~~DRAFT~~

Health Insurance (prudential standard) determination No. 3 of 2015

Prudential Standard HPS 110 Capital Adequacy

Private Health Insurance (Prudential Supervision) Act 2015

I, Ian Laughlin, delegate of APRA, under subsection 92(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* (the Act) DETERMINE *Prudential Standard HPS 110 Capital Adequacy*, in the form set out in the Schedule, which applies to all private health insurers.

This instrument takes effect on the day the *Private Health Insurance (Prudential Supervision) Act 2015* commences~~on 1 July 2015~~.

Dated: [date]

[To be signed]

Ian Laughlin
Deputy Chair

Interpretation

In this Determination:

APRA means the Australian Prudential Regulation Authority.

Private health insurer has the meaning given in the section 4 of the Act.

Schedule

Prudential Standard HPS 110 Capital Adequacy comprises the 11 pages commencing on the following page.

Prudential Standard HPS 110

Capital Adequacy

Objective and key requirements of this Prudential Standard

The purpose of this Prudential Standard is to ensure, as far as practicable, that there are sufficient assets in a health benefits fund conducted by a private health insurer to provide adequate capital for the conduct of the health benefits fund in accordance with the Act and in the interests of the policy holders of the fund.

This Prudential Standard requires the private health insurer to demonstrate that the assets of its health benefits fund will be able to meet the liabilities of the fund after a 12 month period, allowing for the future business plans of the fund and adverse circumstances.

The health benefits fund's compliance with this Prudential Standard is an indication of its future financial strength, on a going concern basis.

The key requirements of this Prudential Standard are:

- that a health benefits fund must maintain required levels of capital;
- that a private health insurer must have, and comply with, a written, board endorsed, capital management policy for each health benefits fund it conducts, and provide this to APRA as soon as is practicable after it has been endorsed; and
- that the board must review the capital management policy at least every two years and as part of each review, consider the insurers access to internal and external capital and the impact on premiums of holding more or less capital than the amount determined.

Authority

1. This Prudential Standard is made under subsection 92~~1~~(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* (the Act).

Application

2. This Prudential Standard applies to all **private health insurers**[1], except where expressly noted otherwise.

3. A private health insurer must apply this Prudential Standard separately to each of its health benefits funds.

4. This Prudential Standard ~~applies to private health insurers from 1 July 2015~~ takes effect on the day the *Private Health Insurance (Prudential Supervision) Act 2015* commences.

Interpretation

5. Terms that are defined in *Prudential Standard HPS 001 Definitions* (HPS 001) appear in bold the first time they are used in this Prudential Standard.

6. Where this Prudential Standard provides for APRA to exercise a power or discretion, the power or discretion is to be exercised in writing.

7. Unless otherwise indicated, the term **health benefits fund** will be used to refer to a health benefits fund of a private health insurer, as relevant.

The role of the board

8. The **board** of a private health insurer must ensure that the private health insurer is compliant with this Prudential Standard.

Capital Adequacy requirement

9. The private health insurer must ensure that, at all times, the value of the **assets** of its health benefits fund is not less than the amount calculated under subparagraph (a) and also not less than the second amount calculated under subparagraph (b), where:

   (a) the amount is the sum of that fund's:

      (i) prudent liabilities amount (see paragraphs 12 to 18); and

      (ii) stress test amount (see paragraphs 19 to 25); and

      (iii) operational risk amount (see paragraph 26); and

      (iv) any capital adequacy supervisory adjustment amount (see paragraphs 27 to 30); and

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[1] Refer to subsection 92~~1~~(1) of the Act.

(v) less any **subordinated debt**; and

(b) the second amount is the sum of that fund's:

(i) prudent liabilities amount; and

(ii) capital adequacy maximum default loss amount (see paragraphs 31 to 32)~~-~~; and

(iii) any capital adequacy supervisory adjustment amount; and

(iv) less any subordinated debt.

10. Any amount or value that is required to be calculated for the purposes of this Prudential Standard must be calculated in accordance with **Australian Accounting Standards**, unless otherwise indicated.

11. All estimates, forecasts and calculations in this Prudential Standard must:

(a) be made having regard to reasonably available statistics and other relevant information; and

(b) not be deliberately or carelessly overstated or understated.

Prudent Liabilities Amount

12. Prudent liabilities amount of a health benefits fund, means the sum, on the **relevant day** of the:

(a) outstanding claims liability amount; and

(b) future claims liability amount; and

(c) risk equalisation special account accrued liability amount; and

(d) other liabilities amount.

13. Outstanding claims liability amount of a health benefits fund is calculated in accordance with the following formula:

Outstanding claims liability × (1 + **size margin**)

14. Outstanding claims liability has the meaning given by the *Australian Accounting Standard Board Standard 1023*, where:

(a) the risk margin applied produces a 75 per cent probability of adequacy; and

(b) discounting is not applied; and

(c) any outstanding claims liabilities from health-~~—~~related business are incorporated; and

(d) receipts from the risk equalisation special account are incorporated.

15. Future claims liability amount of a health benefits fund is calculated in accordance with the following formula:

Future claims liability × (1 + size margin)

16. Future claims liability of a health benefits fund, is the amount calculated, at a 75 per cent probability of adequacy, in accordance with the following calculation:

(a) the sum of:

(i) future cash flows from future claims under current policies; and

(ii) the additional risk margin; and

(iii) the sum of related intangible assets and related deferred acquisition costs.

where all elements of the future claims liability calculation are defined in a manner consistent with the definitions contained in the liability adequacy test set out in the *Australian Accounting Standard Board Standard 1023*, except that discounting is not applied and the constructive obligation component is not included.

17. Risk equalisation special account accrued liability amount of a health benefits fund is the greater of:

(a) 0.1 × unbilled calculated deficit; and

(b) (1.1 × unbilled calculated deficit) – unbilled gross deficit + billed risk equalisation special account liability.

Where:

Billed risk equalisation special account liability means the amount of risk equalisation special account payments, on the relevant day, for which an invoice from the APRA has been received by the insurer but that have not yet been paid by the insurer.

Risk equalisation special account has the same meaning as in the Act.

Unbilled calculated deficit means the central estimate of the sum of all the amounts calculated for each risk equalisation jurisdiction, and under the following conditions:

(a) in accordance with Part 2, Rule 11(1)(e) of the *Private Health Insurance (Risk Equalisation Policy) Rules 2007*;

(b) over the period up to the relevant day;

(c) where the risk equalisation special account payments or receipts have accrued but have not yet been paid; and

(d) where an invoice, notice or receipt from APRA has not yet been received by the private health insurer, for that period.

Unbilled gross deficit means the central estimate of the sum of the eligible benefits notionally allocated to the aged-based pool and the high cost claimants pool, calculated for each risk equalisation jurisdiction, and under the following conditions:

(a) in accordance with Part 2, Rule 11(1)(a) of the *Private Health Insurance (Risk Equalisation Policy) Rules 2007*;

(b) over the period up to the relevant day;

(c) where the risk equalisation special account payments or receipts have accrued but have not yet been paid; and

(d) where an invoice, notice or receipt from APRA has not yet been received by the private health insurer, for that period.

18. Other liabilities amount of a health benefits fund, means the sum of any other liabilities not included in the ~~prudent liabilities amount,~~ outstanding claims liability amount, future claims liability amount, or risk equalisation special account accrued liability amount, valued as follows:

(a) individually, at a 98 per cent probability of adequacy, where the balance sheet value of the liability is not less than 2 per cent of the total value of balance sheet liabilities; and

(b) collectively, at least at a 98 per cent probability of adequacy, where the balance sheet value of the liability is less than 2 per cent of the total value of balance sheet liabilities.

Stress Test Amount

19. The stress test amount of a health benefits fund on the relevant day is the greater of:

(a) $0; and

(b) the amount calculated using the following formula:

$$-N - I - O + T$$

Where:

N is the health benefits fund’s stressed net margin estimate, calculated in accordance with paragraph 20.

I is the health benefits fund's stressed investment income estimate, on the relevant day, calculated in accordance with paragraph 23.

O is the health benefits fund's stressed other income estimate, on the relevant day, calculated in accordance with paragraph 24.

T is the amount of tax that may be attributable to the health benefits fund (which may be a negative amount to reflect future income tax credits), if it achieved its:

(i) stressed net margin estimate; and

(ii) stressed investment income estimate; and

(iii) stressed other income estimate; ~~and~~

for the 12 months after the relevant day.

20. The stressed net margin estimate (N) of the health benefits fund is calculated in accordance with the following formula:

$P \times NM\%$

Where:

P is the **premium income estimate** of the health benefits fund on the relevant day.

~~Premium income estimate of a health benefits fund, is the central estimate of the amount of health insurance business premium income that it will earn in the 12 months after the relevant day, where the premium increase assumption is the lesser of:~~

~~(a) the central estimate of the amount of revenue the private health insurer's health benefits fund will earn in the 12 months after the relevant day; and~~

~~(b) the amount determined in accordance with the methodology published by APRA, as amended from time to time.~~

NM% is the private health insurer's estimate of its health benefits fund's xth percentile net margin percentage for the health insurance business for 12 months after the relevant day calculated:

(a) applying the same premium increases as those assumed in calculating the premium income estimate; and

(b) excluding any possible changes in the unexpired risk liability or constructive obligation during that period.

21. Unexpired risk liability has the meaning given in the liability adequacy test in the relevant *Australian Accounting Standards Board Standard 1023*.

22. In calculating NM% the following must be taken into account:

(a) historical variability in net margins; and

(b) changes in the fund's policy holder growth rate; and

(c) expansion into new complying health insurance product(s); and

(d) expansion into new markets.

23. The stressed investment income estimate (I) of the health benefits fund is the private health insurer's estimate of its health benefits fund's xth percentile investment income for the 12 months after the relevant day, taking into account all significant risks including:

(a) market risk; and

(b) credit risk; and

(c) the risk of incorrect asset valuation on the balance sheet.

24. The stressed other income estimate (O) of the health benefits fund is the private health insurer's estimate of its health benefits fund's xth percentile of its health related business and all other income, less associated expenses for the 12 months after the relevant day.

25. xth percentile means the percentile with which the:

(a) net margin for the health insurance business; and

(b) investment income; and

(c) health-~~–~~related business income and all other income, less associated expenses,

must be measured at, in order to achieve a second percentile profit margin, incorporating allowance for correlation between (a), (b) and (c) of this paragraph.

Operational risk amount

26. Operational risk amount of a health benefits fund means the amount calculated in accordance with the sum of:

(a) 0.5% of its **health business revenue estimate**, on the relevant day; and

(b) $1,000,000 × 1.025 ^ (the calendar year of the relevant day minus 2014).

Capital adequacy supervisory adjustment amount

27. Capital adequacy supervisory adjustment amount means, on the relevant day:

(a) an amount expressed in dollars; or

(b) a percentage figure; or

(c) a factor; or

(d) an amount, or a description of an amount, derived through another basis for calculating the ~~solvency~~ capital adequacy supervisory adjustment amount;

which is not less than 0, and would not result in a negative amount, determined by APRA (including by the application of specified methodology), upon reasonable grounds.

28. In making a determination about a capital adequacy supervisory adjustment amount, APRA may consider the following examples as being examples of reasonable grounds for the determination of the capital adequacy supervisory adjustment but APRA is not limited in its considerations to those examples:

(a) there is a less than 98 per cent probability that the health benefits fund will meet its prudent liabilities in 12 months' time; and/or

(b) the health benefits fund's stress test amount does not make adequate allowance for:

(i) growth in policy holders, including in new markets; and/or

(ii) changes to the fund's products, including the launch of new products; and/or

(iii) a lack of asset diversification; and/or

(iv) market risk; and/or

(v) mismeasurement of asset values; and/or

(vi) credit risk.

(c) the health benefits fund's prudent liabilities amount does not make adequate allowance for inherent uncertainty; and/or

(d) the health benefits fund's operational risk amount does not make adequate allowance for inherent uncertainty; and/or

(e) the health benefits fund's assets are not valued appropriately; and/or

(f) the private health insurer conducting the health benefits fund does not have adequate data to assess the risks of the fund; and/or

(g) the health benefits fund is exposed to contagion risks from a related party, and the private health insurer has not appropriately considered these risks for the purpose of its obligation under this prudential standard; and/or

(h) the health benefits fund's capital adequacy maximum default loss has not been appropriately calculated.

29. APRA may determine the same or different capital adequacy supervisory adjustment amounts for the purposes of paragraphs 9(a) and 9(b) of this Prudential Standard.

30. If APRA is satisfied that there are reasonable grounds to make a determination of the capital adequacy supervisory adjustment, APRA must, as soon as practicable after making the determination in relation to the health benefits fund, notify the private health insurer, in writing, of:

(a) the amount, factor or figure determined and the calculation methodology used to determine this amount; and

(b) the reasons for the decision to make a determination including which of paragraphs 9(a) and 9(b) of this Prudential Standard the capital adequacy supervisory adjustment amount applies to.

Capital adequacy maximum default loss amount

31. Capital adequacy maximum default loss amount of a health benefits fund means, on the relevant day, a prudent estimate of the maximum default loss of a health benefits fund, calculated in accordance with the following:

(a) the capital adequacy maximum default loss amount must be at least as large as the maximum default loss; and

(b) the capital adequacy maximum default loss amount must be less than the maximum default loss plus 10% × (value of assets in the fund – prudent liabilities amount).

32. Maximum default loss means the largest uncompensated loss of the health benefits fund arising from any loss, other than losses arising from assets held with an Australian Government counterparty or deposits held with an **authorised deposit-taking institution**, in relation to:

(a) any asset or any group of related assets of the health benefits fund; and

(b) any individual counterparty or group of related counterparties.

Where:

Uncompensated loss means the likely net loss after insurance, derivative, recoveries, and compensation.

Capital Management Policy

33. A private health insurer must have, and comply with, a written, board endorsed, capital management policy for each health benefits fund it conducts.

34. The capital management policy must include, but is not limited to:

    (a) a capital management plan that must contain:

        (i) a description of the board's risk appetite as it relates to capital needs and the process used to determine that appetite; and

        (ii) capital target levels which have regard to paragraph 37, and details of how they are calculated; and

        (iii) clearly defined capital trigger points, which have regard to paragraph 37; and

        (iv) corrective action options, for each trigger point identified specifying actions and timeframes, for those actions, which a private health insurer may utilise to return capital to capital target levels (identified in subparagraph 34(a)(ii)).

    (b) a pricing philosophy, which must include:

        (i) profitability targets; and

        (ii) direct and explicit consideration of the capital implications of particular profitability levels; and

        (iii) guidelines on the speed of correction of deviations from these profitability targets.

    (c) investment rules, which must include:

        (i) clear objectives; and

        (ii) asset allocation limits; and

        (iii) asset concentration limits; and

        (iv) a consideration of capital strength.

    (d) rules stipulating circumstances under which the capital management policy is to be reviewed, which must include changes in:

        (i) policy holder growth rates; and

        (ii) registration status; and

        (iii) net margin; and

        (iv) broader economic conditions.

35. The private health insurer must provide APRA with a copy of the capital management policy as soon as practicable after it has been endorsed.

36. The board must review the capital management policy at least every two years and either:

    (a) re-endorse the existing capital management policy; or

    (b) endorse a new capital management policy.

37. In meeting the requirements in subparagraphs 34(a)(ii) and 34(a)(iii) a private health insurer must use methods designed to protect the health benefits fund and which consider:

    (a) access to internal and external capital; and

    (b) the impact on premiums of holding more or less capital than the amount determined.

Transition

38. On the commencement of this Prudential Standard, a private health insurer that has any **previously approved subordinated debt** may treat it as having its full value for the purposes of this Prudential Standard, subject to paragraph 39.

39. From the earlier of:

    (a) five years after the commencement of the capital adequacy standard made as Part 6 of the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007* on 31 March 2014; and

    (b) four years before the maturity date of the subordinated debt;

    the value of previously approved subordinated debt, for the purposes of this Prudential Standard, linearly decreases to zero over 48 months.

Notification requirements

40. Under section 9~~5~~4 of the Act, a private health insurer has obligations to notify APRA of certain breaches of this Prudential Standard as well as other matters relating to the financial position of the insurer or its health benefits funds.

Transition arrangements

41. Any approval, determination or other exercise of discretion by PHIAC under Schedule 3 – Capital Adequacy Standard (the PHIAC capital adequacy standard) of the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007* as they existed prior to 1 July 2015 will continue to have effect following 1 July 2015 as though exercised pursuant to a corresponding power under this Prudential Standard. In particular:

    (a) a capital adequacy supervisory adjustment amount determined by PHIAC under subclause 12(1) of the PHIAC capital adequacy standard, and in force immediately before 1 July 2015, continues in effect as if determined under paragraph 27 of this Prudential Standard; and

(b) any methodology determined by PHIAC under paragraph (b) of the definition of premium income estimate in rule 3 of the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007*, and in effect immediately before 1 July 2015, has effect as if determined by APRA under ~~subparagraph 20(b) of this Prudential Standard~~subparagraph (b) of the definition of premium income estimate in HPS 001.

Adjustments and exclusions

42. APRA may, by notice in writing to a private health insurer, adjust or exclude a specific requirement in this Prudential Standard in relation to that private health insurer.