industry, the private health insurance industry is a short-tail industry with most claims paid almost immediately after the claims event. However, compared to general insurance, health insurers are more limited in their capacity to respond to adverse claims experience due to:

- requiring ministerial approval to increase premiums;
- community rating, whereby all consumers must pay the same premium rate, regardless of risk profile;
- inability to refuse cover to any potential new customer; and
- complications arising from the risk-equalisation arrangement, designed to share risks around the industry given the inability for health insurers to set premiums on the risk profile of consumers.

Acknowledging this complexity, the Act was made with a requirement for all registered private health insurers to have an actuary, appointed by the insurer (called the Appointed Actuary); to be available times to provide expert specialist advice to the Board and management. With larger insurers, the Appointed Actuary role is usually filled in-house, with supporting actuarial and analytical teams. Smaller insurers often appoint an external Appointed Actuary, and some actuaries act on behalf of more than one insurer.

No matter the structure of the arrangements, the Appointed Actuary plays an important role in the business and operations of every private health insurer, regardless of their size. The Appointed Actuary is well placed to assist insurers understand their prudential capital requirements, especially the workings of the Capital Adequacy and Solvency Standards.

Capital Adequacy and Solvency Standards

Legislative requirements

The Act provides guidance as to what the capital and solvency requirements should be. For example, Division 140 of the Act provides that a Solvency Standard may be established, and insurers are required to comply with it, in order to ensure that the health benefits funds they conduct remain solvent. Furthermore, Division 143 of the Act provides that a standard may be established, and complied with by insurers, so as to 'maintain the capital adequacy of the health benefits funds'.

While these provisions establish two varying perspectives to view the assets of insurers, both are to be broadly designed to ensure that private health insurers conduct themselves in a manner which means they are in a sound financial position, so as to reduce the likelihood of financial loss to consumers or cause instability in the Australian private health insurance system.

Importantly, it is PHIAC that has been provided with the power to make, via legislative instrument, these aforementioned Capital Adequacy and Solvency Standards.

History of PHIAC's Capital Adequacy and Solvency Standards

PHIAC first introduced a risk-based capital regime for the private health insurance industry in 2001. This regime was developed in consultation with the industry and drew heavily on the capital adequacy and solvency standards that were applied to the life insurance industry at that time.

The Capital Adequacy and Solvency Standards have been reviewed at regular intervals since 2001, resulting in minor modification on three previous occasions since their introduction. These include:

- **2003 -** minor modifications were made after a post-implementation review was conducted;
- **2005 -** further minor amendments were made; and
- **2007 -** the 2005 Capital Adequacy and Solvency Standards were translated into their current legislative form to continue the capital requirements through the introduction of the Act, although little change was made to their underlying requirements.

While minor refinements have been made over time, the core elements of the current Capital Adequacy and Solvency Standards have remained unchanged since 2001.

Summary of the current Capital Adequacy and Solvency Standards

The current Capital Adequacy Standard seeks to ensure that health funds retain sufficient assets to continue operating in the interests of its policyholders, under a range of reasonably foreseeable adverse circumstances. It is based on an 'ongoing business view' of an insurer.

The current Solvency Standard seeks to ensure that the health fund has sufficient assets, at any time, to meet all liabilities incurred for the purposes of the fund, as they become due. It is based on a 'run-off view' of the health fund, which means that the insurer ceases writing new or renewal insurance business. The Solvency Standard therefore requires the insurer to demonstrate that the health fund would be able to reliably meet all accrued liabilities and obligations in the event of the termination of the health fund.

Both the current Capital Adequacy and Solvency Standards require that a health fund's total assets exceed total liabilities plus the capital charges listed below:

a) **Liability risks:** The liabilities can be segregated into policyholder (also known as 'insurance' or 'technical') liabilities, and other liabilities. The policyholder liabilities comprise estimates of claims incurred but not reported, reported claims that are not settled, premium liabilities and Risk Equalisation Trust Fund outcomes. A similar approach is used under both the Capital Adequacy and Solvency Standards, which requires policyholder liabilities to be valued at their central estimate with risk margins then applied – the Capital Adequacy Standard applies partially-prescribed margins and the Solvency Standard applies a fixed 10 per cent margin. These are the Capital Adequacy Insurance Liabilities Amount and Solvency Insurance Liabilities Amount respectively. Other liabilities are valued in accordance with the accounting standards.

b) **Resilience amount:** Both the Capital Adequacy and Solvency Standards include a resilience amount. However, the calculation differs slightly due to the different nature of the Standards. The resilience amount represents the risk to the assets of a health fund associated with the occurrence of shocks to the economic environment (i.e. market risk).

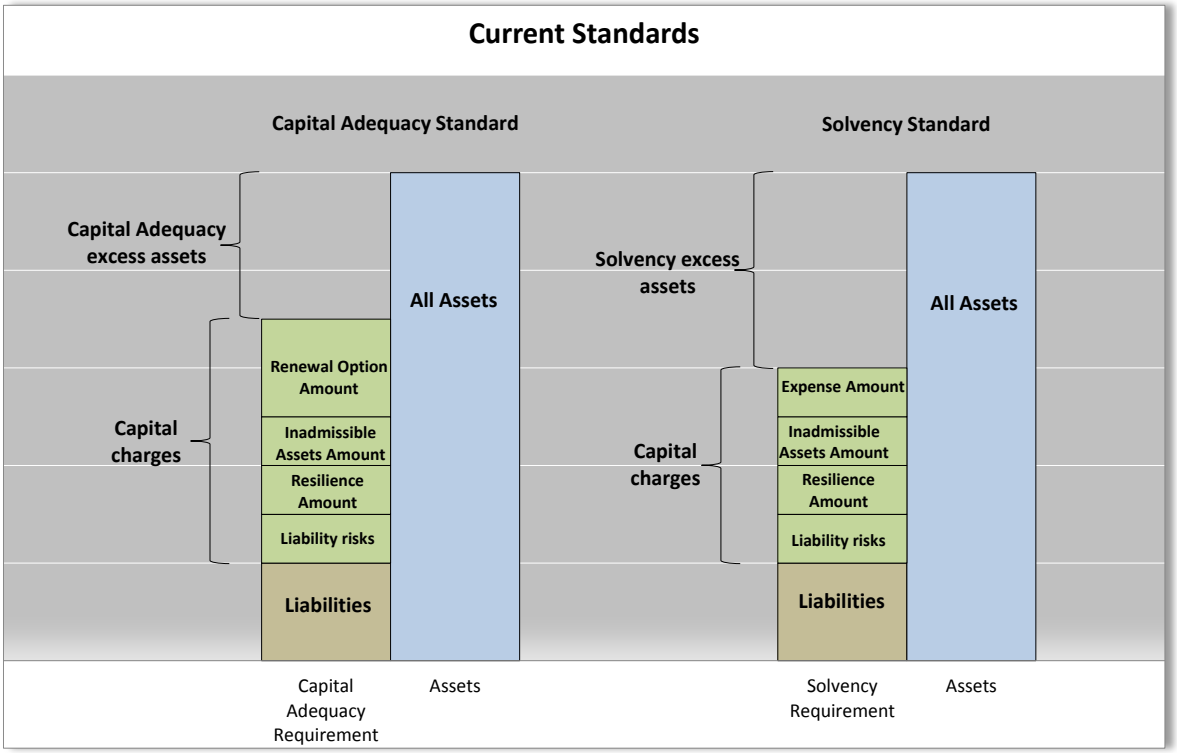
c) **Inadmissible assets amount:** Again both the Capital Adequacy and Solvency Standards include an inadmissible asset amount albeit with different calculations. This amount relates to the risk that the full value of assets is not realised when needed, due to poor quality or liquidity, excessive concentration of counterparty risk or sensitivity to a substantial change in the nature of the business.

d) **Renewal option amount:** The Capital Adequacy Standard includes the renewal option amount as it considers the potential impacts of the fund continuing to operate into the future. This amount provides for the risks and costs associated with membership renewal, and the impacts of the fund's business plans on its available capital. It applies a risk margin (which is partially left to the insurer to determine) to the insurer's best estimate of net cash flows over the next 12 months.

e) **Expense amount:** The Solvency Standard includes an amount for the expected costs associated with a fund ceasing to take new business and entering run-off.

The structure of the current Capital Adequacy and Solvency Standards - before any reduction in capital requirements for Subordinated Debt - and where there is no need for a Business Funding Amount to increase the Capital Adequacy Requirement to equal the Solvency Requirement, is shown in **Figure 1**.

Figure 1: Structure of the Current Standards



In summary, the Capital Adequacy and Solvency Standards are an important mechanism for measuring the financial strength of each organisation's operations. While not a guarantee against business failure, they are designed specifically for the industry and intended to provide consumers with confidence in their private health insurers' ability to pay claims, even under a range of adverse circumstances.

The comparison of the current capital levels of a health fund relative to the Capital Adequacy and Solvency Standards acts as an indicator of financial soundness of the health fund. Early warning signals are sent as capital levels fall close to the minimum levels set by the Capital Adequacy and Solvency Standards, and this enables both the insurer and PHIAC time to respond and take corrective action, before the interests of policyholders are jeopardised.

International examples of other Capital and Solvency Standards

While approaches taken across jurisdictions will differ, all best practice prudential frameworks of financial and insurance regulators include capital standards. Examples include the following:

- In the United Kingdom and throughout Europe, the Solvency II Directive in the insurance sector, and Basel II Capital Framework (working towards Basel III) in the banking sector, include requirements on capital adequacy and risk management for insurers and banks, with the aim of increasing protection for policyholders and customers.

- APRA has prudential standards that relate to both capital adequacy and solvency for Authorised Deposit-Taking Institutions (ADIs), life insurers and general insurers. The general aim of these is to maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities.

PROBLEM IDENTIFICATION

As the prudential regulator of the private health insurance industry in Australia, one of PHIAC's primary roles is monitoring each insurer's compliance with the current Capital Adequacy and Solvency Standards. Through this close and regular interaction, PHIAC has identified a number or areas where the current Standards have posed problems for either the industry or stakeholders. While individually each of these problems are not insurmountable and while overall the current arrangements have worked satisfactorily over the last 12 years in terms of protecting the interests of consumers, cumulatively these problems create a strong case for improving the current Capital Adequacy and Solvency Standards.

The following key problems with the current Capital Adequacy and Solvency Standards are presented in order of descending significance, although it is noted that many of the problems are interrelated and difficult to separate.

Problem 1: Changing industry environment

When the Capital Adequacy and Solvency Standards were developed in the early 2000s, they were designed to reflect the financial risks associated with the insurance business of a health fund which, at that time, was comprised almost entirely of traditional hospital and general treatment claims insurance. They were also developed at a time when there was some instability in the industry and a period when the industry was experiencing long term contraction following the introduction of Medicare in 1984.

Since the risk-based capital standards were introduced in 2001, the risks associated with the conduct of private health insurance, and risk practice generally, have changed, but the basic design and focus of the current Standards has not.

Several factors have led to significant changes in the risk profiles of health insurers including the following:

- **The private health insurance industry has become over more stable over time.** This stems from continued steady growth of the industry since the early 2000s as a result of a number of government measures designed to encourage consumers to purchase private health insurance. The current Standards do not allow sufficient flexibility to adjust for the changing risk environment facing the industry.

- **Private health insurance now encompasses a significantly different suite of business risks** arising from the formal development of a range of policy types for overseas visitors and students, growth in direct service provision and the integration of preventative activities into traditional product suites. The risk of financial losses on these activities is not covered by the current Standards.

- **The operations of the industry are no longer confined within the boundaries of health benefits funds**, with widespread development of integrated activities within insurers and across corporate groups, bringing new elements of risk to the operations of health benefits funds. These arrangements include the outsourcing of key components of the health insurance business and the sharing of staff, systems and other corporate services. Although the outsourcing standard addresses the governance and procedures that must be followed in these arrangements, they still present risks (known as operational risks) which are not adequately reflected in the current Standards.

- **The significance of uncertainty in relation to technical liabilities is lessening**, as more claims are processed electronically and in real time. Emerging as the more significant area of risk for insurers is the uncertainty associated with future business performance. The current Standards do not reflect changing balance of risks.

The current Standards employ a prescriptive approach towards calculating the key insurance and asset risks. For example, key insurance risks are, in part, addressed through the margin in the Renewal Option Amount, which is comprised of a fixed element (a 12.5 per cent stress to profit margins), an element depending on the size of the fund (calculated using a prescribed formula), and a less significant discretionary element. Key asset risks are, in part, addressed through the resilience amount, which prescribes specific stresses to different asset classes.

Consequently, in the face of changes in the risk profile of insurers, this prescriptive approach has become an inferior method for incorporating risk into the Capital Adequacy Standard. For example, as noted above, the volatility of insurance business has changed since the margin in the Renewal Option Amount was formulated, with the use of size based risk factors failing to take account of the full range and magnitude of relevant risks, and the asset stresses are unable to adapt to changing market conditions.

Furthermore, the discretionary element of the margin in the Renewal Option Amount (mentioned above) is not accompanied by adequate guidance governing its use, resulting in a lack of engagement, inconsistency in its application and difficulty in ensuring compliance.

Problem 2: Variation in the overall level of protection afforded consumers

In their current form, the overall level of protection afforded to policyholders by the current Standards varies across insurers and over time. For example, the margin in the Renewal Option Amount gives a level of protection of at least 99.9 per cent for the largest insurers, but would be significantly less for smaller insurers with a more volatile membership base. Furthermore, insurers exposed to more liquidity, operational and credit risk than others would be afforded less protection by the current Capital and Solvency Standards, since these are not explicitly reflected in these Standards.

The absence of requirements for more detailed and fund specific risk measurement means that the protection against the risk of financial loss across insurers is currently not as consistent as it could be. A consistent level of protection afforded by capital standards across the industry is critically important as it enables consumers to be afforded the same level of protection against failure irrespective of the insurer with whom they are insured, and enables PHIAC to behave consistently in its regulatory activities. Furthermore, the direction of regulatory practice both domestically and internationally would see the capital regime providing the same level of protection (in probabilistic terms) across each insurer in the industry.

Problem 3: Standards do not cover all risks faced by insurers and no longer reflect best regulatory practice (domestic and international)

The current Standards make minimal allowance for liquidity, credit and operational risks:

- Liquidity risks relate to the inability to convert the full value of assets to cash in the short term in order to pay claims or expenses.

- Credit risks relate to the impact of potential defaults on the value of the fund's assets.

- Operational risks relate to the people, processes, systems and external events associated with, or affecting, the execution of the business of the health fund.

Each of these risks has the potential to endanger the payment of policyholder benefits.

Additionally, the current Standards are increasingly inconsistent with other domestic and international regulatory developments over the past decade relating to the insurance sector. In particular, there has been a shift in philosophy towards regulation which is directed at improving risk management and engagement with and understanding of key risks, rather than compliance with a set of prescribed rules—the approach largely adopted in the current Standards.

It is noteworthy that the Capital Standards applicable to the life insurance industry in Australia, on which the current capital framework for the private health insurance industry is based, have been significantly modified over recent years to reflect the philosophy now common internationally.

Problem 4: The current Solvency Standard lacks relevance and does not achieve its objectives

There are a number of problems with the current Solvency Standard:

- The Solvency Standard is quantum of assets tests, and forgoes the necessary asset quality considerations necessary to fully meet the statutory objective set out in the Act which focusses on meeting liabilities as they become due at all times, and in an ongoing business sense.

- Although the current Solvency Standard identifies the quantum of capital required to meet a fund's liabilities under run-off, the consideration of asset quality and liquidity characteristics is not comprehensive or adequate in the face of generally accepted practice.

- The standard is based on a theoretical run-off of the fund conducted by each insurer — its usefulness is limited in the ordinary ongoing context of the industry. It is largely irrelevant in the context of a Capital Adequacy Standard that almost always produces a capital requirement greater than or equal to that of the Solvency Standard.

- The relevance of the Solvency Standard to run-off is limited as PHIAC's approval — necessary before an insurer can formally enter run-off — may only be granted if the insurer satisfies the Solvency Standard. This feature of the legislation reduces the purpose and application of the 'run-off' consideration in the current Solvency Standard.

- For a health fund to enter run-off would be highly unusual and is considered a last and unlikely option. It is anticipated to be a costly process which is likely to provide an inferior outcome to merger or other administrative remedies. History has shown that many other insurers have a strong appetite for acquiring new books of business.

- Consideration of a 'run-off scenario' is not helpful to PHIAC or insurers in assessing their ongoing financial strength, especially so when insurers argue that their strategy and plans are formulated based on projected continuation of the business.

- In circumstances where insurers are at low risk, particularly insofar as profitability risk is concerned, the solvency requirement can be larger than the 'raw' capital adequacy requirement, such that it 'drives' the overall minimum capital requirement. In such cases, the 'run-off' perspective of the current Solvency Standard dictates capital requirements.

Problem 5: Complexity of concepts and formulaic approach results in a lack of engagement

The current Standards are complex and highly technical, limiting the opportunity for boards of insurers to engage with the concepts and risks outlined within them. It takes a long time even for highly qualified, technically trained directors to develop a comprehensive understanding of the intricacies of the capital requirements.

It is not uncommon for Directors, management and other industry stakeholders to find it difficult to interpret the strength of a fund's capital position as measured relative to the current Standards. There is often difficulty in describing the nature and severity of adverse events a health fund could withstand, or estimate the number of bad years a health fund could survive as a viable business due to the limited risk meaning associated with the current Capital Adequacy Standards.

This problem stems from the formulaic approach adopted in the current Standards, which do not articulate explicit objectives and risks to be covered. In addition, the formulaic approach, together with the application of a simplistically derived risk proxy, does not reflect generally accepted good business/risk practices which would require deeper consideration and engagement with the broader suite of risks inherent in insurers' conduct of their funds. A regulatory regime which promotes an insurer's ability to describe their risk environment and possible adverse outcomes, especially in relation to the key area of risk of future profitability (that is, what a bad claims and investment year would look like for their business), would provide superior outcomes.

Problem 6: The Standards no longer reflect the Council's risk approach and views on capital efficiency.

A function of PHIAC is to establish a capital requirement framework intended to afford policyholders appropriate protections against the risks which could cause them financial loss.

The form of the current Standards and methods by which capital requirements are determined are not fully reflective of the risk approach preferred by PHIAC and, in many cases, does not satisfy PHIAC's views regarding efficiency in respect of application and capital outcomes.

As an illustration of this point, the risk margins incorporated into the Standards in 2001 were large, reflecting (as noted above) that the industry had just been experiencing a period of some instability, particularly in terms of high volatility in claims experience. Careful analysis of a longer term time horizon has shown that period of time to be an outlier in terms of its high volatility. Thus, the risk margins are providing more consumer protection than is necessary in the long term, or alternatively, higher than necessary prudential capital requirements.

As a result, the current Capital Adequacy Standard has driven many insurers to hold more capital than they might have held otherwise, leading to inefficient outcomes and potentially higher premiums for policyholders in some cases. This is because most private health insurers base their capital targets mostly on a multiple of their regulatory requirements rather than on their own risk appetite.

Problem 7: Treatment of subordinated debt

When a health benefits fund issues fully paid-up subordinated debt, the fund's asset base increases by the cash value paid to the fund by the investors, while a corresponding liability to repay the debt is created. The subordinated nature of subordinated debt ensures that interest and capital

repayments to investors occur only after all debts to policyholders and other creditors have been met. Furthermore, interest and capital repayments cannot be made if, by doing so, the fund would be in breach of either of the Capital Adequacy or Solvency Standards. As such, it makes sense that subordinated debt improves a fund's financial strength in some circumstances. Consequently, the current Standards allow reduction liabilities for subordinated debt provided this debt meets a number of conditions such as a minimum term of 10 years and repayment cannot be accelerated.

However, a problem is that subordinated debt which operates in this way does not necessarily improve the financial strength of a fund. In order to gain additional recognition, the subordinated debt issue should contain genuine loss-absorbing characteristics within its terms and conditions. In particular, these terms and conditions must specify the circumstances for loss absorption, through diminution in value, conversion or other means, of the instrument on a going concern basis, such that prior to non-compliance with the Capital Adequacy Standard the value of the subordinated debt would be reduced by the relevant extent and, if necessary, exhausted.

Problem 8: Sufficiency of risk information

The current Standards do not provide PHIAC or insurers with a clear sense of the financial effects of particular risks, especially in regard to risk of a bad year of profitability. In particular, insurers are not required to quantify the effects of adverse profitability for the following 12 months at any particular likelihood or probabilistic level.

As a result, it is difficult for PHIAC and insurers to estimate how many adverse or bad months (or years) an insurer could survive at a specified probability level. Not knowing this estimated time to a potential capital breach makes capital management challenging for insurers, and the formulation of regulatory intervention strategies challenging for PHIAC.

OBJECTIVES

While addressing the aforementioned problems of the current Capital Adequacy and Solvency Standard are core objectives, at a high level, PHIAC's objectives are to:

- ensure that the regulatory regime faced by private health insurers is best practice, particularly in respect of identifying and assessing the key risks they face;
- ensure a high level of engagement with those risks by the Board and senior managers of insurers;
- ensure that a high quality of risk information is available to PHIAC; and
- increase the transparency and predictability of PHIAC's prudential oversight of the industry.

As noted earlier, while the current Standards are largely working well in that they are providing a good level of protection to insurers and consumers, there is an opportunity to significantly improve the current Standards. A comprehensive review of the Standards is overdue given they have been in place since 2001, and significant efficiencies and gains can be realised. Achieving these improvements is an important objective of PHIAC.

OPTIONS

There are three central options available:

1. **Overhaul of the current Capital Adequacy and Solvency Standards:** This would involve redesigning the Capital Adequacy and Solvency Standards with a view to addressing the problems and achieving the objectives outlined above.

2. **Incremental change to the current Capital Adequacy and Solvency Standards:** This would involve largely maintaining the existing framework, but amending some parameters with a view to lowering current capital requirements. It may also add additional requirements so that credit, operation and liquidity risks are captured in some way which would partially offset the lowering of capital requirements due to parameter changes.

3. **Maintain the current Capital Adequacy and Solvency Standards**: This is the 'do nothing' option.

Option 1 of overhauling the current Standards is considered to be the 'light-handed' option. This is because the proposed new Capital Adequacy Standard empowers the insurer to use its own data and methodology in order to determine the amount of regulatory capital it needs to hold. This is at the opposite end of the spectrum from a heavy-handed approach, whereby the regulator imposes on the insurer a specific amount of regulatory capital, regardless of what the insurer requires and the risks it faces. Further, the proposed new Solvency Standard under Option 1 is more principle-based than the current Solvency Standard which relies on detailed rules.

Option 1: Overhaul of current Capital Adequacy and Solvency Standards (preferred option)

Overview

Under this option, the current Capital Adequacy and Solvency Standards would be replaced with two completely new Standards. The proposed Standards would introduce a comprehensive risk-based capital regime aimed at ensuring the following:

- **Capital Adequacy Standard:** each health benefits fund conducted by an insurer has sufficient assets to ensure the continuing financial soundness of the fund's balance sheet, taking into account business plans and the potential of adverse profitability outcomes and catastrophic losses in the asset portfolio.

- **Solvency Standard**: each health benefits fund conducted by an insurer has sufficient highly liquid assets to ensure that obligations to, and reasonable expectations of, policyholders and creditors can be met when they fall due.

Ensuring compliance with both the Capital Adequacy Standard and the Solvency Standard would be the sole responsibility of the board of the insurer.

As is required under the current Standards, insurers would be required to report compliance, via a standard written form (the PHIAC 2 return), shortly after the end of a specified period, usually quarterly, or monthly in certain circumstances. In the event of non-compliance with either Standard at any time, the insurer would need to immediately notify PHIAC.

The option of overhauling the current Capital and Solvency Standards is the outcome of an extensive consultation process. This included a consultation process on one model to do this commencing in July 2012. This model was refined and presented in a second consultation process commencing in June 2013. The model was refined further in the light of the views of industry stakeholders. The

proposed Capital Adequacy and Solvency Standard described in some detail below is the outcome of this process. More information on the consultation process is provided below.

Capital Adequacy Standard

Under a new Capital Adequacy Standard, each health benefits fund would be required to comply with two separate asset tests:

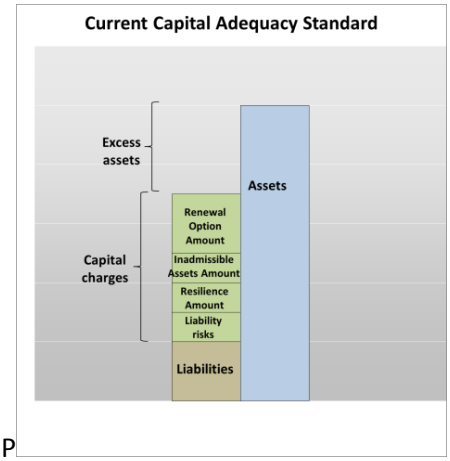
- **Test 1** – quantum of assets test
- **Test 2** – concentration of assets test

The tests are designed to answer the fundamental question posed by the Capital Adequacy Standard which is '*Are the health fund's assets large enough to ensure that it can survive a very bad year with its balance sheet intact?*' This compares with the current Capital Adequacy Standard which asks, *'Is the health fund's capital greater than the prescribed capital charges in an on-going situation?*' This change facilitates more meaningful interpretation of the capital position of the health fund.

Test 1 – quantum of assets test

The right side of **Figure 2** below shows how Test 1- quantum of assets test is proposed to operate. The operation of the current standard is shown on the left for comparison.

Figure 2: Capital Adequacy Standard – Quantum of Assets Test



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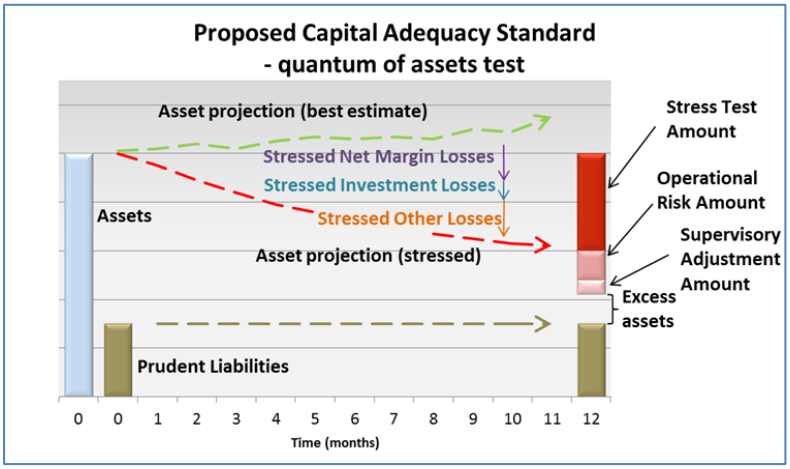


At a high-level, the quantum of assets test aims to ensure that the fund holds sufficient assets so that, after 12 months of adverse experience, it would still have more assets than its (then) prudent liabilities. As such, the Stress Test Amount represents the depletion in assets from 12 months of adverse insurance, investment and other business experience, and an adverse operational event. In contrast, the current Capital Adequacy Standard adds various capital charges to prudential liabilities and compares this with the actual level of assets at a point time.

The quantum of assets test is comprised of the following elements:

a) **Assets:** This quantity is simply the full value of the assets in the health benefits fund, valued in accordance with the accounting standards issued by the Australian Accounting Standards Board (AASB). In other words, all assets are fully admissible - the concentration test deals separately with concentration risks.

b) **Prudent Liabilities Amount:** This essentially incorporates the balance sheet liabilities plus the capital adequacy insurance liabilities amount of the current Capital Adequacy Standard but performs the calculations in a clearer and more technically sound manner. The Prudent Liabilities Amount represents a conservative valuation of the liabilities of the fund, using 98 per cent probabilities of adequacy. Its calculation is a combination of a principles-based approach and prescribed rules. Insurers already apply the same or similar methods in complying with the AASB Standard for General Insurance Contracts (AASB 1023) as would be required under the proposed Capital Adequacy Standard.

c) **Stress Test Amount:** The Stress Test Amount represents the amount by which a fund's capital could deplete over 12 months under a 2nd percentile stressed scenario. That is, its overall purpose is to estimate the extent of capital depletion in the event of, generally speaking, a '1 in 50' year adverse experience. It is designed to perform the combined work of the Renewal Option Amount and Resilience Amount in the current Capital Adequacy Standard. However, it would better quantify risks around adverse future claims experience, and adverse investment and other business income, providing more meaningful risk information for insurers and PHIAC. It would also encourage insurer engagement with those risks.

   The Stress Test Amount would include an appropriate allowance for the following factors:

   - Insurance risk: This is the risk of writing loss-making private health insurance and overseas health cover business.

   - Credit risk and market risk (part of the asset risks): The risk of losses due to defaults, credit downgrades and market movements.

   - Growth risk: When a health fund is experience strong growth in policyholders or expansion into new geographic regions, there is an increased level of uncertainty around future claims experience.

   - Premium increase stress: Given that premium increases are regulated by the Minister for Health, there is always a risk that an insurer would not attain its planned premium increase. Thus, the standard proposes to constrain the assumed next increase to be the lower of the insurer's own planned increase and an amount that is 1 per cent higher than recent benefit inflation.

- Tax: Tax payments in the event of a positive stressed profit, or future income tax credits in the respect of a negative stressed profit.

As such, there are four elements to calculating the Stress Test Amount, covering all aspects that could lead to movements in capital over a 12 month period, namely:

(1) the Stressed Net Margin Estimate;

(2) the Stressed Investment Income Estimate;

(3) the Stressed Other Income Estimate (such as income sourced from overseas visitors and students, direct service provision and preventative activities); and

(4) tax.

The insurer would need to use its own methodology, assumptions and data in order to determine the appropriate percentile at which to stress each element (1) to (3), and determine the size of each of the stresses at that percentile.

This is the key area of difference to the current Standards, where the Renewal Option and Resilience Amounts largely dictate the size of the stresses which must be applied.

Insurers would be required to submit the key outputs from their projections as part of ongoing quarterly returns to PHIAC. In addition, the underlying methodology and assumptions would be required to be submitted to PHIAC at the commencement of the proposed Standards, and whenever material amendments are made to these thereafter.

d) **Operational Risk Amount:** Operational risks relate to the people, processes, systems and external events associated with, or affecting, the execution of the business of the fund. This is a new allowance which does not feature explicitly in the current Capital Adequacy Standard. It is an important risk which needs to be taken into account and would be calculated by applying a simple formula designed to represent potential losses from operational events over the coming 12 months.

e) **Capital Adequacy Supervisory Adjustment Amount**: The principles-based measurement of capital requirements necessitates significant subjective judgement, and without any capacity for a supervisory adjustment would completely rely upon the quality of risk assessment carried out by the insurer. Furthermore, the very broad range of possible risks means the Capital Adequacy Standard cannot be expected to perform consistently under every possible circumstance. Thus, it is critical that to cater for unusual circumstances, PHIAC has the capacity to apply a supervisory adjustment. Internationally, in all other cases where capital standards have moved from prescriptive to principles-based capital regimes, the move has been accompanied by the introduction of a supervisory adjustment capacity.

The application of a Capital Adequacy Supervisory Adjustment Amount, in either the quantum of assets test or the concentration of assets test, could arise when the calculation of any of the other elements in those tests prove inadequate. Examples when this could occur are where:

- the fund's Stress Test Amount makes inadequate allowance for growth in policyholders (including in new markets), changes to the fund's products (including the launch of new products), a lack of asset diversification, market risk, mis-measurement of asset values; or credit risk.

- the fund's Prudent Liabilities Amount provides insufficient protection;
- the fund's Operational Risk Amount provides insufficient protection;
- the fund's assets are not valued appropriately;
- the insurer has inadequate data to assess the fund's risks;
- the fund is exposed to contagion risks from a related entity not captured by the Standards; or
- the fund's Capital Adequacy Maximum Default Loss Amount provides insufficient protection.

A Capital Adequacy Supervisory Adjustment Amount would be applied only after extensive examination of the particular area of risk and in-depth discussion and consultation with the affected insurer. In most circumstances, PHIAC envisages that these discussions would result in either the insurer satisfactorily allaying PHIAC's concerns, or the insurer electing to adjust its calculations accordingly.

If, after discussions with the insurer, PHIAC still considers that the insurer requires an adjustment, PHIAC would notify the insurer, in writing, of the nature of the adjustment (either a fixed dollar value or a prescribed methodology for calculating its value).

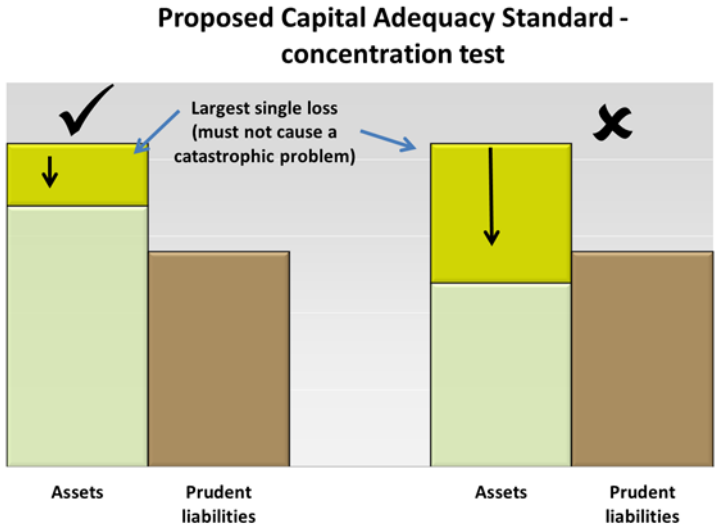
Insurers would have the opportunity to appeal, through the Administrative Appeals Tribunal, against any decision by PHIAC to apply an adjustment.

f) **Treatment of subordinated debt:** Only subordinated debt that exhibits genuine loss-absorbing characteristics will be taken into account in the asset requirements under the Capital Adequacy Standard. The adjustment would take the form of a negative liability (to offset the liability created by the issue) by subtracting subordinated debt from the Prudent Liabilities Amount in both the quantum of assets test and the concentration of assets test. However, it is proposed that subtraction of subordinated debt may only occur following a successful application by the insurer to PHIAC for approval. Key criteria that PHIAC would consider for approval would be that the issue is genuinely loss-absorbing when the fund is considered in an ongoing sense, as it is only under this condition that a subordinated debt issue can improve the fund's chances of answering the fundamental question posed by the Capital Adequacy Standard.

Test 2 – concentration of assets test

Figure 3 below shows how the concentration of assets test operates. This test is separately applied to address the risks associated with asset concentration, namely, credit and liquidity risks. This test aims to ensure that no single plausible asset loss should be catastrophic to a fund's financial health. This would be measured by ensuring the fund would still have enough assets to meet its prudent liabilities after such a loss. Figure 3 shows where a health fund would satisfy and fail the test as indicted by the tick and cross respectively.

Figure 3: Capital Adequacy Standard – concentration of assets test



Capital Management Policy

As well as the stipulated requirements on assets (through the two different tests described above), the Capital Adequacy Standard would also require insurers to have a Board-endorsed Capital Management Policy relating to their fund. This would include:

- a capital management plan, featuring probabilistically-determined capital targets and triggers;
- a pricing philosophy, with explicit consideration of capital implications; and
- investment rules, which include consideration of capital strength.

Solvency Standard

The proposed new Solvency Adequacy Standard has three elements.

- First, each health benefits fund would be required to hold cash balances (essentially funds held in an on-demand deposit account with a bank) representing at least 1 per cent of expected premium income over the next twelve months plus the difference (if it is a positive amount) between expected cash outflows from the health benefits fund less expected cash inflows under a stressed scenario over the next 30 days.
- Second, in a similar way to the Capital Adequacy Supervisory Adjustment Amount to cater for unusual circumstances, PHIAC would have the capacity to apply a Solvency Supervisory Adjustment Amount. Its application could arise when the calculation of the above amount was judged to be inadequate in the particular circumstances. It would be applied only after extensive examination of the particular area of risk and in-depth discussion and consultation with the affected insurer.
- Third, insurers are required to have in place a board-endorsed Liquidity Management Plan relating to their fund. This plan would be designed to ensure ongoing compliance with the Solvency Standard including management action triggers to ensure compliance. It would be comparable to the Capital Management Policy.

Option 2: Incrementally change PHIAC's existing Capital Adequacy and Solvency Standards

Under this option, the exiting framework would be maintained but three incremental changes could be made to the current Standards.

1. Add an allowance for risks (liquidity, operational and credit) not presently captured in the current Standards. This would increase capital requirements a little.

2. Revise the parameters used to calculate the current capital charges (such as the renewal option amount and the resilience amount) and provide parameters which are currently not specified (such as within the renewal amount). These changes could be made with a view to making the capital requirements consistent across industry and to lower capital requirements on average across the industry.

3. Specify a consistent level of capital adequacy to be targeted. This could be 98 per cent probability of surviving an adverse experience. This parameter is unspecified in the current Capital Standards and would provide clarity on the protection afforded by the level of capital held by a health insurer.

Overall, these changes would be designed to lower the capital requirements across the industry. This would mean that the lowering of capital requirements due to points 2 and 3 above would only be partially offset by the changes specified in point 1. This lowering of capital requirements would be a response to the current market environment.

Option 3: Maintain the current Capital Adequacy and Solvency Standards.

Under this option, there would be no change to current arrangements, and PHIAC would continue to review the capital position of insurers under the extant standards in the context of its program of review of periodic returns and fund reviews. PHIAC would continue to provide recommendations and redress in relation to problematic capital structuring or levels on an individual, fund-by-fund basis.

Where necessary, PHIAC would hold direct discussions with insurers to negotiate their individual capital management planning, and PHIAC would have to rely on its relationship with individual insurers to ensure resolution of any issues and disagreements arising out of potential differences between the developed way PHIAC envisages sound capital management, and that stipulated by the current Standards, and therefore implemented by insurers.

IMPACT ANALYSIS

Option 1: Overhaul of current Capital Adequacy and Solvency Standards

Benefits

The benefits of the proposed new Capital Adequacy and Solvency Standards centre on addressing the problems with the current Standards, in a way consistent with PHIAC's objectives. In particular, the proposed changes to the Capital Adequacy and Solvency Standards more accurately assess the key risks faced by insurers, improve insurers' engagement with those risks, and improve the quality of information available to support PHIAC's regulation of the industry. They would also increase the transparency and predictability of PHIAC's regulation, and the generally lower capital requirements

should increase efficiency and stimulate competition. The improvements to the Capital Adequacy and Solvency Standards would provide additional and more consistent protection to policyholders.

In particular, the following are the five key improvements that would result from the proposed overhaul of the current Standards:

- The Standards would be modernised in the light of industry changes and changes to regulatory practices, and incorporate protection against liquidity risk, credit risk, operational risk and the risk of losses from other business activities.

- PHIAC would be able to obtain precise risk information relating to the key financial risk of stressed future profitability. This would allow the proposed Standards to provide a consistent level of policyholder protection, remove uncertainty over the timing of regulatory intervention and remove inefficient capital management techniques.

- The proposed Solvency Standard would become highly relevant with a focus on liquidity risk.

- The principles-based nature of the Stress Test would lead to improved insurer and board engagement with their key financial risk of stressed future profitability.

- The simplicity of the new concepts and legislation would make the Standards far more accessible to all stakeholders, particularly insurer boards, who would be able to interact more meaningfully with the Standards and use them as managerial tools to aid decision-making.

These issues are discussed in more detail below.

Alignment with current and future industry characteristics and risks (addresses problem 1 and 3 (in part) with the current Standards)

The proposals incorporate allowance for changes in the industry and some new risks currently at play in the industry, but not allowed for the current Standards. The proposed introduction of the stress test focuses regulatory oversight of the industry on the key risks. This is consistent with the direction of regulatory best practice being followed by APRA and international regulators.

More precise and consistent risk information (addresses problem 2 and 8 with the current Standards)

The proposed new Capital Adequacy Standards provides PHIAC with a clear sense of the financial effects of a bad year of claims experience, at a specified level of stress. The provision of this information to PHIAC lowers regulatory burden on insurers in that PHIAC can readily obtain the information it requires rather than under the current regime where PHIAC has to make special requests to insurers. In addition, the application of the 2nd percentile measure for all insurers would ensure a consistent level of policyholder protection across the industry and lead to PHIAC intervening in a more measured and consistent way.

Protection against liquidity risk, operational risk and credit risk (addresses problem 3 (in part) with the current Standards)

The proposed new Capital Adequacy Standard would take account of operational and credit risk, while the new Solvency Standard would protect against liquidity risk. This represents a material improvement on the current Standards. In particular, it would focus insurers on these risks and improve PHIAC's regulatory oversight of these risks.

Relevance of the proposed Solvency Standard (addresses problem 3 (in part) and 4 with the current Standards)

The proposed new Solvency Standard would move from being largely irrelevant to being highly relevant. It is proposed to be no longer focused on the insurer in a run-off scenario, but instead focused on the quality and liquidity of assets to meet adverse experience. This means that the proposed Solvency Standard complements the proposed Capital Adequacy Standard.

The focus of the proposed Solvency Standard on liquidity issues means that a health fund would need to ensure it will always hold sufficient cash to meet stressed cash needs. This would provide policyholders with additional protection, and provide PHIAC with a sound basis to undertake some form of intervention.

Principles-based Stress Test would lead to more engagement with the risk of adverse profitability (addresses problem 5 with the current Standards)

The inclusion of a principles-based stress test is an important change between the proposed Capital Adequacy Standard and the current Standard. The main difference lies in the Stress Test Amount of the proposed Standards, where the insurer must decide by how much it is necessary to stress forecast profits in order to produce a '1 in 50' bad outcome. In contrast, the current Standards largely prescribe how big these stresses should be. As such, this test aims to better quantify and hence manage risks around adverse future claims experience as well as adverse investment experience. Further, the capital stress built around, generally speaking, a '1 in 50' bad year provides boards with valuable information and is intended to be a useful tool for board decisions. Boards should be able to change inputs and check the subsequent change in risks very quickly and easily. The proposed new Capital Adequacy Standard also lend themselves to time-based 'survival' measures, which would be more useful than the current 'multiple' measures, in setting how much capital a particular insurer should hold.

Simpler new concepts and legislation would increase engagement, understanding and usefulness of the Standards. The main body of the proposed Capital Adequacy Standard is eight pages long, compared to the 13 pages of the existing Standard. The main economies relate to simplification of subordinated debt treatment, simpler principles underpinning investment and claims risk, the decoupling of the two Standards, less detailed prescription of methodologies, and a simpler structure and drafting.

The main body of the proposed Solvency Standard is four pages long, compared to the 11 pages of the existing Standard. It is shorter because of the simplicity of both its concepts and calculations. Further, proposed Solvency Standard does not consider a run-off scenario and does not require consideration of discounting, tax. It also has simpler and clearer drafting.

The much simpler core legislation would allow insurers and boards to understand all elements of the new proposed Standards, something that has generally not been possible with the current Standards. This improved level of understanding would lead to more engagement with the Standards and with the risks protected by them.

Reductions in prudential capital requirements (addresses problem 6 with the current Standards)

The capital requirements for most insurers would reduce significantly under the proposals. This allows for a more efficient use of capital, and potentially lower premium outcomes for policyholders over the medium to long term.

Improved treatment of subordinated debt (addresses problem 7 with the current Standards)

Only subordinated debt that exhibits genuine loss-absorbing characteristics is included as an adjustment to the asset requirements under the Capital Adequacy Standard. It is only under this condition that a subordinated debt issue can improve the fund's chances of answering the fundamental question posed by the Capital Adequacy Standard.

Costs

The potential costs associated with the proposed reforms to the Capital Adequacy and Solvency Standards relate to implementation costs and ongoing costs.

Implementation costs

Private health insurers would need to meet the initial compliance and administrative costs of implementing the proposed reforms to the Capital Adequacy and Solvency Standards. This includes insurers modifying their systems and processes to measure, monitor and report their capital and liquidity position. Initially, substantial management and board attention would be needed to adopt the changes and time would need to be needed to develop internal systems as well as enhanced internal management processes. The implementation costs could be more material for the small insurers as they (as mentioned above) tend to rely on external actuarial assistance whereas the medium to large insurers tend to have internal actuarial resources to draw upon.

These short-term implementation costs would be absorbed by insurers or borne by consumers. It has not been possible to quantify the implementation costs. However, these costs are not expected to be material given that they are small in the context of the total revenue collected by insurers and total costs borne by insurers.

PHIAC will also incur some small implementation costs. This includes changing systems to accommodate the revised PHIAC 2 form and building capability in assessing returns made by insurers. This cost will be absorbed within PHIAC's existing resources.

Ongoing costs

After implementation, the ongoing administrative costs are not be expected to be significantly different than the costs in complying with the current Standards, particularly for those insurers that already conduct their risk analysis in a best-practice manner. PHIAC will monitor whether there is any rise in insurers management expenses pre and post implementation of the proposed new Standards.

Through the QIS2, insurers have given PHIAC an indication of the likely outcomes under the proposed capital adequacy standard:

- Quantum of assets test—only one insurer would have a (marginally) higher capital requirement. For the remainder, the capital requirements would be reduced, some by a significant amount. Across the industry, capital requirements could reduce by around 60 per cent (around $1 billion).

- Concentration of assets test—all insurers would comfortably pass this new test.

It is important to note that any increase in the capital requirement may not necessarily result in a need for any further capital build up. This is because insurers in this circumstance are likely to still hold significant assets in excess of the new requirements.

PHIAC has assessed cash flow information supplied to us by some funds. Most insurers would hold significant amounts of cash in excess of the requirement and so would pass this test comfortably. Those insurers that do not currently comply with the proposed new Solvency Standard may need to liquidate some current investments in order to meet the new requirements. This is not expected to be a material issue for these insurers.

Distributional and competition effects

There are unlikely to be any noticeable distributional or competition effects on the industry under this option. Consumers are not expected to notice any change in premiums and product design flowing from implementation of the proposed new Standards, and there is unlikely to be any impact of choice of provider. As mentioned above, the current Standards result in variation in the level of protection afforded to consumers. The proposed Standards are likely to reduce this variation. In terms of the impact on large, medium and small insurers it is not possible to make any generalisations.

Net Benefits

Based on comparing Option1 of overhauling the current Standards with Option 3 of maintaining the current Standards, it is assessed that the benefits associated with implementing Option 1 materially outweigh the costs over the medium to long term. The benefits centre on addressing the problems with the current Standards which are considered to be long term and latent, while the costs, which centre on implementation costs, are short term (around 12 months). Importantly, reducing the capital requirements across the industry allows for a more efficient use of capital, and potentially lower premium outcomes for policyholders over the medium to long term while maintaining protection of the consumers' interests and stability of the industry.

Option 2: Incremental change to current Capital Adequacy and Solvency Standards

Benefits

The primary benefits of incrementally changing the current Capital Adequacy and Solvency Standards are three fold.

- First, the changes would be made to add allowances for risks (liquidity, operational and credit) not presently captured in the current Standards. Consequently, Option 2 partially addresses problem 5 with the current Standards of not capturing certain risks.

- Second, the changes would result in lower capital requirements across the industry. In this sense, Option 2 addresses problem 6 with the current Standards imposing an inefficiently large capital requirements on the industry.

- Third, the Capital Standards would be applied more consistently across the industry. This mainly stems from the change to specify parameters which are currently left to individual insurers to determine themselves.

Overall, incrementally amending the current Standards could produce a similar outcome in terms of capital requirements on average across the whole industry as Option 1. That is, the parameters in the current Capital Standard, particularly the fixed component of 12.5 per cent used to determine the Renewal Option Amount, could be adjusted to produce a similar capital outcome as Option 1. This is based on the view that in the current environment the level of capital produced by Option 1 is

an appropriate and efficient level. However, the rationale for producing such an outcome under Option 2 would not be clearly apparent as would be the case under Option 1.

Costs

Regulatory costs

Incrementally changing the current Standards addresses, in a small way, some of the problems with the current Standards discussed above. This includes a closer alignment with PHIAC's views relating to approaching risk and the level of capital an insurer should hold (problem 6), and capturing several important risks (such as credit and operational risk) which are currently not captured (problem 3). This means that other problems with the current Standards are not addressed by incremental change. These problems include:

- problem 1: the Standards will not take account of the changing industry environment;
- problem 2: the Standards will continue to provide an inconsistent overall level of consumer protection;
- problem 3: the Standards will continue to be inconsistent with best regulatory practice (domestic and international);
- problem 4: the Solvency Standard will continue to lack relevance and would not fully achieve PHIAC's objectives;
- problem 5: the Standards will continue to be complex and formulaic, and continue the extant lack of insurer engagement with key risks;
- problem 6: the Standards will continue to not reflect PHIAC's risk approach and views regarding efficiency of capital;
- problem 7: the Standards will continue to not make appropriate allowance for subordinated debt; and
- problem 8: the Standards will continue to result in inadequate risk information being provided to PHIAC.

The implication of the failure to address these problems means that the costs of adopting Option 2 of incremental change are considered to be long term and latent relative to Option 1 where these problems are address by adopting a completely new framework. If risks are not appropriately assessed, this opens the possibility of poor practices occurring in the industry and in the extreme case could contribute to failure of a private health insurer. This could result in loss of benefits for policyholders and impose costs on society more generally if the insurer requires government support.

Another problem with Option 2 is that the various parameters within the current Standards would be adjusted to reflect current market conditions. This means that Option 2 would represent a short term solution as the parameters may need to be re-calibrated as market conditions change.

Implementation costs

There would be small (but not material) costs with implementing Option 2 and with ongoing compliance with the new Standards. Any costs would be much smaller than Option 1 as the reform involves incremental change rather than an overhaul of the current Standards.

Distributional and competition effects

Like Option 1, there are unlikely to be any noticeable distributional or competition effects on the industry under Option 2.

Net Benefits

Based on comparing Option 2 of incrementally changing the current Standards with Option 3 of maintaining the current Standards, it is assessed that the benefits of Option 2 outweigh the costs of Option 2. The benefits of Option 2 are material in terms of producing a lower capital requirement across the industry while the implementation costs are low. However, costs of Option 2 relative to Option 1 of overhauling the current Standards are material in terms of the fact that Option 2 means that most of the problems with the currents Standards remain unaddressed.

Option 3: Maintain PHIAC's current Capital Adequacy and Solvency Standards.

Benefits

The benefits in maintaining PHIAC's current Capital Adequacy and Solvency Standards would be the avoidance of the costs incurred in implementing the changes. This is considered to be a small short-term benefit relative to the large long-term costs described below.

Costs

Making no change to the current Capital Adequacy and Solvency Standards leaves insurers and PHIAC exposed to the deficiencies with the current Standards as discussed above. These deficiencies would continue to magnify as the industry continues to grow and evolve over time. For example, sub-optimal risk practices of insurers would continue and capital levels would be likely to continue at inefficiently high levels due to poor risk understanding

The costs of adopting this option are considered to be long term and latent. If risks are not appropriately assessed, this opens the possibility of poor practices occurring in the industry and in the extreme case could contribute to failure of a private health insurer. This could result in loss of benefits for policyholders and impose costs on society more generally if the insurer requires government support.

Net Benefits

It is assessed that the benefits of Option 1 are small relative to the costs of not addressing the problems with the current Standards.

CONSULTATION

Overview and statement of compliance

The proposed changes to the Capital Adequacy and Solvency Standards have been subject to extensive consultation with industry stakeholders. This included:

- initial consultations over the period from 2007 to the first half of 2012;
- a first round of consultation on a specific reform proposal over a three month period commencing in July 2012;
- a second round of consultations on a proposal developed as a result of feedback from the first round of consultations over a two month period commencing in June 2013; and
- a third and final round of consultation on refinements to the proposed reform arising out of the second round of consultation in August 2013.

As noted in the introduction, this process commenced well before the commencement of the new Regulatory Impact Analysis process on 8 July 2013. Consequently, a formal 'options-stage RIS' has not been produced. However, PHIAC considers that the release of two consultation papers and extensive consultation with industry stakeholders as detailed below means that PHIAC has fully complied with the intent of an options-stage RIS. In particular, the two consultation papers (in combination):

- included discussion of the problem, objectives and options – the minimum three elements of an options-stage RIS;
- included various options for reform including the option of no change;
- were released on the basis of an announced decision that PHIAC would regulate the capital and solvency position of the industry, but against the background of no announcement of a decision on the form of this regulation; and
- were approved (certified) for release by PHIAC.

Initial consultations

PHIAC is in constant contact with the private health insurance industry regarding its overall regulatory stance, and its approach to specific areas of concern. The origins of the current review date back to a review of the Capital Adequacy and Solvency Standards in 2007 and 2008 with the issue of two consultation papers. That review focused on making some changes to how the various elements of the current Standards are calculated rather than on redesigning the Standards, but no substantive changes were made as a result of this review. Since then, there has been periodic discussion with the industry including in the first half of 2012 about the design parameters of the current Capital Adequacy and Solvency Standards at a more fundamental level.

First consultation round

This led to PHIAC releasing a consultation paper on 2 July 2012 setting out problems with the current Capital Adequacy and Solvency Standards and proposed reforms to these Standards by suggesting a

completely new framework for both Standards. The objective of this consultation round was to determine whether there is a strong case to reform the Standards, as well as to obtain feedback on an option overhaul the Standards and on whether a more incremental change is preferred.

Health insurers were also provided the opportunity to complete a Quantitative Impact Study (QIS). The QIS enabled insurers to better understand the nature and extent of the proposed changes to capital and solvency requirements, and the practices applied to determine those requirements. It also provided insurers and PHIAC with qualitative and quantitative information on the impact of the proposed changes. The QISs were completed on the basis of the position of the health benefits fund as at 30 June 2012.

Submissions commenting on the proposed reforms, and QIS responses were sought from industry stakeholders by 1 October 2012, or three months after the release of the consultation paper. Of the 24 responses to this first round of consultation, most were broadly supportive of the proposed framework, although there was considerable discussion of the technical detail. PHIAC agreed with many of the comments and suggestions from industry, the most significant of which were:

- removing the growth component of the operational risk formula;
- increasing the level of sufficiency from 95 per cent to 98 per cent;
- allowing insurers three more months to implement the standards;
- broadening the definition of qualifying assets; and
- simplifying the calculations relating to concentration risk

Furthermore, the consultation resulted in further proposals to modify the Solvency Standard, which led to the proposal to replace the current Solvency Standard with a standard focused on testing the liquidity position of the health fund.

Second consultation round

PHIAC then released to the private health insurance industry a second consultation paper on 3 June 2013. This consultation paper set out a number of proposed changes arising out of the first round of consultations, and contained a draft of the legislation containing the proposed Capital Adequacy and Solvency Standards. The proposal presented in the consultation process was based on the new framework suggested in the first consultation process.

The industry was also provided the opportunity to complete a second QIS based on the proposal set out in the second discussion paper. Clarification on some items in the QIS was issued on 12 July 2013. Further, PHIAC met with all 34 private health insurers and a number of other stakeholders for one-on-one discussions during June and July 2013. Submissions from industry stakeholders were sought by 31 July 2013.

A total of 27 submissions were received, with 21 from private health insurers and 6 from other industry stakeholders.

Industry stakeholders, overall, provided very positive feedback on the design of the proposed Capital Standard and the comments were mainly confined to technical issues. These comments and the proposed response are as follows:

- Industry stakeholders suggested removing making allowance for a specific technical liability from the Standard, namely, the constructive obligation which arises in certain circumstances where insurance contract losses are expected in the period to the next premium renewal. When arising, this liability captures the risk of loss in a similar way to the stress test, effectively double counting the risk. In response, it is proposed to accept this suggestion.

- Industry stakeholders consider that the size of the 15 per cent risk margin to be applied to the risk equalisation liability is too high. In the light of evidence provided during consultation, it is proposed to reduce the size of this risk margin from 15 per cent to 10 per cent.

- Some industry stakeholders consider that timeframe to implementation a fully compliant capital management policy could be too short, as significant board involvement is required. PHIAC does agree that significant board engagement will be necessary in order to create a suitably comprehensive high-quality capital management policy, and so would now allow insurers until 1 July 2014 to implement these.

- Some industry stakeholders consider that implementation timeframe of 31 March 2014 is too short given the system changes required for the new PHIAC 2 form. However, more insurers than not consider that the proposed timeframe is satisfactory. There are few actual data changes necessary to complete the return. Further, insurers have been provided with a draft PHIAC 2 in June 2012 and finalisation of PHIAC 2 in September/October 2012 should provide sufficient time to undertake system changes by 31 March 2014.

- Some industry stakeholders consider that it would be preferable setting a higher level of sufficiency than 98 per cent. In particular, reference was made APRA's 99.5 per cent sufficiency for the general insurance industry and question why PHIAC does not adopt the same approach. In general and life insurance, the risks relate to insurance contracts with prices and benefits committed to. In private health insurance, insurers can change prices during the year, change benefits during the year, or close an entire product if it is performing poorly. The ability of management and PHIAC to respond to adverse experience through the year means that such a high level of sufficiency is not necessary. Adding to this, further protections afforded by the concentration test effectively means that the proposed 98 per cent test provides much more than 98 per cent protection in practice.

- Some industry stakeholders expressed discomfort with application of the supervisory adjustment amount. The supervisory adjustment amount is an important part of the proposed Standards given the degree of judgement to be exercised by insurers in setting their capital requirements. Further, it is common practice for regulator supervisors (including APRA) to have the flexibility to impose a supervisory adjustment amount. PHIAC will seek to provide clarity on how the supervisory adjustment amount might be applied in practice. It is also noted that any decision by PHIAC to impose a supervisory adjustment amount is subject to review by the Administrative Appeals Tribunal. This provides comfort to insurers.

- Industry stakeholders made a number of drafting suggestions to improving clarity around the assumed premium increase and cap assets 'look-through' sections. In response, these suggestions have been largely accepted.

The second consultation round presented a particular option for the Solvency Standard requiring health benefit funds to comply with the following two separate tests:

- Test 1 – liquidity test designed to ensure that the fund has sufficient high quality liquid assets in order to meet three months of stressed liquidity needs.

- Test 2 – concentration of liquid assets test designed to provide assurance that the fund would survive after an asset default from within the fund's portfolio of cash or cash equivalent assets.

The key design features of these tests involved determining the following components:

- Band 1 assets representing cash and cash equivalent assets.

- Band 2 assets representing the market value of securities listed on certain stock exchanges discounted by 50 per cent.

- Cash management amount representing a buffer that health benefit funds would need to hold to ensure that they are able to survive potential timing mismatches that may occur between cash inflows and cash outflows. This buffer was taken to be 8 per cent of a health benefits fund's revenue over the next twelve months.

- Stressed losses amount representing a buffer that health benefit funds would need to hold to ensure that they are able to survive adverse losses that may arise in the fund over the next three months.

In essence, the liquidity test requires a health benefit fund to hold Band 1 and 2 assets is excess of the sum of the cash management amount and the stressed losses amount. The concentration of liquid assets test requires a health benefit fund to hold Band 1 assets representing at least 60 per cent of the cash management amount less an amount representing largest single potential loss.

Industry stakeholder comments on the proposed Solvency Standard were more fundamental. The main comments centred on the following issues:

- what should be considered to be a liquid asset for the purposes of the test;

- what type of assets should qualify as cash or cash equivalent (i.e. a Band 1 asset) particularly in respect of the treatment of term deposits which may or may not be breakable;

- the proposed size of the cash management buffer of 8 per cent of premium income was considered by many industry stakeholders to be too high; and

- the complexity around having two tests and the possibility that that insurers could meet their solvency requirement with Band 2 assets such as equities or listed corporate bonds while holding no or little cash.

In the light of this feedback, the proposed approach to the Solvency Standard was materially changed. As discussed above, the proposed approach involves requiring health benefit funds hold cash balances (essentially funds held in an on-demand deposit account with a bank) representing at least 1 per cent of expected premium income over the next twelve months plus the difference (if it is a positive amount) between expected cash outflows from the health benefits fund less expected cash inflows under a stressed scenario over the next 30 days. This significantly simplifies the proposed Solvency Standard relative to the approach presented in the second consultation round. Further, it means that the proposed Solvency Standard becomes a pure liquidity test focussing on

ensuring that the health benefit fund has sufficient liquid assets to meet liabilities as they become due.

The outcome from the first and second consultation rounds resulted in the proposed approach set out in Option 1 above of overhauling the current Standards. The Option 2 of incrementally changing the current Standards was subject to consultation in 2007 and 2008 including the release of two consultation papers.

Keeping Stakeholders Informed

PHIAC has committed to informing the industry about the direction of proposed changes as a further measure of consultation and transparency.

CONCLUSION

The preferred option is overhauling the current Capital Adequacy and Solvency Standards (Option 1). This involves introducing a comprehensive risk-based capital regime aimed at ensuring the following:

- **Capital Adequacy Standard:** that each health benefits fund has sufficient assets to ensure the continuing financial soundness taking into account business plans and the potential of adverse profitability outcomes and catastrophic losses in the asset portfolio.

- **Solvency Standard**: that each health benefits fund has sufficient highly liquid assets to ensure that obligations to, and reasonable expectations of, policyholders and creditors can be met when they fall due.

The preferred option, Option 1, addresses all the problems identified with the current the Capital Adequacy and Solvency Standards and meets PHIAC's objectives in regulating the capital and solvency position of the Australian private health insurance industry. The material benefits associated with rectifying the problems with the current Standards are expected to outweigh the small implementation costs associated with the proposed new Capital Adequacy and Solvency Standards.

Option 2 provides some benefits and the implementation costs are small, but many of the problems with the current Standards remain unaddressed. Option 1 provides a long term regulatory regime in setting capital and solvency standards for the private health insurance industry while Option 2 would be a short term solution and not provide long term benefits. Option 3 of maintaining the current Standards means that pressure will mount for some future change to address the deficiencies with the current Standards. Consequently, Options 2 and 3 are not preferred.

IMPLEMENTATION AND REVIEW

Commencement dates

The commencement dates for the new Capital Adequacy Standard are planned to be from 31 March 2014 for the quantum of assets test and concentration of assets test component, and from 1 July 2014 for the capital management policy component. This means that health insurers would be required to report for the first time on their compliance with the quantum of assets test and concentration of assets test components of the new Capital Adequacy Standard at 31 March 2014.

The commencement date for the Solvency Standard is planned to be from 1 July 2014.

This staged implementation allows insurers time to first focus on the implementation of the asset tests in the Capital Adequacy Standard, before focusing on the implementation of the liquidity test. Further, it allows for the capital management policy and liquidity management plan to be implemented concurrently.

Initially, a 1 July 2013 commencement date was flagged with the industry. However, PHIAC has taken on board the feedback of the industry arising from the first consultation round that such a timetable had significant implementation risks, and as such, delayed its planned implementation, and allowed insurers three more months to adapt to the proposed standards.

Transitional Arrangements

PHIAC does not envisage that ensuring compliance with either Standard on the implementation date would cause insurers any difficulty which would require transition relief, as:

- all insurers would be expected to already comply with the asset tests without the need for significant management action;

- most of the requirements on systems and processes necessitated by the new Standards would either be already in place or relatively straightforward for insurers to adapt towards; and

- a reasonable period of time is being provided for insurers to adapt systems and processes to reflect the new Standards in the areas where larger scale changes are necessary.

However, where an insurer is not able to comply with requirements in the Capital Adequacy and Solvency Standards on commencement, the insurer may seek additional time in which to comply. This would be considered by PHIAC on a case by case basis.

Transitional provisions in relation to previously existing approved subordinated debt are proposed. PHIAC proposes that these arrangements would continue to count in respect of the proposed Standards, but would be wound down over time.

Consequential changes to the Private Health Insurance (Insurer Obligations) Rules 2009

The Appointed Actuaries Standard, a prudential standard within the meaning of Division 163 of the Act and located at Schedule 2 of the *Private Health Insurance (Insurer Obligations) Rules 2009 (Cth)*, articulates PHIAC's expectation of the role, rights and responsibilities of an Appointed Actuary. A consequential amendment needs to be made to the duties and powers of the Appointed Actuary involving replacing the reference to the discretionary margin used in the Renewable Option Amount with a reference to the proposed Stress Test Amount.

Additionally, PHIAC proposes to make minor changes to the *Private Health Insurance (Insurer Obligations) Rules 2009 (Cth)* which removes the obligation for private health insurers to provide PHIAC with a number of different pieces of information under paragraph 169-5 (1) (b) of the Act, and to certify accounts or statements in accordance with subsection 169-5(2) of the Act. These changes are consequential and minor in nature, in that they reflect the less prescriptive regulatory style of the proposed Capital Standards. These amendments have no regulatory impact.

Industry Training

Should stakeholders indicate a need exists for training in relation to any changes, PHIAC would provide industry training via seminars before the Capital Adequacy and Solvency Standards came into effect, or after were there to be a demand for specific issues to be addressed. The purpose of the training seminars would be to explain the operation of the Standards in detail and to provide the industry with a forum to discuss implementation issues.

Review

The proposed Capital Adequacy and Solvency Standards would be initially reviewed by PHIAC in consultation with industry stakeholders after 2 years of operation. They would be reviewed again after five years, consistent with the Government's five yearly review process of regulatory changes.

These reviews would seek to ensure that the proposed Capital Adequacy and Solvency Standards continues to reflect good practice, and remain relevant and effective in the light of ongoing change in the private health insurance industry. Further, as part of these reviews, PHIAC would liaise with other regulatory bodies to ensure that its governance requirements remain consistent with domestic and international best practice. It is not expected that these reviews will require PHIAC to collect additional data from the industry to that data it already collects.

The Capital Adequacy and Solvency Standards would be subject to the standard 10 year sun-setting provisions pursuant to Part 6 of the *Legislative Instruments Act 2003*.