



Australian Government

**Private Health Insurance
Administration Council**

**Private Health Insurance
(Health Benefits Fund Administration) Rules**

Solvency and Capital Adequacy Standards

Invitation for Comment

About PHIAC

PHIAC is an independent statutory authority established by the *National Health Act 1953*. PHIAC is the prudential regulator of the Private Health Insurance Industry and supervises more than 35 private health insurers and the management of the more than \$7 billion in health benefits fund assets. PHIAC regulates the industry consistently with the policy set down by the Australian Commonwealth Department of Health and Ageing.

PHIAC is currently required by sections 73BCB(1) and 73BCG(1) of the National Health Act 1953 respectively, to establish:

- (a) the Solvency Standard, the purpose of which is to ensure, as far as practicable, that at any time the financial position of the health benefits fund conducted by a registered organisation is such that the organisation will be able, out of the assets of the fund, to meet all liabilities referable to the health insurance business of the organisation as those liabilities become due; and
- (b) the Capital Adequacy Standard, the purpose of which is to ensure, as far as practicable, that there are sufficient assets in the health benefits fund conducted by each registered organisation to provide adequate capital for the conduct of the health insurance business in accordance with this Act and in the interests of the contributors to the fund.

The Private Health Insurance Bill 2006 proposes, under Divisions 140 and 143, that these requirements will continue after 1 April 2007 under the Private Health Insurance Act.

The Solvency and Capital Adequacy Standards

The Solvency and Capital Adequacy Standards were introduced in legislation in 2000 with effect from 1 January 2001. An initial review was conducted after the first year of operation and PHIAC gave a commitment that the Standards would be fully reviewed after five years of operation from effect.

In early 2006 PHIAC announced that it would undertake a major review of the Solvency and Capital Adequacy Standards to ensure that these Standards remain relevant to the environment and operations of Private Health Insurers in Australia.

Notwithstanding that no major issues appear to have arisen in relation to the operation of the present Standards, PHIAC decided to review them with the aim of assessing and improving the efficiency, effectiveness and appropriateness of the current Standards in their practical business settings, having regard to the evolving environment of private health insurance.

The comprehensiveness of the review of the Standards meant that the process was expected to take 12-15 months from inception to completion. This timeframe, however, was affected by an announcement by the Department of Health and Ageing of changes to the policy and legislative framework affecting the environment of the health insurance industry, and particularly, the operation of health benefits funds.

As the timeframes of the Department of Health and Ageing's legislation reform agenda and that of the Standards review overlapped, rather than pursue the full review of the

Standards initially proposed, PHIAC has concentrated its efforts in recent months in better understanding the impact of the proposed legislation on the operation of the existing Standards, and what changes will be necessary to ensure that the Standards remain both relevant and appropriate in the circumstances of the changing environment of the industry.

PHIAC is also aware of the industry's strong desire to delay major changes to the Standards so that the industry can focus on the introduction and implementation of the revised legislative framework. To minimize the impact of concurrent major changes in the policy, legislative and capital regulation frameworks, a staged approach to the review of the Standards is being pursued.

The first phase of the project addresses those changes considered necessary in light of the revised legislative framework, and also minor changes that were previously identified can be made without delay. It is these changes to which this consultation paper relates.

Form of the Standards

As the changes to the Standards are closely related to the legislative framework reforms, the Solvency and Capital Adequacy Standards have been drafted to be implemented with the Private Health Insurance Act 2007, and are intended to become effective on and from 1 April 2007.

The Standards have been developed for implementation consistent with Divisions 140 and 143 of the Private Health Insurance Bill.

The Standards are being distributed as separate and stand-alone documents for the purposes of stakeholder consultation, but will (subject to approval of the Private Health Insurance Bill) form part of the broader Private Health Insurance (Health Benefits Fund Administration) Rules.

Summary of Changes

Changes made for the purposes described above are summarized below. It is incumbent upon each interested party and stakeholder to determine the effect of these changes for themselves.

This summary should be read in conjunction with the revised Standards and provides an overview of the changes made. Readers should refer to the Draft Standards for detail of the changes.

Minor Structural Changes

The Solvency and Capital Adequacy Standards previously issued by PHIAC required reference to a third Standard, the Interpretation Standard, in order for an insurer to determine the prudential capital required to be held and to ensure compliance with the prudential standards.

The relevant requirements of the Interpretation Standard have been incorporated into the Solvency and Capital Adequacy Standards to;

- reflect the specific requirements of the Private Health Insurance Bill (see Divisions 140 and 143), which make reference only to a Solvency Standard and a Capital Adequacy Standard.
- make clear the distinction of the requirements of each Standard and reduce confusion between them.

Management Capital Amount

The Management Capital amount required to be held by insurers is intended to provide assurance to policyholders against risks that;

- are non-proportional to the size and nature of the business activities of the health benefits fund conducted by the insurer
- are not specifically assessed by the Solvency and Capital Adequacy Standards
- attach to the business activities of the health benefits fund conducted by the insurer, but emanate from another source (contagion risks).

Such risks can manifest themselves as unusual costs on restructure, run-off or termination of the health insurance business, costs associated with unforeseen events and impact from business (other than the business of the insurer as a private health insurer) conducted by the insurer.

Review of the existing Standards revealed that the Management Capital Amount did not, in all circumstances, provide an amount of capital suitable to provide reasonable protection against the impact of those risks described above.

The Solvency and Capital Adequacy Standards have been amended to include an amount of capital (the Management Capital Amount) to be held over and above the amount of capital required to protect against risks that are specifically assessed by the Standards.

For most insurers, this will require that an additional amount of capital be held within and amongst the funds conducted by the insurer.

In addition, for those insurers that conduct businesses outside the health benefits fund, an additional amount of capital must be held within the health benefits funds to provide reasonable protection for policyholders from adverse impacts stemming from these businesses. However, this amount may be able to be offset where the insurer possesses capital separate and distinct to that of the capital of the health benefits funds conducted by it.

Capital to Provide Reasonable Protection against Additional Risk from New Business

Changes to the legislative framework will provide insurers the capacity to offer products that provide cover for a broader range of services provided in a broader range of settings.

For some, and possibly many insurers, at the time that these broader coverage products are offered, the expected utilisation and cost factors associated with them will be unknown.

In order to provide reasonable assurance to private health insurance policyholders in these circumstances, the Capital Adequacy Standard has been amended in the following manner;

- The Renewal Option Reserve includes more detailed assessment of the performance of the major lines of business for each fund of the insurer,
- The insurer has the capacity to determine that the risk associated with each line of business is such that an additional (discretionary) margin is applied,
- The suggested high value of the Capital Adequacy Margin has been increased from 25% to 30% to allow for uncertainty above and beyond the normal course of business experience.

Treatment of Health Related Businesses

The Draft Standards have been amended to clarify the classification and treatment of health related businesses. Such businesses, conducted from within a fund of the insurer, can be varied in nature (forms of insurance, dental, optical, and possibly other forms of business) and in the extent of dependence on the private health insurance business of the fund, or funds, conducted by the insurer.

To clarify the rules for identification and treatment of these businesses, the Standards provide for the following;

- the cash flows of health related businesses are considered explicitly in renewal option reserve.
- Where the health related business is an insurance business, the liabilities and assets of that business are treated in a manner similar to that of the private health insurance business of the insurer.

Submission of Comments regarding Solvency and Capital Adequacy Standards

Written comments regarding the proposed Solvency and Capital Adequacy Standards are invited from all stakeholders and other interested parties.

Comments should be addressed to;

Prudential Standards Review
Private Health Insurance Administration Council
Suite 16, 71 Leichhardt St
KINGSTON ACT 2604

Or by email: phiac@phiac.gov.au

Comments must be received by at either of the above addresses by 12 February, 2007.