



# Private Health Insurance (Health Benefits Fund) Rules

## Schedule # 02

### Private Health Insurance – Capital Adequacy Standard 2007

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THE PRIVATE HEALTH INSURANCE ADMINISTRATION COUNCIL:

- (a) makes this Standard under Division 140 of the *Private Health Insurance Act, 2007*..

Dated

**DRAFT**

Chief Executive Officer  
Private Health Insurance Administration Council

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#### **Name of Standard**

This Standard is the Private Health Insurance – Capital Adequacy Standard 2007.

#### **2 Commencement**

This Standard commences on 1 April 2007.

#### **3 Establishment of Standard**

This Standard is established for the purposes of Division 143 of the *Private Health Insurance Act, 2007*.

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# Private Health Insurance – Capital Adequacy Standard

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## Chapter 1 Introduction

### Part 1.1 Introduction

#### Division 1.1-1 This Standard

- 1.1-1 This Capital Adequacy Standard is established under the *Private Health Insurance Act, 2007 (the Act)*, and is an integral component of the prudential reporting and management regime for registered Private Health Insurers under the Act.
- 1.1-2 The Act specifies a two tier capital requirement for the health benefits fund of an Insurer with each tier considering the capital requirements in a different set of circumstances.
- 1.1-3 The first tier is intended to ensure the basic solvency of the health benefits fund. The second tier is intended to secure the financial soundness of the health benefits fund in a going concern sense. It is expected that in most circumstances this second tier will provide an additional buffer of capital above the minimum solvency requirement.
- 1.1-4 The Solvency Standard looks at the first tier capital requirement, referred to as the Solvency Requirement. This Capital Adequacy Standard looks at the second tier capital requirement, referred to as the Capital Adequacy Requirement.
- 1.1-5 The amount by which the Capital Adequacy Requirement exceeds the Reported Liabilities is the Capital Adequacy Reserve.
- 1.1-6 The stated purpose of the Capital Adequacy Standard under section 143-10 of the Act 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 fund: in accordance with this Act; and in the interests of the policy holders of the fund.’
- 1.1-7 Therefore, the purpose of the Capital Adequacy Standard is to prescribe the capital requirement of a health benefits fund to ensure that the obligations to, and reasonable expectations of, policy holders and creditors are able to be met under a range of adverse circumstances, in the context of a viable ongoing operation.
- 1.1-8 The Capital Adequacy Requirement is thus based on an ongoing view of a Fund (and Insurer) where the requirement is for the Fund to

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demonstrate that it has sufficient capital to fund its business plans, absorb short term adverse experience from time to time, and continue to remain solvent.

- 1.1-9 The Capital Adequacy Requirement will not be disclosed in the financial statements of the Insurer. It will however be disclosed to PHIAC on a confidential basis and will be used as an indicator of the longer term financial position of the Insurer.
- 1.1-10 This Standard generally adopts a less prescriptive approach than the Solvency Standard, in recognition of the differing business strategies of Insurers. Reliance is placed on the due diligence of the Board to appropriately assess the Capital Adequacy Requirement of the Fund in accordance with the principles of this Standard.

### **Division 1.1-2      How to use and interpret this Standard**

- 1.1-11 In this Standard the following conventions apply:
- a) **the legislative requirements prescribed in this Standard are shown in bold type;**
  - b) commentary is shown in normal print directly following the legislative sections to which it relates;
  - c) some sections of the Standard are also preceded by an overview — shown in normal print — intended as a plain English introduction to the principles which are developed in greater detail in the relevant section.
- 1.1-12 The commentary and overview can be used as an aid to interpretation, and to the intent of this Standard. In addition, circulars and other advice released periodically by PHIAC will provide further background and an insight to its considerations in the development of this Standard.
- 1.1-13 Terminology used in this Standard, to the extent it is not specifically defined, takes the same meaning as that in the *Private Health Insurance Act, 2007*.

**Division 1.1-3      Application of the Capital Adequacy  
Standard**

1.1-14    This Capital Adequacy Standard is made for the purposes of section 143-5 of the *Private Health Insurance Act, 2007*.

## Part 1.2 Definitions

For the purposes of this Standard the terms set out below have the specific meaning assigned:

### ***Actuary***

Fellow of the Institute of Actuaries of Australia or an Accredited Member of the Institute of Actuaries of Australia.

### ***Authorised Deposit-taking Institution***

Means a body corporate in relation to which an authority under subsection 9 (3) of the *Banking Act 1959* is in force.

### ***Average Deficit Per SEU***

For each quarter, the Average Deficit Per SEU is determined for each Risk Equalization Jurisdiction by PHIAC as the Gross Deficit for the Risk Equalization Jurisdiction for that quarter divided by the average number of SEUs for the Risk Equalization Jurisdiction for that quarter.

### ***Best Estimate***

A Best Estimate assumption, basis, projection or other best estimate of future experience is one which:

- (a) is made having regard to reasonably available statistics and other information; and
- (b) is neither deliberately or carelessly overstated or understated.

### ***Business***

The Business of a Health Benefits Fund comprises health insurance business, plus where applicable health related insurance business and health related other business.

### ***Calculated Deficit***

The Calculated Deficit for a Fund is determined as the Risk Equalization Jurisdiction Average Deficit Per SEU multiplied by the Insurer's average membership in SEUs over the relevant period.

### ***Capital Adequacy Standard***

Means the *Private Health Insurers — Capital Adequacy Standard 2007*.

### ***Central estimate***

If all the possible values of the liability being estimated are expressed as a statistical distribution, the central estimate is the mean of that distribution.

### ***Fund***

The Health Benefits Fund of an Insurer established in accordance with the provisions of the *Private Health Insurance Act, 2007*.

### ***Gross Deficit***

The Gross Deficit is the amount of the benefits paid by an Insurer that can be recovered from the Risk Equalization Trust Fund.

### ***Insurer***

An Insurer registered under the *Private Health Insurance Act, 2007* (as amended) as a Private Health Insurer to conduct a Health Benefits Fund.

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### ***Margin***

The capital adequacy margin as defined in this Standard.

### ***Premium***

The premium or contribution payable in respect of a health insurance or health related insurance policy.

### ***Risk Equalization***

Refers to the statutory pooling arrangements under the Health Benefits Risk Equalization Trust Fund.

### ***Related Party***

In relation to an Insurer, a Related Party includes:

- a) any entity that has control or significant influence over the Insurer;  
or
- b) any entity that is subject to control or significant influence by the Insurer; or
- c) any entity that is controlled by the same entity that controls the Insurer — referred to as a situation in which entities are subject to common control; or
- d) any entity that is controlled by the same entity that significantly influences the Insurer; or
- e) any entity that is significantly influenced by the same entity that controls the Insurer; or
- f) any director of the Insurer or any of their director-related entities;  
or
- g) any director of any entity identified as a related party under any of paragraphs (a) to (e), or any of their director-related entities.

### ***Reported Liabilities***

The value of the liabilities of the Health Benefits Fund as set out in the Financial Statements of the Fund at the valuation date, less any amounts deemed to count as capital in accordance with this Standard.

### ***SEU***

Single equivalent unit, and is determined in accordance with the requirements of the Risk Equalization Trust Fund.

### ***Solvency Standard***

Means the *Private Health Insurance — Solvency Standard 2007*.

## Chapter 2 Principles

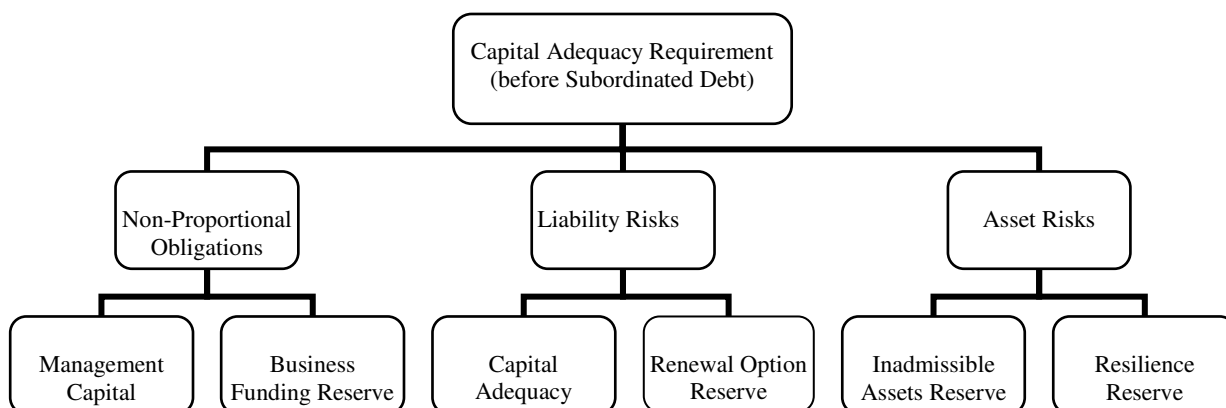
### Part 2.1 Capital Adequacy Standard Principles

#### Division 2.1-1 Overview

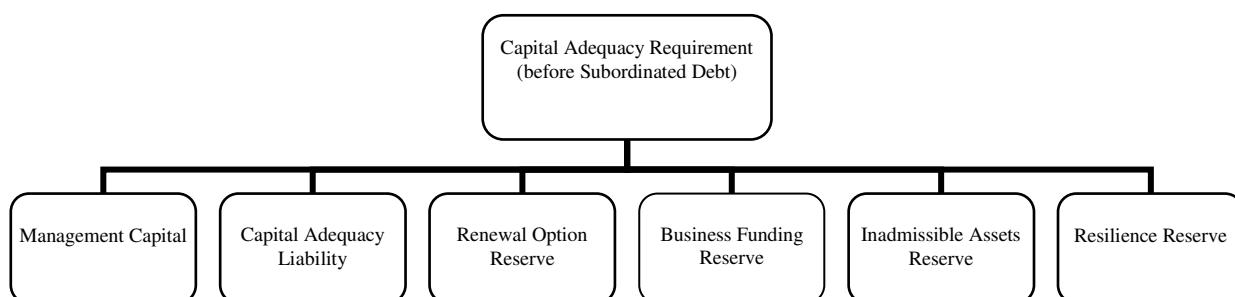
- 2.1-1 The Solvency Standard requires that the Fund of an Insurer has available a minimum level of capital - the Solvency Requirement - to provide security over the existing obligations to contributors under a range of adverse conditions.
- 2.1-2 However, the prudent regulation of the private health insurance industry requires that the level of security offered to policy holders exceeds that of a standard which secures only short term solvency. The Capital Adequacy Standard requires that the Fund has available capital sufficient to provide confidence in the longer term financial strength of the Fund. A capital adequate Fund would have the ability to continue to accept premiums from new and existing policy holders, in an unfettered manner, with the expectation of remaining solvent into the future.
- 2.1-3 The Capital Adequacy Requirement is determined by considering the various risks which could impact the longer term solvency of the Fund and the security of the policy holders' entitlements, and requires the provision of a prudent level of reserves against such risks.
- 2.1-4 These risks, and the assessment of the prudent reserves, are considered in the context of an ongoing operation; a Fund open to new and existing policy holders and soundly meeting policy holder obligations in a competitive market.
- 2.1-5 A Fund that meets the Capital Adequacy Requirement would be considered by PHIAC to be a financially strong Fund. However this does not imply an absolute guarantee of security to policy holders.
- 2.1-6 In assessing the capital adequacy requirement of a Fund consideration is given to:
- a) the risks which may affect the value of its liabilities; and
  - b) the risks which may affect the value of its assets supporting those liabilities; and
  - c) the risks and capital financing involved in the Fund continuing to accept new liabilities in future and continuing to fund the business plans of the Insurer.
- 2.1-7 The level of provision against these risks is set relative to the overall objectives of the Capital Adequacy Standard.

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2.1-8 Based on the above considerations, the structure of the Capital Adequacy Requirement, before the use of any alternative sources of capital such as subordinated debt, is as follows:



2.1-9 For practical calculation purposes, the structure of the Capital Adequacy Requirement is expressed as follows:



2.1-10 The Capital Adequacy Requirement is an assessment of the financial strength of the Fund on the basis of an ongoing operation. The Capital Adequacy Requirement must be sufficient for the Fund to be expected to remain solvent for at least the next three years after the valuation date, on the basis of assuming future experience during that period in accordance with the best estimate experience underlying the current business plans of the Insurer.

### 2.1-11 Management Capital Requirement

The Capital Adequacy Standard specifies requirements that are essentially proportional to the risks and size of a Fund. However, many management risks are not simply proportional to the size of a Fund and consideration needs to be given to the dimensions of the overall Insurer and its risk profile outside the Fund. Security of the entitlements of policy holders, however, cannot be considered totally isolated from risks associated with operations outside the Fund. In the case of friendly societies, the risks associated with the administration and operational support of the Fund are borne outside the Fund. Further, a health insurer may operate businesses (other than health insurance related business) outside its health benefits funds. The risks incurred in all respects have

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implications for the overall security of the company and hence of the policy holders.

### 2.1-12 The Capital Adequacy Liability

The Capital Adequacy Requirement must make provision for the risks pertaining to each element in respect of which an assumption is required in valuing the accrued liabilities of the Fund.

### 2.1-13 The Renewal Option Reserve and The Business Funding Reserve

As the prescribed capital adequacy test considers the obligations of the Fund in an ongoing sense, provision for the risks associated with policy renewal and the consequences for available capital of the intended business plans of the Insurer must be included.

#### a) *Renewal Option Reserve:*

Holders of complying health insurance or health related insurance policies have an expectation to maintain and renew their policies in future. To the extent that current premium rates may prove inadequate to cover future benefits and related Fund expenses some prospective renewal option reserve is needed. This would reflect the time taken to identify and verify emerging adverse experience and for appropriate corrective action to be implemented.

Similarly it is not appropriate that holders of complying health insurance policies or health related insurance policies subsidise health related other businesses within a health benefits fund. To the extent that the current business plans of a health related other business project a loss for the following 12 months, some prospective reserve is required.

#### b) *Business Funding Reserve*

A provision is required for planned business growth or other relevant business development strategies that are likely to absorb existing capital resources, with the intention of securing the continued solvency of the Fund over a prescribed period of three years.

### 2.1-14 The Inadmissible Assets Reserve

The Capital Adequacy Requirement must provide a reserve — the Inadmissible Assets Reserve — in respect of:

- a) holdings in an associated entity which is an institution itself subject to legislated minimum capital requirements; and
- b) the risks arising from asset concentration.

### 2.1-15 The Resilience Reserve

The Insurer must assess the resilience of the Fund and provide for an appropriate reserve — the Resilience reserve. In this context, resilience is assessed as the ability of the Fund to sustain shocks to the economic environment in which it operates and which are likely to result in an adverse movement in the value of its assets relative to the value of its liabilities.

### 2.1-16 Subordinated Debt Allowance

It is intended that the capital adequacy requirements of a Fund may be

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met via a combination of shareholder/member capital and retained earnings in the Fund, and other suitable means such as the use of Subordinated Debt. As any debt liability of a Fund is disclosed as part of the underlying reported liabilities of the Fund, the approach in this Standard is to allow the Capital Adequacy Requirement to be reduced by the amount of Approved Subordinated Debt that may be counted for capital adequacy purposes.

## **Chapter 3 Capital Adequacy Standard Calculation Methods**

### **Part 3.1 Health Benefits Fund Capital Adequacy Requirement**

#### **Division 3.1-1 Calculation of Capital Adequacy Requirement**

- 3.1-1 At any time, the reported value of the assets of the Fund must be of an amount considered sufficient to allow the Fund to continue to meet, into the future, its obligations to policy holders and creditors referable to the Fund. This amount is referred to as the Capital Adequacy Requirement (HBFCAR).
- 3.1-2 The HBFCAR is an intermediate calculation and is determined as:
- a) Management Capital Amount, plus
  - b) Capital Adequacy Liability; plus
  - c) Renewal Option Reserve; plus
  - d) Business Funding Reserve; plus
  - e) Inadmissible Assets Reserve; plus
  - f) Resilience Reserve.
- 3.1-3 The performance of each subsequent step in the calculation process described in paragraph 3.1-2 must not reduce the progressive result from its amount at the completion of the previous step.
- 3.1-4 The Capital Adequacy Requirement is then determined as:
- a) HBFCAR; less
  - b) Approved Subordinated Debt.
- 3.1-5 The Capital Adequacy Excess Assets measure for the Fund is determined as:
- a) Total Fund Assets; less
  - b) Capital Adequacy Requirement.
- 3.1-6 The Capital Adequacy Reserve measure for the Fund is determined as:
- a) Capital Adequacy Requirement; less
  - b) Reported Liabilities.
- 3.1-7 In determining the Capital Adequacy Requirement, allowance must be made for any guarantees or obligations stated or implied to policy holders arising from legislation, the Fund's membership rules and current or past promotional material of the Fund or Insurer.

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- 3.1-8 **The Capital Adequacy Requirement must provide for the value of the liabilities of the Fund in respect of current and prospective obligations to policy holders and other creditors of the Fund, resulting from the adoption of a basis more conservative than best estimate.**
- 3.1-9 **The Capital Adequacy Requirement, in considering scenarios of adverse experience, must provide for risks associated with both the valuation of the liabilities and the valuation of the assets.**
- 3.1-10 **As the prescribed capital adequacy test considers the obligations of the Fund in an ongoing sense, provision for the risks associated with membership renewal and the consequences for available capital of the intended business plans of the Insurer must also be included in the Capital Adequacy Requirement.**

*Commentary* The methodologies for determining the Capital Adequacy Requirement for a Fund recognise the diversity of the private health insurance industry, in particular the potential diversity of business plans and strategies of Insurers. The Capital Adequacy Standard provides some flexibility in determination, while preserving the objectives of simplicity and comparability of results across Insurers.

## Part 3.2 Materiality

### Division 3.2-1 Overview

- 3.2-1 In many cases in practice, the calculation processes outlined in this Standard and the Interpretation Standard will be able to be simplified by the Insurer as it becomes apparent that certain components in the required calculations dominate for certain Funds in certain circumstances. It is not the intention of this Standard to require expensive calculations to be undertaken which have a negligible impact on the overall Capital Adequacy Requirement determined.
- 3.2-2 However, equally, items that have a material impact on the results should not be understated.
- 3.2-3 Particular values or components are considered material to the overall result of a calculation when their misstatement or omission would cause the Capital Adequacy Requirement result to be misleading.
- 3.2-4 Materiality tests assess the significance of the particular value/component by relating it to the amount of the overall result to which it contributes.

### Division 3.2-2 Materiality Standards

- 3.2-5 **The amounts determined in accordance with this Standard are subject to materiality standards applied at a Fund level.**
- 3.2-6 **In determining the Capital Adequacy Requirement, the *base amount* for materiality purposes is the Health Benefits Fund Capital Adequacy Requirement (*HBFCAR*) of the Fund.**
- 3.2-7 In applying the materiality standard described above, the materiality must be considered relative to the base amount of both:
- a) the major individual components of the base amount; and
  - b) the overall cumulative effect of those individual components.
- 3.2-8 It is appropriate that in any circumstances where the base amount approaches zero, alternative key indicators be used in establishing materiality.
- 3.2-9 Materiality relative to the base amount may be based on the following:

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- a) variations in amounts of 10% or more of the base amount may be presumed material;
  - b) variations in amounts of 5% or less of the base amount may be presumed immaterial.
- 3.2-10 Materiality applies to all aspects of the determination of the base amount and covers the acceptability of grouped data, modelled projections and approximate valuation methods.
- 3.2-11 Judgment is needed in the application of the materiality provisions to a Fund. However, such judgment should not result in the Fund being inappropriately exposed to technical insolvency.
- 3.2-12 It also needs to be considered, at each reporting date, whether detailed valuations need to be performed to demonstrate the continued appropriateness of any approximate methods.

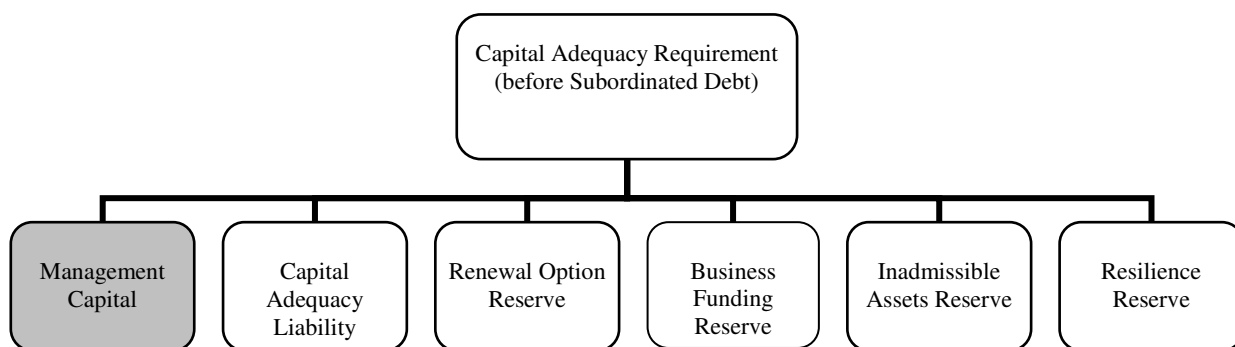
## Chapter 4 Calculation of Components

### Part 4.1 Management Capital Amount

#### Division 4.1-1 Overview

4.1-1 The Management Capital Amount is an intermediate component in the determination of the Health Benefits Fund Capital Adequacy Requirement (*HBFCAR*) which reflects the need for:

- a) a minimum dollar amount in respect of the business risks that are not proportional to the size of an operation; and
- b) prudential capital in relation to the risks associated with business activities undertaken outside the Fund but within the Insurer.



4.1-2 As noted elsewhere in the Standards, the components of the HBFCAR consider risks that essentially relate to the size of the Fund in question, and the Fund is basically considered as a discrete entity.

4.1-3 However, it is acknowledged that some business risks are not proportional to the size of an operation and some risks, if crystallised, are likely to be incurred in amounts of at least a minimum practical dollar amount per event.

4.1-4 As a practical matter, these risks are addressed under the Capital Adequacy Standard by requiring the application of a fixed dollar minimum Capital Adequacy Requirement.

4.1-5 Security of the entitlements of policy holders, however, cannot be considered totally isolated from risks associated with operations outside the Fund. In the case of friendly societies, the risks associated with the administration and operational support of the Fund are borne outside the Fund. Further, a health insurer may operate businesses outside its health benefits funds. The risks incurred in all respects have implications for the overall security of the company and hence of the policy holders.

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- 4.1-6 Where an Insurer conducts business within the entity but outside the Fund, the management capital amount includes capital in relation to the risks associated with the business activities undertaken outside the Fund but within the Insurer.
- 4.1-7 However, where an Insurer maintains a management, shareholders' or members' fund (or similar) outside the Fund, but available within the Insurer to support the obligations of the Fund, then it may be appropriate to offset some of the management capital requirements of the Fund by the net assets available outside the health benefits funds. In this case any offset would need to be subject to the business risks reflected outside the health benefits funds being properly reserved against.

## **Division 4.1-2 Calculation of Management Capital Amount**

- 4.1-8 The Management Capital Amount is determined as the sum of:
- a) the HBF Management Capital Amount; and
  - b) the Insurer Management Capital Amount.
- 4.1-9 The HBF Management Capital Amount is an amount that, when summed with the HBF Management Capital Amounts held in other health benefits funds of the insurer equals \$1 million.
- 4.1-10 The HBF Management Capital Amount cannot be less than zero.
- 4.1-11 The Insurer Management Capital Amount is:
- a) in the case of insurers which, other than the regulation of the health benefits fund by PHIAC, are regulated by the Australian Prudential Regulation Authority; nil.
  - b) in the case of insurers that have no assets or liabilities outside the health benefits fund(s); nil.
  - c) in the case of all other insurers; the Default Management Capital Amount less the Management Capital Offset.
- 4.1-12 The Default Management Capital Amount is determined according to the following formula:

**Default Management Capital Amount =**

- (a) Expense Component; plus
- (b) Inadmissible Assets Component; plus
- (c) Resilience Component; plus
- (d) New Business Component.

## **Division 4.1-3 Expense Component**

- 4.1-13 The Expense Component is determined as  $M \times \text{Run-Off Expenses}$
- 4.1-14 The multiple 'M' is the net of tax multiple based on a gross multiple of 1 adjusted for the tax deductibility of expenses only to the extent that a tax deduction would reasonably be expected to be realised on ceasing business.
- 4.1-15 Run-off expenses, for this purpose, is to be determined by reference to the total actual expenses of the Insurer outside the health benefits funds for the 12 months prior to the valuation and is determined as total actual expenses less the variable expenses included in that amount.

## **Division 4.1-4 Inadmissible Assets Component**

- 4.1-16 **The Inadmissible Assets Component is determined in respect of the assets of the Insurer outside the health benefits funds as the sum of:**
- a) **A reserve in respect of Assets Used for the Conduct of Business and determined on a basis consistent with Division 4.4-4 of the Solvency Standard; plus**
  - b) **A reserve in respect of Holdings in Associated and Subsidiary Entities which are Prudentially Regulated Institutions and determined on a basis consistent with Division 4.4-5 of the Solvency Standard; plus**
  - c) **A reserve prescribed in respect of Asset Concentration Risks and determined on a basis consistent with Division 4.4-6 of the Solvency Standard.**
- 4.1-17 **Where the Inadmissible Assets Component is reduced by deferred tax provisions or other liabilities relevant to the inadmissible portion of the assets, the reduction must only be to the extent those provisions/liabilities are assessed as likely to be realised.**

## **Division 4.1-5 Resilience Component**

- 4.1-18 **The Resilience Component is determined on a basis consistent with Division 4.5-3 of the Solvency Standard in respect of the assets and liabilities of the Insurer outside the health benefits funds.**

## **Division 4.1-6 New Business Component**

- 4.1-19 **The Management Capital Requirement must provide for any additional capital required to ensure that the Insurer will be able to remain solvent over the next three years, given;**
- a) **levels of projected business over that period in accordance with the realistic business plans of the insurer; and**
  - b) **experience during that period in accordance with Best Estimate Assumptions.**

**Division 4.1-7      Management Capital Offset**

4.1-20    **The Management Capital Offset is determined as the greater of:**

- a)    **The net tangible assets within the Insurer but outside the health benefits funds, less**

**The sum of;**

- (i) the Default Management Capital Amount determined in accordance with this Part, and**

- (ii) \$2.5 million;**

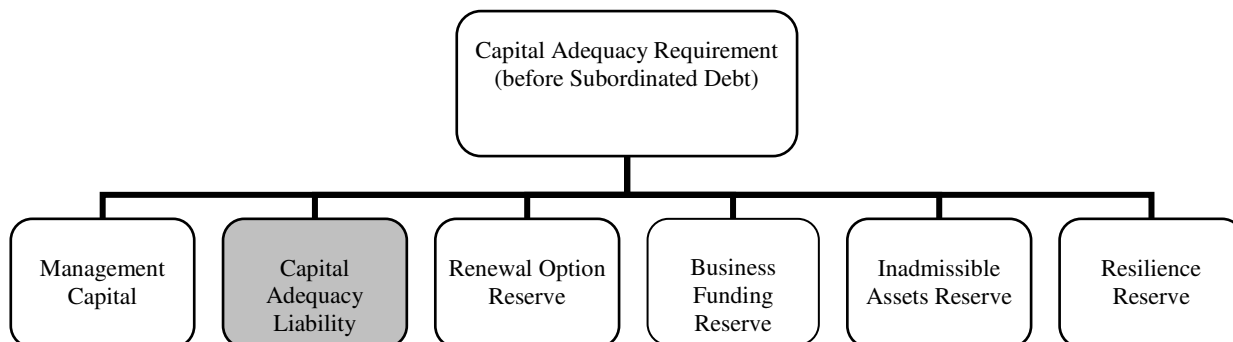
**And**

- b)    **zero.**

## Part 4.2 Capital Adequacy Liability

### Division 4.2-1 Calculation of Capital Adequacy Liability

4.2-1 The Capital Adequacy Liability is an intermediate component in the determination of the Health Benefits Fund Capital Adequacy Requirement (**HBFCAR**), which reflects the assessed liabilities of the Fund on the basis of assumptions which are more conservative (anticipate a more adverse experience) than best estimate assumptions.



4.2-2 The risks pertaining to each element include the risk of mis-estimation of the mean, the risk of deterioration of the assumed mean, the risk of adverse statistical fluctuations about the mean and the risk of unexpected changes in the underlying distribution of experience.

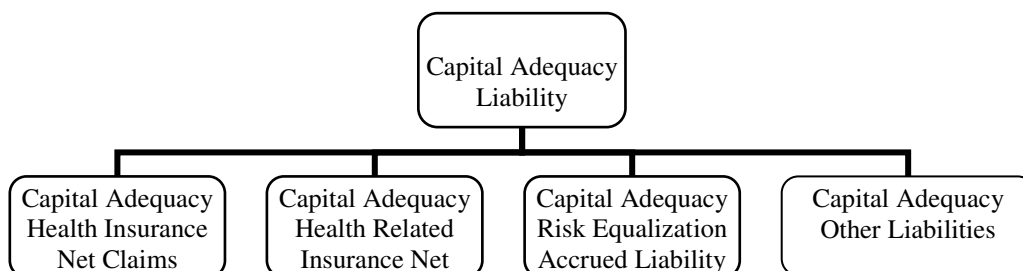
4.2-3 In essence the Capital Adequacy Liability has a minimum value equal to the liabilities determined in accordance with the requirements of this Standard plus a loading of ‘margin’ as a risk margin for those elements of the liability assessment that contain uncertainty.

4.2-4 **The margin for risk to be included in the Capital Adequacy Liability is to be determined in accordance with the provisions of Division 4.2-2 of this Standard.**

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4.2-5 **The Capital Adequacy Liability of a Fund is to be determined as the sum of the following components:**

- a) **Capital Adequacy Health Insurance Net Claims Liability; plus**
- b) **Capital Adequacy Health Related Insurance Net Claims Liability (determined separately for each separate health related insurance business); plus**
- c) **Capital Adequacy Risk Equalisation Accrued Liability; plus**
- d) **Capital Adequacy Other Liabilities.**



### **Division 4.2-2 Determination of Capital Adequacy Margin**

4.2-6 **The margin for risk to be included in the Capital Adequacy Liability (Part 4.2) and the Renewal Option Reserve (Part 4.3) is to be determined by the Board as the appropriate level within the quantitative range prescribed in this Standard. The Board is to determine the appropriate margin after consideration of the qualitative factors specified.**

4.2-7 **The margins adopted must not be less than the minimum value specified in the prescribed range, but may be greater than the high value specified in the prescribed range.**

4.2-8 **The Margin specified under the Capital Adequacy Liability and the Renewal Option Reserve has the following prescribed quantitative range:**

<b>Minimum Value:</b>	<b>12.5%</b>
<b>High Value:</b>	<b>30.0%.</b>

4.2-9 **The qualitative factors to be considered in selecting the Margin with regard to the above range is the reliability and stability of the relevant components of the HBFCAR:**

- a) **A Fund with a large membership base and with a history of stable membership, stable utilisation rates and stable unit costs, could adopt a factor close to or at the Minimum Value above.**
- b) **A Fund with a small membership base and with a history of variable membership, variable utilisation rates and variable unit costs would adopt a factor close to or at the High Value above.**

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- c) A Fund offering products or benefits for which little credible experience is available in respect of utilisation rates and/or units costs, and where the overall impact of the product or benefits on the fund has a high degree of uncertainty, would be expected to increased its discretionary margin following the release of the products or benefits.

4.2-10 The following table is intended to give a general guide to the assessment of the appropriate Margin required under Capital Adequacy Liability and the Renewal Option Reserve. The suggested approach follows a process of adding to the Minimum Value for the various factors indicated:

Factor	Margin
Starting Point (Minimum Value)	+12.5%
Fund Size, defined as the Fund's total number of hospital single equivalent units (SEU). <ul style="list-style-type: none"> <li>➤ Greater than 199,999</li> <li>➤ Less than 200,000 and greater than 19,999</li> <li>➤ Less than 20,000 and greater than 3,999</li> <li>➤ Less than 4,000</li> </ul>	<p>+0%</p> <p>+ 0% + 2.5%<math>\times</math>(<math>\frac{200,000-SEU}{180,000}</math>)</p> <p>+ 2.5% + 5.0%<math>\times</math>(<math>\frac{20,000-SEU}{16,000}</math>)</p> <p>+7.5%</p>
Fund Membership and Claims Experience Stability: <ul style="list-style-type: none"> <li>➤ Minimum margin</li> <li>➤ High margin</li> </ul>	<p>+0%</p> <p>+10%</p>

4.2-11 **Fund Membership and Claims Experience Stability;**  
The more the following conditions exist, the closer the margin should be to the minimum margin:

- a) Membership numbers have been stable over a number of years.
- b) Utilisation rates and unit costs (allowing for expected seasonal fluctuations) have been stable over a number of years.
- c) Loss ratios have been stable or falling over a number of years.
- d) All the Fund's products or benefits have been on offer for some time and have significant credible experience.

4.2-12 The more the following conditions exist, the closer the margin should be to the high margin:

- a) Membership numbers have been significantly variable over recent years.
- b) Utilisation rates and unit costs (allowing for expected seasonal fluctuations) have been significantly variable over recent years.
- c) Loss ratios have been increasing over a number of years.
- d) A new product or benefit has been introduced which is expected to materially impact the finances of the fund but about which little credible experience is available in respect of utilisation rates and units costs, and where the overall impact of the product on the fund has a high degree of uncertainty.

### **Division 4.2-3      Calculation of Capital Adequacy Health Insurance Net Claims Liability**

4.2-13    **The Capital Adequacy Health Insurance Net Claims Liability is determined as the greater of:**

- a)    **the sum of:**
  - (i)    **{1 + Margin} times the value of the central estimate Outstanding Claims Liability determined in accordance with Division 4.2-6 of this Standard; plus**
  - (ii)    **{1 + Margin} times the value of the Risk Equalization Outstanding Claims Liability determined in accordance with Division 4.2-7 of this Standard; plus**
  - (iii)    **the greater of:**
    - (A) **the value of the Unexpired Risk Reserve determined in accordance with Division 4.2-8 of this Standard; and**
    - (B) **the value of the Unearned Premium Liability determined in accordance with Division 4.2-8 of this Standard; and**
- (b) **the net value of these liability components reflected in the Reported Liabilities of the Fund.**

### **Division 4.2-4      Calculation of Capital Adequacy Health Related Insurance Net Claims Liability**

4.2-14    **The Capital Adequacy Health Related Insurance Net Claims Liability is determined separately for each health related insurance business as the greater of:**

- a)    **the sum of:**
  - (i)    **{1 + Margin} times the value of the central estimate Outstanding Claims Liability determined in accordance with Division 4.2-6 of this Standard; plus**
  - (ii)    **the greater of:**
    - (C) **the value of the Unexpired Risk Reserve determined in accordance with Division 4.2-8 of this Standard; and**
    - (D) **the value of the Unearned Premium Liability determined in accordance with Division 4.2-8 of this Standard; and**
- b)    **the net value of these liability components reflected in the Reported Liabilities of the Fund.**

### **Division 4.2-5      Calculation of Capital Adequacy Risk Equalization Accrued Liability**

4.2-15    **The value of the Capital Adequacy Risk Equalization Accrued Liability is determined as:**

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- a) **{1 + Margin} times Calculated Deficit; minus**
- b) **Gross Deficit.**

### **Division 4.2-6 Outstanding Claims Liability**

- 4.2-16 The *Outstanding Claims Liability* is a central estimate of the liability in respect of the accrued but not admitted claims, and related expense, liabilities of the Business at the valuation date.
- 4.2-17 The Outstanding Claims Liability forms the basis for the relevant intermediate component in the determination of the Capital Adequacy Liability.
- 4.2-18 **The difference between the Outstanding Claims Liability as stated in the insurers financial statements and the value reported for prudential purposes will count as capital for the purposes of these prudential standards.**
- 4.2-19 **The Outstanding Claims Liability is to be the central estimate of the value of the outstanding claims liability of the Business as at the valuation date. This includes an allowance for claims handling expenses. Outstanding claims relate to claims that have been reported and have not yet been settled, claims that have been incurred but not yet reported (IBNR) and claims which have been administratively finalised but which may be reopened.**
- 4.2-20 **For health insurance business the Outstanding Claims Liability is to be determined gross of recoveries from the Risk Equalization Trust Fund.**
- 4.2-21 **The valuation method to be adopted to determine the Outstanding Claims Liability must take appropriate account of:**
  - a) **the historical pattern, over a minimum period of the 12 months immediately prior to the valuation date, of the rate of reporting of claims, the rate of settlement of claims, the development of benefit payments and the impact of refunds; and**
  - b) **trends in utilisation rates and unit costs, especially regarding seasonality and other factors which may influence claims lodgement or processing trends; and**
  - c) **any special features or changes to the experience such as changes in benefit design, claims handling procedures and the mix of products and members.**
- 4.2-22 **Whether the Outstanding Claims Liability includes any allowance for the discounting of future claim payments is at the option of the Fund in accordance with the relevant accounting standards.**
- 4.2-23 **The discount rate adopted should be consistent with, and no greater than, the risk free rate determined from the market yield available**

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on Commonwealth Government Treasury Bonds for the relevant duration.

### **Division 4.2-7 Risk Equalization Outstanding Claims Liability**

- 4.2-24 In this Standard, Risk Equalization refers to the statutory pooling arrangement under the Health Benefits Risk Equalization Trust Fund.
- 4.2-25 At any point in time a Fund needs to allow for the two components of Risk Equalization, namely:
- a) **the** net amount in respect of recoveries from and payments to the Risk Equalization Trust Fund in respect of unrepresented and outstanding claims (*Risk Equalization Outstanding Claims Liability*); and
  - b) the net amount in respect of recoveries from and payments to the Risk Equalization Trust Fund in respect of the period just ended (*Risk Equalization Accrued Liability*).
- 4.2-26 The Risk Equalization Outstanding Claims Liability reflects the central estimate Risk Equalization liability in respect of the Outstanding Claims Liability of the Fund. The net amount is determined as the difference between the relevant Calculated Deficit and the relevant Gross Deficit.
- 4.2-27 Whether the Risk Equalization Outstanding Claims Liability includes any allowance for the discounting of future expected receipts / payments is at the option of the Fund in accordance with the relevant accounting standards.
- 4.2-28 The discount rate adopted should be consistent with, and no greater than, the risk free rate determined from the market yield available on Commonwealth Government Treasury Bonds for the relevant duration.
- 4.2-29 **In determining the Capital Adequacy Liability, proper allowance for the statutory pooling Risk Equalization arrangements must be made. It is the liabilities net of Risk Equalization costs and benefits which must be determined in accordance with this Standard.**
- 4.2-30 **In this context it is noted that risk Equalization can involve both asset and liability components (both recoveries into and payments out of the Fund). This Standard covers the assessment of all component impacts of risk Equalization irrespective of whether the net results of the risk Equalization is, or is anticipated to be, an asset or liability of the Fund.**
- 4.2-31 **Anticipated recoveries from the Risk Equalization Trust Fund are to be treated as a deduction from the liabilities, and not an asset, of a Fund.**

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- 4.2-32 **The Risk Equalization Outstanding Claims Liability relates to the net Risk Equalization liability, determined as the Calculated Deficit minus the Gross Deficit, in respect of the Outstanding Claims Liability determined under Division 4.2-6 of this Standard.**
- 4.2-33 **The Calculated Deficit in respect of the outstanding claims liability is to be determined on a basis consistent with the quarterly determination of the Calculated Deficit required under the Risk Equalization Trust Fund.**
- 4.2-34 **The Calculated Deficit is to be determined from a best estimate of the insured profile of the Fund and a best estimate Average Deficit Per SEU for the relevant period.**
- 4.2-35 **The best estimate Average Deficit Per SEU is to be determined taking into account the Average Deficit Per SEU for previous quarters, historical seasonal trends in the Average Deficit Per SEU, reasonable assumptions in respect of the claims experience of the industry at Risk Equalization Jurisdiction level and reasonable assumptions in respect of the insured population of the industry at Risk Equalization Jurisdiction level.**
- 4.2-36 **The Gross Deficit is the amount in respect of the outstanding claims liability that can be recovered from the Risk Equalization Trust.**
- 4.2-37 **The Gross Deficit is to be based on the underlying determination of the Outstanding Claims Liability with the estimated recoveries to be based on the historic relationship of the gross claims and recoveries experience.**
- 4.2-38 **The Risk Equalization recoveries would be determined on the same method as specified for the associated Outstanding Claims Liability, but based on Risk Equalization recovery amounts rather than gross claim payments made. Where the Risk Equalization recovery does not vary by claims delay duration, the risk Equalization recovery amount may be estimated via a uniform proportion of the gross projected claims amount, where the uniform proportion is based on historic experience.**

### **Division 4.2-8 Unearned Premium & Unexpired Risk Reserve**

- 4.2-39 **The *Unearned Premium Liability* is the amount of premiums received prior to the valuation date for insurance cover to be provided for periods after the valuation date.**
- 4.2-40 **The *Unexpired Risk Reserve* is a calculation of the value of future claims, Risk Equalization (for health insurance business) and expense liability of the Fund arising in respect of the amount of Unearned Premiums.**

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- 4.2-41 The Unearned Premium and Unexpired Risk Reserve liabilities form the basis for the relevant intermediate component in the determination of the Capital Adequacy Liability.
- 4.2-42 Any unexpired risk liability recognised in the balance sheet will count as capital for the purposes of these prudential standards.
- 4.2-43 **The Unearned Premium amount is to be determined in respect of premiums paid in advance, that is premiums paid prior to the date of valuation which provide cover to members in respect of some period beyond the valuation date. The Unearned Premium amount is the pro rata amount of a premium in respect of the period of cover after the valuation date relative to the total period originally covered by the premium paid.**
- 4.2-44 **The pro rata calculation required of subsection (1) is to be determined on a precise number of days basis for each premium amount.**
- 4.2-45 **The Unexpired Risk Reserve is determined as the Unearned Premium times the Loss Ratio specified below.**
- 4.2-46 **The Loss Ratio is ordinarily to be determined as the sum of the Claims Ratio and the Expense Ratio. Where the Board believes that this may no longer be a best estimate measure of the prospective annualised loss ratio for the Fund on the current premium rates, a suitable alternative ratio is to be adopted.**
- 4.2-47 **The Claims Ratio is determined as the ratio of the Business's expected claims, Risk Equalization payments (for health insurance business) and Risk Equalization recoveries (for health insurance business) to earned premiums underlying the effective premium rate of the Business.**
- 4.2-48 **The Expense Ratio is determined as the ratio of the Business's expenses to earned premiums underlying the effective premium rate of the Business.**
- 4.2-49 It is noted that the onus is on the Board to adopt a realistic and genuine best estimate of the Loss Ratio. This should have regard to the most recent premium rate review for the Business, recent actual experience of the Business (adjusted for changes in underlying premium rates) and the effect of cyclical changes in this ratio over the year.
- 4.2-50 The Unexpired Risk Reserve would normally be calculated at an aggregate level for the health insurance business and separately for each health related insurance business.
- 4.2-51 The prospective annualised loss ratio should be determined on the basis of the 12 month period following the valuation and would normally be

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expected to reconcile to that used in determining the Renewal Option Reserve.

### **Division 4.2-9 Capital Adequacy Risk Equalisation Accrued Liability**

- 4.2-52 In this Standard, *Risk Equalization* refers to the statutory pooling arrangement under the Risk Equalization Trust Fund.
- 4.2-53 At any point in time a Fund needs to allow for the two components of Risk Equalization, namely:
- a) the net amount in respect of recoveries from and payments to the Risk Equalization Trust Fund in respect of unrepresented and outstanding claims (*Risk Equalization Outstanding Claims Liability*); and
  - b) the net amount in respect of recoveries from and payments to the Risk Equalization Trust Fund in respect of the period just ended (*Risk Equalization Accrued Liability*).
- 4.2-54 The Risk Equalization Accrued Liability reflects the central estimate net Risk Equalization liability in respect of the period ending at the valuation date and not payable until after the balance date. The net amount is determined as the difference between the relevant Calculated Deficit and the relevant Gross Deficit.
- 4.2-55 **In determining the Capital Adequacy Liability proper allowance for the statutory pooling risk Equalization arrangements must be made. It is the liabilities net of risk Equalization costs and benefits which must be determined in accordance with this Standard.**
- 4.2-56 **In this context it is noted that risk Equalization can involve both asset and liability components (both recoveries into and payments out of the Fund). This Standard covers the assessment of all component impacts of risk Equalization irrespective of whether the net results of the risk Equalization is, or is anticipated to be, an asset or liability of the Fund.**
- 4.2-57 **Anticipated recoveries from the Risk Equalization Trust Fund are to be treated as a deduction from the liabilities, and not an asset, of a Fund.**
- 4.2-58 **The Capital Adequacy Risk Equalization Accrued Liability relates to the net risk Equalization liability, determined as the Calculated Deficit minus the Gross Deficit, that has accrued under the Risk Equalization Trust Fund, in respect of the period ending at the valuation date.**
- 4.2-59 **The Calculated Deficit is to be determined from the actual relevant historic membership profile of the Fund and a best estimate Average Deficit Per SEU for the period concerned.**

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- 4.2-60 **The best estimate Average Deficit Per SEU would usually be determined taking into account the Average Deficit Per SEU for previous quarters, historical seasonal trends in the Average Deficit Per SEU, reasonable assumptions in respect of the claims experience of the industry at Risk Equalization Jurisdiction level and reasonable assumptions in respect of the total membership of the industry at Risk Equalization Jurisdiction level.**
- 4.2-61 **The Gross Deficit is to be determined on the basis of the actual benefits paid during the period that can be recovered from the Risk Equalization Trust Fund.**

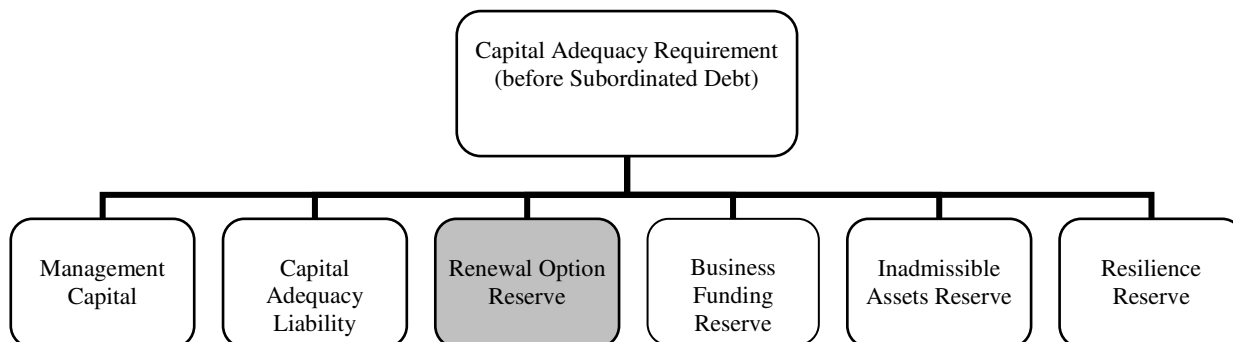
### **Division 4.2-10 Other Liabilities**

- 4.2-62 The Other Liabilities of the Fund relate to all other accrued liabilities of the Fund not covered under the other liability components specified under this Standard. These would normally include liabilities for health related other business, employee entitlements, amounts due to trade creditors and other normal business obligations outstanding.
- 4.2-63 **The Other Liabilities amount is to include all liability amounts of the Fund not counted under the other liability components specified under this Standard.**
- 4.2-64 **The Other Liabilities of the Fund are to be assessed and determined on the basis of relevant Australian Accounting Standards or other generally accepted accounting practice and principles.**
- 4.2-65 **Where the determination of the liabilities of the Fund in accordance with this standard would have the effect of changing the Other Liabilities assessment of the Fund, then such change should be reflected in the Other Liabilities amount considered under paragraph 4.2-64.**
- 4.2-66 The primary adjustment that may be relevant to the Other Liabilities under paragraph 4.2-66 would be in respect of any deferred tax liability held where the Fund was subject to income tax. To the extent that any increase in the Fund's liability provisions would generate a corresponding tax benefit, it may be appropriate to allow for the tax benefit in respect of the cost of the capital adequacy margin held via an adjustment to any deferred tax liability within the Other Liabilities.

## Part 4.3 Renewal Option Reserve

### Division 4.3-1 Calculation of Renewal Option Reserve

4.3-1 The Renewal Option Reserve is an intermediate component in the determination of the Health Benefits Fund Capital Adequacy Requirement (*HBFCAR*), which reflects the risks associated with the ability of the Fund to accept new policy holders with an appropriate degree of premium rate stability.



4.3-2 Holders of complying health insurance or health related insurance policies have an expectation to maintain and renew their policies in future. To the extent that current premium rates may prove inadequate to cover future benefits and related Fund expenses some prospective renewal option reserve is needed. This would reflect the time taken to identify and verify emerging adverse experience and for appropriate corrective action to be implemented.

4.3-3 Similarly it is not appropriate that holders of complying health insurance policies or health related insurance policies subsidise health related other businesses within a health benefits fund. To the extent that the current business plans of a health related other business project a loss for the following 12 months, some prospective reserve is required.

4.3-4 The risks pertaining to each element include the risk of mis-estimation of the mean, the risk of deterioration of the assumed mean, the risk of adverse statistical fluctuations about the mean and the risk of unexpected changes in the underlying distribution of experience.

4.3-5 The Renewal Option Reserve will generate a reserve requirement to the extent that the profit margin contained within the prospective premium rates is insufficient to cover any premium rate shortfall, plus the value of the risks evaluated.

4.3-6 **The Renewal Option Reserve must make provision for the risks and potential costs in providing the right of renewal to policy holders. This reserve is to be assessed via a separate projection, for the health insurance business and each health related insurance business, of**

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**future premiums, claims and expense experience over the prescribed period.**

- 4.3-7 **The margin for risk to be included in the Renewal Option Reserve is to be determined in accordance with the provisions of Division 4.2-2 of this Standard.**
- 4.3-8 **The Renewal Option Reserve for the health insurance business must not be less than zero.**
- 4.3-9 **The Renewal Option Reserve for each health related insurance business must not be less than zero.**
- 4.3-10 **The Renewal Option Reserve is determined based on a conservative business projection of the health insurance business and each health related insurance business over the twelve month period subsequent to the valuation date.**
- 4.3-11 **The Renewal Option Reserve must also make provision for potential costs of conducting health related other business within the health benefits fund. This reserve is to be assessed via a separate projection of future cash flows for each health related other business.**

### **Division 4.3-2 Insurance Business Projection**

- 4.3-12 **Except for those circumstances described in paragraph 4.3-13, the required business projection for the health insurance business and each health related insurance business is the current business plan, with an appropriate margin for risk included in the projection.**
- 4.3-13 **Where the current business plan has not been determined on a best estimate basis, the business projection adopted for the purposes of the Renewal Option Reserve should be a best estimate projection, with an appropriate margin for risk included in the projection.**
- 4.3-14 **The Business Projection may be determined either:**
  - a) **as detailed in paragraphs 4.3-16 to 4.3-17; or**
  - b) **by an Actuary.**
- 4.3-15 **Where the Renewal Option Reserve is determined by an actuary, the actuary must take into account the requirements of this Division in respect of the individual components of the projection.**
- 4.3-16 **The required Fund business projection must allow for the following:**
  - a) **Earned premium income allowing for:**
    - (i) **The premium rates reflected in the current business plan.**
    - (ii) **The premiums projected to be paid during the projection period.**

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- (iii) **The Unearned Premium liability held at the start of the projection period as income, and the corresponding liability at the end of the period as outgo.**
  - (iv) **The Premium in Arrears asset held at the start of the projection period as outgo, and the corresponding asset at the end of the period as income.**
  - b) **Incurred claims allowing for:**
    - (i) **Benefit claims outgo based on the claims assumption specified in paragraphs 4.3.20 to 4.3.22.**
    - (ii) **The benefits projected to be paid during the projection period.**
    - (iii) **The Outstanding Claims liability held at the start of the projection period as outgo, and the corresponding liability at the end of the period as income.**
  - c) **Administration and all other expense outgo on the expense assumptions specified in paragraphs 4.3-26 to 4.3-28.**
  - d) **For health insurance business, Risk Equalisation income and outgo as specified in paragraphs 4.3-23 to 4.3-25.**
  - e) **Investment income at the rate specified in paragraph 4.3-29. This is to be based on the Unearned Premium and Outstanding Claims liabilities at the start of the period and projected net cash flows during the period. Investment income on Fund surplus at the start of the projection period is to be excluded.**
- 4.3-17 **The Renewal Option Reserve is determined as the net present value of the cash outflows less the cash inflows. The rate of interest used for the present value calculation is to be the same as that used under paragraph 4.3-29. If the net present value result is less than zero (projected income exceeds outgo), the result is to be taken as zero.**

### **Premium Amounts**

- 4.3-18 **The projection specifies reference to the premium rates in the current business plan. To the extent that the current business plan makes no allowance for future premium rate increases, then the existing premium rates should be used in the projection. Note that to the extent that current or any future increased premium rates are not immediately applicable to all policy owners, the resulting premium income shortfall is to be allowed for in the projection.**
- 4.3-19 **However, benefit claims are to be based on the full premium rate irrespective of any actual premium shortfall as this is the basis on which the claims ratios adopted have been specified and determined.**

### **Benefit Claims Amounts**

- 4.3-20 **The projected gross benefit claims are to be determined via the application of a claims ratio to the membership and the effective premium rate over the projection period. The claims ratio used is to be {1 + Margin} times the greater of:**

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- a) the equivalent claims ratio used for the purpose of the last premium rate application made in respect of the business (where appropriate); and
  - b) the equivalent best estimate claims ratio underlying the current business plans of the Insurer in respect of the relevant business; and
  - c) the best estimate claims ratio used to determine the outstanding claims liability in accordance with Division 4.2-6 of this Standard.
- 4.3-21 The cost of any additional options provided to members must also be allowed for based on {1 + Margin} times the best estimate cost of these.
- 4.3-22 The Margin specified above is to be the Margin determined in accordance with the provisions of Division 4.2-2 of this Standard.

### **Risk Equalisation Amounts for Health Insurance Business**

- 4.3-23 Risk Equalisation outgo and risk equalisation income are to be assessed explicitly and separately in the health insurance business renewal option reserve.
- 4.3-24 In the case of the Risk Equalisation Trust Fund:
- a) Income related to actual claims experience is to be determined based on the relevant component of the benefit claims projected and the lesser of the best estimate ratio of claims recoveries to gross claims, and the actual ratio observed over the previous twelve month period.
  - b) Payments related to membership profiles, are to be based on the best estimate Average Deficit Per SEU for each quarter of the twelve month period.
- 4.3-25 In the case of the base amounts determined under paragraph 4.3-24:
- a) The amount determined under sub-paragraph (a) is to be increased by the same Margin as applies under paragraph 4.3-20.
  - b) The amount determined under sub-paragraph (b) is to be increased by the same Margin as applies under paragraph 4.3-20.

### **Administration and Other Expenses**

- 4.3-26 These are to be based on the greater of:

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- a) the best estimate non-claim expenses ratio of the Business over the next 12 months; and
  - b) the actual non-claims expense ratio (adjusted to the projected premium rate) over the previous 12 month period.
- 4.3-27 The amount determined under paragraph 4.3-26 is to be increased by a margin equal to 50% of the margin applicable under section 4.3-20.
- 4.3-28 The non-claims expense ratio is the ratio of all expense outgoings of a Business excluding claims and Risk Equalization amounts, to the gross premium income of the Business.

### Investment Earnings Rate

- 4.3-29 The rate of investment earnings to be adopted is to be taken as the market yield available on one year Commonwealth Government Treasury Bonds as at the start date of the projection, less 0.01 (1%).

### Taxation

- 4.3-30 Where an Insurer is subject to taxation, appropriate allowance should be made for taxation in the determination of the Renewal Option Reserve. To the extent that any increase in the Fund's liability provisions would generate a corresponding tax benefit, it may be appropriate to allow for the tax benefit in respect of the cost of the capital adequacy margins held via an adjustment to any deferred tax liability within Other Liabilities.

### Division 4.3-3 Other Business Projection

- 4.3-31 Except for those circumstances described in Section 4.3-32, the required business projection for each health related other business is the relevant current business plan.
- 4.3-32 Where the relevant current business plan has not been determined on a best estimate basis, the business projection adopted for the purposes of the Renewal Option Reserve should be a best estimate projection.
- 4.3-33 The Business Projection may be determined either:
- a) as detailed in sections 4.3-34 to 4.3-35; or
  - b) by an Actuary.
- 4.3-34 Where the Renewal Option Reserve is determined by an actuary, the actuary must take into account the requirements of this section in respect of the individual components of the projection.
- 4.3-35 The Renewal Option Reserve is determined as the net present value of the cash outflows less the cash inflows. In determining the

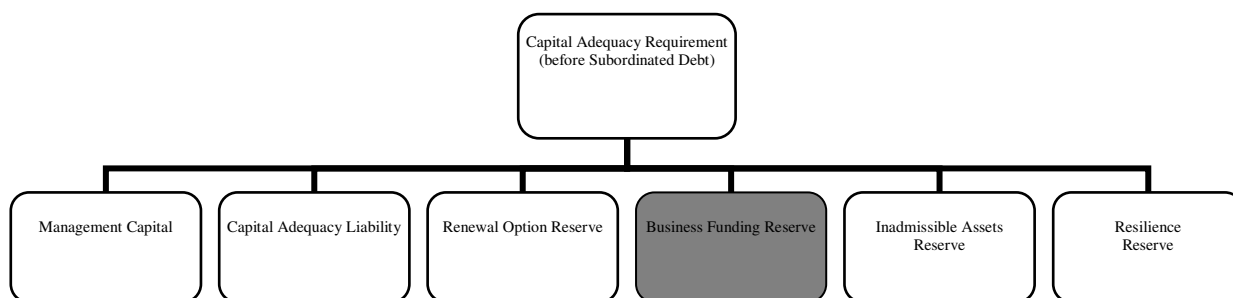
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**appropriate cash flows to adopt, the principles outlined in Division 4.3-2 must be followed. The rate of interest used for the present value calculation is to be the same as that used under section 4.3.29. If the net present value result is less than zero (projected income exceeds outgo), the result is to be taken as zero.**

## Part 4.4 Business Funding Reserve

### Division 4.4-1 Overview

4.4-1 The Business Funding Reserve is an intermediate component in the determination of the Health Benefits Fund Capital Adequacy Requirement (HBFCAR) which allows for the planned business growth or other relevant business development strategies that are likely to require increased capital reserving or otherwise absorb existing capital resources.



4.4-2 The Capital Adequacy Liability and Renewal Option Reserve secure the Fund's obligations in respect of the general level of membership of the Fund and the basic operation of the Fund. However, in the context of an ongoing operation, it is appropriate to also allow for the impact of anticipated levels of business growth and the impact of related or other relevant business development strategies and plans.

4.4-3 A significant increase in the membership of a Fund will at least require the establishment of related Capital Adequacy Requirements, and may involve the incidence of material acquisition costs in terms of items such as advertising expenses and 'special offers'. Major systems or business redevelopment and restructuring projects are another item of potential capital strain on an Insurer and its Fund.

4.4-4 It is inappropriate that the drain on capital involved in these circumstances be borne at the expense of the security of existing policy holder entitlements.

4.4-5 A Fund should not be considered capital adequate where a projection of the business of that fund over the next three years, assuming future experience during that period in accordance with best estimate assumptions, and reflecting realistic (best estimate) planned levels of growth in the business, reveals a breach of the Solvency Standard.

4.4-6 It can be argued that it is onerous to require the advance commitment of capital to a Fund, where the actual need for that capital may not emerge for a number of years. However, as the required capital is a consequence of the business plans of the Insurer, it is appropriate that the source of

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that capital be identified. Accordingly it is appropriate to recognise internally sourced capital (shareholders'/members' capital, existing and/or emerging profits) to the extent that the capital is available to meet the business requirements of the Fund. It is appropriate to recognise externally sourced capital to the extent that the capital has been committed to the business requirements of the Fund.

- 4.4-7 It is considered appropriate to count, for this purpose, capital residing in, or emerging from, elsewhere in the Insurer, to the extent it is excess to the prudential capital requirements of the entity or other health benefits funds and can be transferred into the Fund.
- 4.4-8 In considering the future (3 year) viability of the fund, it is appropriate to assume that the experience of the fund over that period will be in line with the Board's best estimates underlying its business plans at the reporting date. The Solvency Requirement which it is necessary to meet into the future is, however, determined in accordance with the Solvency Standard, with appropriate allowance for experience more adverse than best estimate.

### *PLEASE NOTE*

*The Business Funding Reserve, in ensuring the Fund's ability to meet the Solvency Requirement over the next three years, must by implication secure the Solvency Requirement as at the reporting date.*

*Although some items of prospective capital expense may be intended to be capitalised and amortised over time, to the extent the related assets are not admissible for Solvency purposes, their capital cost cannot be ignored in the Business Funding Reserve.*

### **Division 4.4-2      Determination of the Business Funding Reserve**

- 4.4-9 **The HBFCAR must provide for a reserve in respect of any additional capital likely to be required to ensure that, if experience during the next three years is in accordance with the intended business plans of the Insurer, the Fund will be able to meet the Solvency Requirement (in accordance with the Solvency Standard) over those three years.**
- 4.4-10 **The Business Funding Reserve is determined as:**
- a) **the additional amount required to ensure that the Solvency Requirement of the Fund will be able to be met over the next three years, allowing for any capital released over that period from the existing business of the Fund; less**
  - b) **New Business Capital.**
- 4.4-11 **New Business Capital is the aggregate of:**

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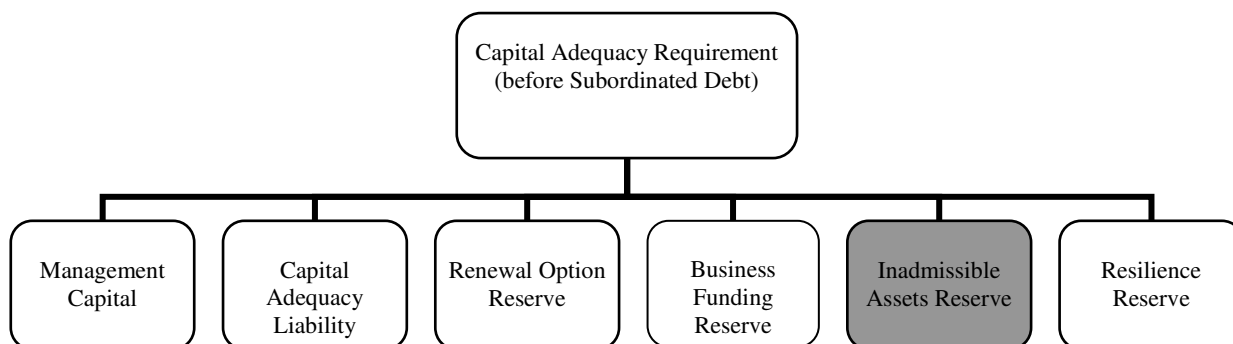
- a) **existing, binding arrangements for the external raising of capital specific to the growth of business within the Fund; and**
- b) **available capital (existing or emerging) in any other health benefits fund of the Insurer which is in excess of the Capital Adequacy Requirement of that fund at that time and can be transferred to the Fund; and**
- c) **available capital (existing or emerging) within the Insurer but outside the health benefits funds which is in excess of any prudential capital requirement and can be transferred to the Fund.**

4.4-12 **The Business Funding Reserve must not be less than zero.**

## Part 4.5 Inadmissible Assets Reserve

### Division 4.5-1 Overview

4.5-1 The Inadmissible Assets Reserve is an intermediate component in the determination of the Health Benefits Fund Capital Adequacy Requirement (*HBFCAR*) which reflects certain asset risks.



4.5-2 The risks reflected in the Inadmissible Assets Reserve of the HBFCAR are as follows:

- a) Holdings in Associated Entities which are Prudentially Regulated:  
The value at which an associated entity is held in the Fund should not have the effect of double counting the legislated capital requirement of the associated entity (ie. using the same capital for both entities).
- b) Asset Concentration & Non-Systemic Risks  
Diversification is an important principle of prudent investment. To the extent the asset exposure of a Fund is excessively concentrated in a particular asset, or with a particular obligor, a reserve should be established against the part of the value of that exposure considered excessive.
- c) Credit Risks  
In general, it is considered that the combined effect of adopting the net market value of the assets and the reserves for asset concentration would address the average costs of default and marketability/liquidity risks. Where a fund has significant exposure to non-sovereign credit risks, the Board should provide an appropriate reserve allowance for such credit risks, along with any other asset risks.
- d) Liquidity Risks  
It is noted that the Board of each Insurer in formulating the Fund's investment policy and discharging its responsibilities in the financial operations of the Insurer and the Fund would include consideration of liquidity risks. Notwithstanding the prescribed limits of this Standard, the Board must have regard to the particular circumstances of the Fund. If in the opinion of the

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Board the overall portfolio of assets of the health benefits fund is too illiquid, the Board must increase the reserves appropriately.

e) Note:

It is not the intention of these reserves to limit the investment practices of Insurers. Rather it is to ensure that the risks associated with particular investment strategies are appropriately assessed and provided for..

4.5-3 Beyond this it is noted that the Board of each Insurer in implementing the Fund's investment policy and discharging its responsibilities in the financial operations of the Insurer and the Fund would include consideration of credit and liquidity risks. It is not the intention of these reserves to limit the investment practices of Insurers. Rather it is to ensure that the risks associated with particular investment strategies are appropriately assessed and provided for.

### **Division 4.5-2 Asset Exposure**

4.5-4 **In assessing the asset risks, the Insurer must:**

- a) **take account of the effective exposure of the Fund to various asset classes, regardless of the physical asset holdings of the Fund; and**
- b) **consider exposure to counterparty risks including, but not limited to, futures and options contracts, swaps, hedges, warrants, forward rate and repurchase agreements.**

4.5-5 **In the case of investment entities, it is the exposure of the Fund to the underlying assets of the entity, determined by adopting a 'look through' approach, that is relevant. For this purpose, an investment entity is an entity whose assets are solely investments, where the sole purpose of the entity is investment activities and where the investor investing in that entity has security directly linked to those assets.**

4.5-6 As an example of the asset exposure to be adopted in assessing asset risks, an unlisted unit trust or securitised mortgage instrument would generally be considered an investment entity and the assessment of asset risks should be based on the underlying assets of the trust/instrument. However, in practice, examples exist of arrangements where the security of the investor is not directly linked to the underlying assets, but is subordinated to the interests of a third party. In this case, it would not be appropriate to base the assessment on the underlying assets.

### **Division 4.5-3 Calculation of the Inadmissible Assets Reserve**

4.5-7 **In determining the Health Benefit Fund Capital Adequacy Requirement (HBFCAR), the Inadmissible Assets Reserve for the Fund is determined as the sum of:**

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- a) **the reserve prescribed in respect of Holdings in Associated and Subsidiary Entities which are Prudentially Regulated Institutions (Division 4.5-4); plus**
- b) **the reserve prescribed in respect of Asset Concentration Risks (Division 4.5-6).**

4.5-8 **Where the Inadmissible Assets Reserve is reduced by deferred tax provisions or other liabilities relevant to the inadmissible portion of the assets, the reduction must only be to the extent those provisions/liabilities are assessed as likely to be realised.**

### ***PLEASE NOTE***

*The value of an asset is the value as determined in accordance with Australian Accounting Standards.*

### **Division 4.5-4 Holdings in Associated and Subsidiary Entities that are Prudentially Regulated Institutions**

- 4.5-9 It is the intention that the integrity of the capital requirements of separate entities be maintained. It is not appropriate that assets being held in respect of one institution's capital requirements are counted in meeting the capital requirements of another.
- 4.5-10 It is recognised that the methods for valuing financial entities, in particular the minimum capital requirements thereof, vary depending on the nature of the financial institution, the assets backing its capital requirement and the circumstances of the association. Accordingly, the responsibility for appropriate reserving in this respect is placed with the Board.
- 4.5-11 Where the entity is a financial institution or a private health insurance institution subject to prudential regulation which requires the maintenance of minimum capital levels, it is not appropriate that, in determining the HBFCAR of the Fund, credit be taken for the capital already securing those minimum capital requirements.
- 4.5-12 Where a part of the capital requirement of the entity is externally sourced, for example, by a subordinated debt arrangement, the fair value or net market value of the entity should not recognise this debt as a net asset, and accordingly it is not necessary to further reduce that market value in respect of that part of the capital requirement.
- 4.5-13 **Where the associated entity is a financial institution subject to prudential regulation that requires the maintenance of minimum capital, the HBFCAR must include a reserve to the extent that the value of the asset in the financial statements includes some value in respect of that capital.**

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- 4.5-14 **The prescribed additional reserve in respect of holdings in associated and subsidiary entities which are prudentially regulated is to be determined as the extent to which the value placed on the entity in accordance with paragraph 4.4-13f) of the Solvency Standard includes a component of value in respect of the prudential capital requirement of the entity.**

### **Division 4.5-5 Asset Concentration Risks**

- 4.5-15 **The HBFCAR must establish a reserve against the adverse impact of a concentration of investment in a particular asset, with a particular obligor or with a Related Party.**
- 4.5-16 Notwithstanding the prescribed limits, if in the opinion of the Board the overall portfolio of assets of the Fund has too little diversification, is too illiquid or has too great an exposure to one obligor of low credit standing, the Insurer should add to the reserve for inadmissible assets an amount considered necessary to adequately protect the interests of the members of the Fund.
- 4.5-17 **Except for those assets described in paragraph 4.5-18, the prescribed reserve for asset concentration risks is determined as the amount by which the value of any single asset or credit exposure (with a particular obligor or related party) exceeds 10% of the value of the assets of the Fund.**
- 4.5-18 **For those assets set out below, the prescribed reserve for asset concentration risks is determined as the amount by which the value of any single asset or credit exposure (with a particular obligor or related party) exceeds:**
- a) **100% of the value of the assets of the Fund, where the asset or credit exposure concerned is:**
    - (i) **guaranteed by a national government, being the national government of the country in whose currency the liabilities of the Fund are denominated; or**
    - (ii) **guaranteed by an Australian State government;**
  - b) **the greater of 50% of the value of the assets of the Fund and \$5 million, where the asset or credit exposure concerned is:**
    - (i) **guaranteed by a local government or public sector entity; or**
    - (ii) **secured by banks bills or deposits with an Authorised Deposit-taking Institution which is regulated by the Australian Prudential Regulation Authority and which has net assets of at least \$50 million;**
  - c) **the greater of 25% of the value of the assets of the Fund and \$5 million, where the asset or credit exposure concerned is secured by deposits with an Authorised Deposit-taking Institution which is regulated by the Australian Prudential**

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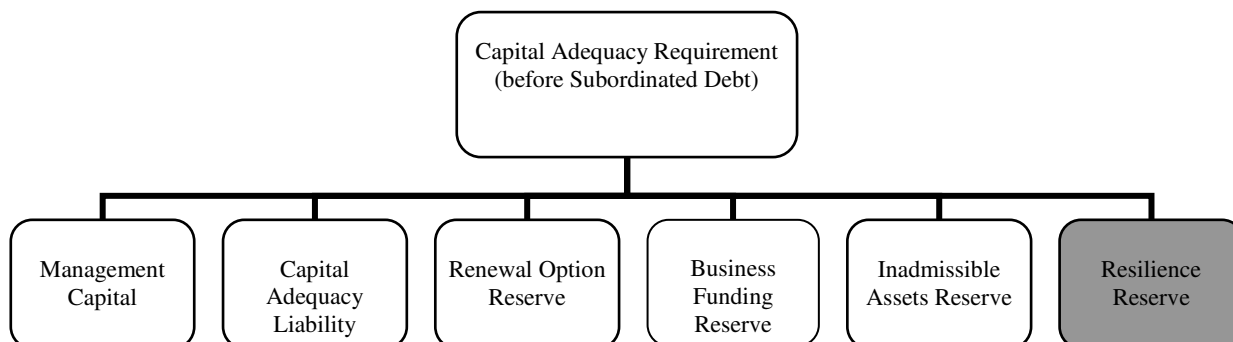
### **Regulation Authority and has net assets of less than \$50 million and which is not a Related Party.**

- 4.5-19 In respect of banks bills and deposits with Authorised Deposit-taking Institutions, the standards permit the following maximum concentrations of assets:
- a) for bank bills and deposits with an Authorised Deposit-taking Institution that has at least \$50 million in net assets, the greater of 50% of total assets and \$5 million;
  - b) for deposits with an Authorised Deposit-taking Institution that has net assets less than \$50 million and is not a Related Party, the greater of 25% of total assets and \$5 million;
  - c) for deposits with an Authorised Deposit-taking Institution that has net assets less than \$50 million and is a Related Party, 10% of total assets.
- 4.5-20 In assessing the Inadmissible Asset Reserve requirements, asset risks should be assessed on the basis of effective asset exposures and adopting a 'look through' approach.

## Part 4.6 Resilience Reserve

### Division 4.6-1 Overview

4.6-1 The Resilience Reserve is an intermediate component in the determination of the Health Benefits Fund Capital Adequacy Requirement (*HBFCAR*) which reflects the risks of the Fund in respect of any mismatching of asset and liability exposures.



4.6-2 To the extent that the value of liabilities is not directly linked to the value of the underlying assets, an adverse movement in the day to day value of the assets effectively reduces the level of reserves supporting the liabilities. It is prudent that an Insurer recognise the risk associated with such asset valuation volatility and hold sufficient reserves such that the obligation of each Fund would still be able to be met following an adverse systemic market movement.

4.6-3 An assessment of the resilience of the Fund, while targeting the assessment of an asset related risk, theoretically involves consideration of the movements in both the value of assets and the value of liabilities under the prescribed scenario of adverse market movement.

4.6-4 While this will often not be a significant concern in the circumstances of the generally short term liabilities and renewal option risks of a health insurer, it is important that this position is verified, and appropriate allowance be made where relevant.

### Division 4.6-2 Asset Exposure

4.6-5 **In assessing the asset risks, the Insurer must:**

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- a) **take account of the effective exposure of the Fund to various asset classes, regardless of the physical asset holdings of the Fund; and**
  - b) **consider exposure to counterparty risks including, but not limited to, futures and options contracts, swaps, hedges, warrants, forward rate and repurchase agreements.**
- 4.6-6 **In the case of investment entities, it is the exposure of the Fund to the underlying assets of the entity, determined by adopting a ‘look through’ approach, that is relevant. For this purpose, an investment entity is an entity whose assets are solely investments, where the sole purpose of the entity is investment activities and where the investor investing in that entity has security directly linked to those assets.**
- 4.6-7 As an example of the asset exposure to be adopted in assessing asset risks, an unlisted unit trust or securitised mortgage instrument would generally be considered an investment entity and the assessment of asset risks should be based on the underlying assets of the trust/instrument. However, in practice, examples exist of arrangements where the security of the investor is not directly linked to the underlying assets, but is subordinated to the interests of a third party. In this case, it would not be appropriate to base the assessment on the underlying assets.

### **Division 4.6-3 Determination of Resilience Reserve**

- 4.6-8 **The Insurer must assess the resilience of the Fund and provide for an appropriate reserve — the Resilience Reserve.**
- 4.6-9 **In this context, resilience is assessed as the ability of the Fund to sustain shocks to the economic environment in which it operates and which are likely to result in an adverse movement in the value of its assets relative to the value of its liabilities.**
- 4.6-10 **The Resilience Reserve is determined as the additional amount that needs to be held before the happening of a prescribed set of changes in the economic environment, such that after the changes the assets of the Fund exceed its liabilities, including assessed liability risks in accordance with this Standard.**
- 4.6-11 **The Resilience Reserve is determined by reference to the Admissible Assets of the Fund.**
- 4.6-12 **The Resilience Reserve is determined in accordance with the following formula:**

$$\text{RR} = \{ L' \times f \} - L$$

where

**RR = Resilience Reserve.**

**L = The liability held for the Fund for capital adequacy purposes to reflect the liability risks prior to the**

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prescribed economic change. That is L is equal to the Management Capital plus the Capital Adequacy Liability plus the Renewal Option Reserve plus the Business Funding Reserve.

<b>L'</b>	=	The value of the liabilities after the prescribed economic change.
<b>f</b>	=	A / A'.
<b>A</b>	=	Value of the admissible assets of the Fund prior to the prescribed economic change.
<b>A'</b>	=	Value of those assets after the prescribed economic change.

4.6-13 The Resilience Reserve must not be less than zero.

4.6-14 For the determination of A', the prescribed changes to the economic environment are:

<b>INVESTMENT SECTOR</b>	<b>PRESCRIBED ECONOMIC CHANGE FOR CAPITAL ADEQUACY</b>
Equities	Fall in Capital Value of (35% x DF)
Property (other than listed property trusts)	Fall in Capital Value of (25% x DF)
Listed property trusts	Fall in Capital Value of (25% x DF)
Interest Bearing	Rise in Yield of (2.5% x DF)
Indexed Bonds	Rise in Yield of (1.0% x DF)
<b>CURRENCY</b>	<b>PRESCRIBED EXCHANGERATE MOVEMENT FOR CAPITAL ADEQUACY</b>
All	15% reduction in value of assets exposed to a denomination other than that of the liabilities.

4.6-15 DF in the above table is the diversification factor.

4.6-16 Unless the Fund has a reasonable spread of investments across the equity, property and cash/fixed interest sectors, the diversification factor will be close to a value of 1.0. Consequently for many funds DF can be set equal to 1.0 without the need to perform the additional calculation set out below.

4.6-17 DF is determined in accordance with the following formula:

$$DF = \{ \sqrt{(E^2 + P^2 + F^2)} \} / (E + P + F)$$

where

**E =** the proportionate holding of admissible assets in the equity sector times 30%.

**P =** the proportionate holding of admissible assets in the property sector times 20%.

**F =** the proportionate holding of admissible assets in the cash and fixed interest sector times 1.5% times the average term to maturity for the sector.

4.6-18 *Yield*, as referred to in the above table, should be taken to mean:

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- a) for interest bearing securities, redemption yield (running yield in the case of irredeemable securities); and
- b) for indexed bonds, real yield.

### 4.6-19 Determination of L':

The required Resilience Reserve is determined by assuming changes in the economic environment which cause asset values to vary. In certain circumstances, these changes also cause the bases of determining liabilities to vary. Such changes to the value of the liabilities should be allowed for in determining the overall impact of the changes.

Particular examples are:

- a) Where the outstanding claims liability is determined on a discounted basis, the discount rate may be increased consistently with the above interest rate environment scenario.
- b) The Renewal Option Reserve component of the Capital Adequacy Liability is based on a present value calculation. The interest and discount rate used in its determination may be increased consistently with the above interest rate environment scenario.
- c) Where there is a provision for deferred taxation. This should be adjusted in a manner consistent with the change in associated asset values. Note however, that any resulting net future income tax benefit arising would not normally be counted as an asset as it would be subject to the inadmissible asset considerations.

### 4.6-20 Currency Movements:

The prescribed exchange rate movement would normally be applied to the value of the assets following the application of the prescribed economic change and not to the gross value of assets prior to the application of the prescribed economic change.

- 4.6-21 In assessing the Resilience Reserve requirements, asset risks should be assessed on the basis of effective asset exposures and adopting a 'look through' approach in accordance with the principles set out in Division 4.6-2.

## **Part 4.7 Subordinated Debt & alternative sources of capital**

### **Division 4.7-1 Overview**

- 4.7-1 The Capital Adequacy Requirement may be satisfied by either:
- a) shareholders' or members' funds represented by the disclosed net assets of a Fund, in terms of the retained earnings and capital held within the Fund, that are subordinate to the other obligations of the Fund; or
  - b) the use of alternative sources of capital support for the business of a Fund such as subordinated debt, where the obligations to the debt party under the instrument are subordinate to the other obligations of the Fund.
- 4.7-2 Under the Capital Adequacy Standard, only Approved Subordinated Debt may qualify as subordinated debt in determining the Capital Adequacy Requirement.
- 4.7-3 The purpose of this Division is to:
- a) specify the terms on which debt may qualify as Approved Subordinated Debt; and
  - b) specify the amount of Approved Subordinated Debt that may be counted for the purposes of the Solvency Requirement and the Capital Adequacy Requirement.
- 4.7-4 **This Division sets out the minimum terms that a debt instrument must contain and the requirements that it must satisfy in order to be considered by PHIAC for approval as Approved Subordinated Debt.**
- 4.7-5 **However, it is noted that nothing in this Standard obliges PHIAC to approve any particular subordinated debt instrument for a Fund. Irrespective of whether an instrument meets the specified minimum terms and requirements, PHIAC has final discretion as to whether or not to give its approval to the debt instrument.**
- 4.7-6 **Not all of the value of an Approved Subordinated Debt will necessarily count towards the Capital Adequacy Requirement of the Act. This Standard sets out the amount of Approved Subordinated Debt that may count for these purposes from time to time.**
- 4.7-7 **Alternative sources of capital support for the business of a Fund, where the obligations to the party under the instrument are subordinate to the other obligations of the Fund, may be considered by PHIAC from time to time.**

## **Division 4.7-2      Approved Subordinated Debt**

- 4.7-8      All proposals to issue or borrow subordinated debt, the purpose of which is, at the time of issue or borrowing, or may be in the future, to contribute to the capital requirements of a health benefits fund, must be submitted to PHIAC for individual approval.
- 4.7-9      An Instrument of Issue of subordinated debt will be assessed once only, prior to the time of issue. The quantum of the proposed issue and timing for draw down will be important items in that assessment. However, separate requirements limit that quantum, to the extent it is Approved Subordinated Debt, on a continuous basis into the future.
- 4.7-10     PHIAC will use the criteria set out in this Division when assessing the terms and conditions of an Instrument of Issue of subordinated debt. However, each proposed issue will be considered taking into account the particular circumstances of the Fund involved and the proposed terms and conditions of the issue.
- 4.7-11     **Approved Subordinated Debt must continuously meet the conditions and requirements set out in the following paragraphs.**
- 4.7-12     **An Approved Subordinated Debt instrument must provide for the following terms and conditions:**

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- a) **It must have a minimum term of ten years at the commencement of the loan.**
  - b) **There are to be no circumstances where repayment may be called at the lender's option.**
  - c) **Interest charges under the instrument may be based on a fixed, floating or other commercial basis. However, the basis must be set on a defined, non-escalating basis, for minimum periods of five years under the instrument.**
  - d) **Interest bases may be subject to review no more frequently than five yearly, and may include default rate escalation provisions. However, any default escalation is subject to a maximum of 2% at each review date.**
  - e) **Interest payments are not to be payable where the payment of these would cause the Fund to breach its Solvency Requirement.**
  - f) **Interest payment obligations may be cumulative including interest being charged on delayed interest payments. However, penalty interest may not be charged on interest payment delay where the payment of the penalty interest would cause the Fund to breach its Capital Adequacy Requirement.**
  - g) **Capital repayments are not to be made where the repayment of these would cause the Fund to breach its Capital Adequacy Requirement.**
  - h) **Delayed capital repayments may be subject to continuing interest charges, on the above interest charge and payment conditions.**
- 4.7-13 **The debt instrument must be approved by PHIAC as Approved Subordinated Debt in writing. Such approval by PHIAC may include such additional conditions applicable to the approval of the debt as PHIAC requires.**
- 4.7-14 **If at any time a debt instrument approved under this Standard ceases to meet any of the conditions or requirements under subsection (5) or (6), then the debt instrument will immediately be disqualified as Approved Subordinated Debt.**

### **Division 4.7-3 Amount of Approved Subordinated Debt**

- 4.7-15 It is accepted that Insurers should be able to fund their business operations using a range of acceptable funding mechanisms. It is accepted that this may include the reasonable use of subordinated debt as provided under this Standard. However, it must also be acknowledged that it would not be acceptable to fund the capital needs of a health benefits fund only via third party funding such as subordinated debt. A reasonable balance between member/shareholder funding and third party funding is necessary.

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- 4.7-16 Under this Standard it is specified that a reasonable balance would not have debt funding exceed 50% of the risk based capital requirements of a health benefits fund.
- 4.7-17 **The maximum amount of Approved Subordinated Debt that may be counted towards the Capital Adequacy Requirement of a Fund at any time is 50% of the Fund's Health Benefits Fund Capital Adequacy Reserve of the Fund.**