



Australian Government

**Private Health Insurance
Administration Council**

Review of the Solvency and Capital Adequacy Standards

Preliminary Views Paper

PHIAC

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Foreword

Purpose of this paper

The purpose of this paper is to express PHIAC's preliminary views on the Capital Standards review and to initiate further consultation.

The issues discussed in this paper follow from the proposals contained in PHIAC's discussion paper, *Review of the Solvency and Capital Adequacy Standards – Invitation for Comment (Invitation for Comment)*, issued on 21 August 2007. In that paper, PHIAC proposed that the Capital Standards will be reviewed to assess whether more refined methodologies could be adopted to broaden the approach in addressing the risks facing private health insurers.

Whilst PHIAC is open to comments and suggestions on the issues raised in this paper, a preferred position in each section has been provided as a foundation for discussion.

Readers guide

The issues detailed in this paper further examine the specific issues identified by PHIAC in the *Invitation for Comment*, and matters raised by the industry. The paper is structured to emphasise components of the Standards that may be substantially changed and to foster discussion.

The body of the report details the background, objective and lists the main issues of each section, together with PHIAC's preliminary view. Further analysis and discussion of the main issues and options considered by PHIAC are included in the appendices.

While the views expressed in this paper are those of PHIAC, we wish to acknowledge the assistance of Deloitte Actuaries & Consultants Limited in articulating those views.

About PHIAC

In 1989, the Private Health Insurance Administration Council (PHIAC) was established as a body corporate under section 82B of the National Health Act 1953. The Private Health Insurance Act 2007 (PHI Act) came into effect from 1 April 2007.

The functions of the Council pursuant to section 264-10 of the PHIA include:

- to administer the Risk Equalisation Trust Fund
- to administer the registration of private health insurers
- the information collection function
- the compliance functions
- the enforcement functions

- the public information functions
- the agency cooperation functions
- to advise the Minister about the financial operations and affairs of private health insurers
- functions incidental to any other functions of the Council, and
- any other functions conferred on the Council by this, or any other, Act.

The compliance functions of the Council include:

(a) to establish a solvency standard and a capital adequacy standard to be complied with by private health insurers, and to give solvency directions and capital adequacy directions to private health insurers; and

Note: The solvency standard and the capital adequacy standard are detailed in the Private Health Insurance (Health Benefits Administration) Rules.

(b) to exercise powers and discretions under the prudential standards, and to give directions to private health insurers relating to compliance with the prudential standards.

Note: The prudential standards are detailed in the Private Health Insurance (Insurer Obligations) Rules.

Freedom of information

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified. PHIAC will determine FOIA requests, if any, in accordance with the provisions of the FOIA and the PHIA.

Abbreviations used in this report

| | |
|-------|--|
| ADI | authorised deposit-taking institution |
| ALM | asset liability matching |
| APRA | Australian Prudential Regulation Authority |
| CMP | capital management plan |
| CPI | consumer price index |
| IAIS | International Association of Insurance Supervisors |
| KPI | key performance indicators |
| LIASB | Life Insurance Actuarial Standards Board |
| PHIA | Private Health Insurance Act, 2007 |
| PHI | Private Health Insurer |
| PHIO | Private Health Insurance Ombudsman |
| PHIAC | Private Health Insurance Administration Council |
| RETF | Risk Equalisation Trust Fund |
| SEU | Single Equivalent Unit |

Executive Summary

Purpose of this paper

This paper expresses PHIAC's preliminary views on changes to the Capital Standards and invites public comment. The paper follows PHIAC's initial discussion paper, *Review of the Solvency and Capital Adequacy Standards – Invitation for Comment (Invitation for Comment)*, issued on 21 August 2007 in which the scope of the review was outlined.

Comments on the Preliminary Views should be sent to PHIAC by Friday 26th September 2008.

Consultation with industry will also be accommodated through a Standards Reference Group, which will convene following the close of comments. Further consultation with the industry will be provided by PHIAC communicating directly with insurers and during latter stages of the review.

Principles-based approach

PHIAC's general preference is for the prudential standards to be "principles-based" rather than "rules-based". This gives greater freedom for funds to take responsibility for their own risk management practices and to implement best practice risk mitigation measures.

However this is not practical in all cases, and a balance between the use of principles and more prescriptive rules will be applied as necessary.

Preliminary views

Overview

In forming its preliminary views PHIAC has considered a range of available material, including:

- stakeholder feedback
- local and overseas developments
- PHIAC's experience with Australian health insurers and the Australian PHI industry
- performance of the current Standards
- standards of other regulatory bodies

An extensive data base of past claims for each insurer has been used to model the effect of claims volatility and these results have also been taken into account in forming the Preliminary Views. PHIAC intends to use these results in individual discussions with each insurer during the next consultation phase.

PHIAC has considered a number of options before forming its preliminary views on the issues set out below. The options are explored in more detail in the appendices to this paper.

Liability risk margin

PHIAC's preliminary view is that the risk margin in the solvency standard should be based on a desired level of sufficiency, and derived from the volatility of the experience of each fund. There should be a specified minimum margin, to ensure that funds which temporarily demonstrate a low level of volatility are not able to implement a negligible risk margin. For simplicity, the margin derived for outstanding claims liabilities could be applied to all balance sheet insurance liabilities, with the exception of the unexpired risk reserve.

PHIAC has calculated the volatility of each fund's claims experience using several methodologies, and has derived margins for each fund that satisfy various levels of sufficiency. These results will be shared with each insurer during the next consultation phase.

PHIAC's preliminary view is to implement a sufficiency margin of at least 90%. The level of sufficiency sought by PHIAC will be formalised following the consultation period.

Renewal option amount

The renewal option amount continues to be a valid component of the Capital Adequacy standard. The projection period should be lengthened to 24 months because in practice it will take between 12 and 27 months for a fund to take corrective action regarding a permanent deterioration in claims experience. The assumptions used in the projections should continue to be set by the insurer, subject to more detail being provided.

It is anticipated that the risk margin would be set to require an amount of capital similar to the current Standards. Two options for the derivation of the risk margin are being considered:

- (a) the prescription of a methodology based on accuracy of past forecasts and growth expectations
- (b) provision by PHIAC of a table of risk margin ranges for use by funds

Future liabilities (e.g. for loyalty bonuses) should also be included in the projection.

Health-related insurance business would initially be included on the same basis as PHI, but non-insurance health-related business would continue to not be subject to a risk margin.

Termination expense amount

Under the PHIA there is a minimum set period and a prescribed timetable for the termination of an insurer. The termination expense amount should recognise this, with regard both to management expenses and to claim costs.

A hybrid approach is preferred, where an insurer will have the option of either:

- (a) reserving on a simple formula supplied by PHIAC (similar to the current 40% of expenses), or
- (b) reserving on a more detailed basis appropriate to the insurer (subject to provision of appropriate information to PHIAC)

A mandatory 3 to 5 month unexpired risk constructive obligation to renew policies should be recognised either in this reserve or the unexpired risk reserve. This is to reflect the potential for adverse experience during the termination period, prior to the termination date.

Specifically this relates to the statutory obligation to continue to offer renewals on all policies for 3 to 5 months after PHIAC approves the termination. This is in addition to the balance sheet unexpired premium liability.

PHIAC's preliminary view is that for the termination amount a risk margin greater than the current 10% is likely to be required.

Resilience amount

No comments were received from the industry on the resilience amount. PHIAC recognises that some change to the PHI resilience amount is desirable to reflect developments such as hedging and use of derivatives.

PHIAC's view is that the resilience amount should recognise derivatives and hedging instruments. In principle, PHIAC is considering the merits of aligning the treatment of market risk to that of best practice principles. Details will be assessed during the next phase of the review.

Credit / Counterparty risk

PHIAC has considered a number of options for using the inadmissible assets amount to recognise in more detail the variety of credit and counterparty risks. PHIAC's preliminary view is to expand the current categories in the Standards and incorporate third party credit ratings to gain greater specificity on the credit worthiness of an investment.

PHIAC is considering whether there is scope for role of the Appointed Actuary to certify that these risks have been addressed appropriately, for the purposes of the capital standards. This would be instead of PHIAC implementing predetermined limits and/or margins.

Liquidity risk

PHIAC's preliminary view is to incorporate liquidity risk into the Standards, through the inclusion of principles. These principles are intended to be broad in nature and require that consideration be given to the liquidity needs and risks of a fund.

PHIAC believes that insurers should develop their own investment policies, which specifically detail the management of liquidity risk and asset/liability matching requirements. The inclusion of principles regarding the consideration of liquidity risk would ensure that liquidity is considered in the capital management of a fund and provide a framework conducive to the strategy of a fund.

Asset identification and classification

The range of asset classes used for the Standards will be broadened to include more detail on derivatives and other investments.

PHIAC's view is to enhance the identification of asset exposure; specifically to further detail the vulnerability of equity portfolios, property portfolios, derivative instruments and off-balance sheet risks.

Asset valuation principles

In general assets should be valued in accordance with Australian Accounting Standards. Specific provisions against these values should be made in the capital standards where:

- buildings (including strata title properties) are owned or occupied by the insurer
- a thin market exists such that sale at the fair value may not be immediately possible
- the asset will have a different value in a termination situation from that as a going concern
- there is a concentration of assets, such as several strata titles in the same building such that the value on sale of one may differ from the value on sale of several at once
- the methodology used to value of an asset is different to the fair or market value of a portfolio.

In all cases the substance of the assets should prevail over the form in setting the value for capital standard purposes.

Use of capital / Business Funding Amount

PHIAC regards the Business Funding Amount as necessary to ensure that the capital requirements arising from management decisions are available when required without jeopardising policyholders' security. The period for this projection has previously been set at three years and PHIAC intends to continue with this as it is consistent with strategic and capital management plans.

It is noted that capital requirements of a fund can include the issuance of future dividends. At this stage PHIAC has not formed a view on whether future dividend payments should be included into this amount or the capital adequacy reserve. A view on this matter will be provided following further consultation.

The availability of capital subscriptions from a parent or shareholders can be recognised as a source of future capital, if this is reasonable in the insurer's particular case. PHIAC is reviewing the extent to which future capital injections can be incorporated into the Standards.

The Capital Adequacy requirement cannot be less than the Solvency Requirement, and PHIAC will continue to require that the Business Funding Amount be set such that this is achieved.

Subordinated debt

The maximum subordinated debt allowable for capital standard purposes should be increased to 50% of capital. In the case of a newly registered insurer PHIAC should have discretion to vary this amount.

To be "approved" and hence treated as capital, subordinated debt will be required to meet the same conditions as at present.

Within 5 years to maturity, an increasing portion of the subordinated debt should be treated as a liability. The same treatment for subordinated debt should be applied across both the Solvency and the Capital Adequacy standards.

Minimum capital adequacy requirements

A Minimum Capital Adequacy requirement should continue in the standards. This should be increased above the current \$1.5 million, to a figure in the range \$2 million to \$5 million. Regular indexation of the amount should occur, although not necessarily annually.

The purpose of this requirement is primarily to meet adverse claims and management expenses, and it should be treated as a minimum against only the liability reserves. Its purpose is not to meet the asset risks, and so it will not cover the asset reserves such as inadmissible assets and resilience amounts. PHIAC is considering a number of methodologies to calculate this amount to achieve its objective. These include:

- Increase the amount to a specific figure between \$2 and \$5 million
- Introducing a fixed baseline amount, in which other reserves are additional to the minimum
- Considering separately a reserve which calculates an amount to provide assurance against risks that are non proportional to the size of operations, or not directly addressed by the Standards.

Contagion risk

Currently the inadmissible asset amounts is used to prevent double use of regulatory capital where another member of a group is also a regulated entity, recognising the risk from intercompany loans and the value of related entities in a company run-off situation.

Apart from considerations regarding the value of assets that appear in a fund's balance sheet, PHIAC believes that contagion risk is most properly dealt with as part of the insurer's risk management processes and capital management plans. No additional requirements are proposed for the capital standards.

Capital management planning

PHIAC believes that regulation governing the development and introduction of formal capital management mechanisms is necessary to ensure that insurers consider the broad range of risks inherent in their business and the risk/capital relationship that is critical to the sound financial management of the insurer.

PHIAC would prefer the development and implementation of capital planning requirements to be conducted separately from the review of the capital standards.

1 Introduction

1.1 Background

The Solvency and Capital Adequacy Standards (Capital Standards) were introduced in legislation in 2000 and had effect from 1 January 2001. At that time PHIAC gave a commitment to a post implementation review after the first year of operation and a comprehensive review after five years. The Capital Standards have been modified slightly in the period since 2001 to simplify application and allow for changes to the accounting and legislative regimes.

The legislative basis for the Capital Standards was changed with the introduction of the *Private Health Insurance Act, 2007* (the PHIA). PHIAC has the authority, under sections 140-5 and 143-5 of the PHIA to establish the Capital Standards to provide for the financial security of the health benefits fund(s) conducted by an insurer.

The purpose of the Capital Standards is identified in the legislation as follows:

- The Solvency Standard is to ensure, as far as practicable, that at any time the financial position of the health benefits fund conducted by a private health insurer is able, out of the fund's assets, to meet all liabilities that are referable to a fund as those liabilities become due; and
- The Capital Adequacy Standard is to ensure, as far as practicable, that there are sufficient assets in a health benefits fund conducted by a private health insurer to provide adequate capital for the conduct of the fund in accordance with the Act and in the interests of policy holders of the fund.

PHIAC's August 2007 discussion paper invited submissions on the proposals set out in that paper. A summary of the issues raised in these submissions have been included in this paper.

1.2 Terms of reference

The terms of reference included a wide-ranging review of all aspects of the standards. Many of the areas listed in the terms of reference have not proven contentious, with little or no industry comment.

1.3 The prudential framework

PHIAC intends to broaden the framework to ensure that insurers' risk management processes ensure that enough assets of sufficient quality are available to produce a high likelihood that liabilities will be met.

PHIAC is reviewing the prudential standards to assess whether a more refined methodology could be implemented that reflects the risk exposure of a fund. PHIAC is aware the measurement of insurance liabilities, the sufficiency of capital reserving and the disclosure of assets need to reflect this approach. A range of alternatives and PHIAC's broad approach is discussed in this report.

1.3.1 Principles based approach

Although the Capital Standards remain largely appropriate for the industry, PHIAC would prefer to move to a more principles based approach to the industry to further enhance risk management practices.

This report seeks to initiate standards with a balance of formulated "rules-based approach" with that of a "principles-based approach". The principles-based approach provides for shorter, less complex prudential standards that can be applicable to all funds, regardless of size and complexity of business operations. It also offers greater freedom for insurers to take responsibility for their own risk management practices and to implement best practice risk mitigation measures.

1.3.2 Future developments

The Capital Standards are considered to be one component of an overarching prudential framework that deals more broadly with the risk management of private health insurers. At this stage of PHIAC's review, regulations covering the capital management plan and the overarching prudential framework are still under development. Aspects of these areas are addressed separately and later throughout the standards review process and may well become stand-alone components of overall regulatory prudential review requirements.

This report has been compiled with reference to other regulatory organisations, domestically and internationally. However, the Australian private health insurance industry has unique features and as a result, PHIAC has only adopted similar approaches where appropriate.

2 Next Steps

2.1 Comments from industry

PHIAC invites all stakeholders to provide comments relevant to the issues outlined in this paper.

The due date for comments in response to this paper is Friday, 26th September 2008.

Comments regarding this paper should be sent directly to PHIAC, addressed to:

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

Or by email: phiac@phiac.gov.au

Following receipt of comments and subsequent analysis, PHIAC will be communicating directly with each insurer on some of the aspects contained in this report and will form a Standards Reference Group (SRG).

2.2 Standards Reference Group

To assist in the review, PHIAC will be establishing and operating a Standards Reference Group (SRG). The SRG would comprise of key industry stakeholders, such as representatives from AHIA, HIRMAA and the Health Practice Committee of the Institute of Actuaries of Australia.

The SRG will operate as a consultative body during the later stages of the review, providing an efficient source of advice to PHIAC, communicating the industry's views and provide a medium to discuss the issues of the review. Stakeholders are invited to contact members of the SRG to discuss the review and specific concerns regarding matters raised in this paper.

Stakeholders are also invited to contact PHIAC directly to express their opinions regarding the Capital Standards. Where detailed discussions regarding any impact on an individual insurer or fund are necessary, PHIAC will approach each insurer directly.

It is anticipated that the SRG primarily meet by teleconference and will formally convene 2-3 weeks following the close of industry comments.

2.3 Proposed changes paper

Following consultation on PHIAC's preliminary views and further analysis, a paper detailing the proposed changes to the Capital Standards will be distributed to the industry. This paper will detail the rationale underlying the changes proposed and any expected impacts on industry.

2.4 Draft Capital Standards

Following the responses and discussions on PHIAC's proposed changes the next step will be to draft the Capital Standards. This will be prepared and made available for consultation and comment.

2.5 Implementation of revised Capital Standards

The timeframe in which the revised Capital Standards will be implemented is dependent upon the nature and the magnitude of any changes as well as the responses from industry. At this stage PHIAC is looking at an implementation date of early 2010.

It is noted that any change to the current solvency or capital adequacy standards will potentially have a significant impact on the total reserving requirements of funds. Hence all changes, and their impact on each fund, will be communicated directly with individual funds. If additional capital is required, PHIAC will work with each fund to ensure an orderly transition.

3 Liability Risk Margins

The liability risk margin in this chapter's context, relates to the capital or risk margins applied to the solvency liability, currently set at 10%.

3.1 Background

Insurance liabilities are inherently uncertain. At the time financial reports are prepared the exact amount of an insurance liability is not known and the amounts reported are an estimate of their expected value. Holding assets equal to the expected value of an insurance liability will result in a fund having insufficient assets to meet the liabilities every second quarter or a level of sufficiency of approximately 50%.

To increase the likelihood that a fund has sufficient assets to meet its insurance liabilities, the current standards apply a margin to these liabilities, requiring a fund to hold more assets than the expected value. The current margins were designed to result in a level of sufficiency of approximately 97.5%. However, because each fund exhibits a different volatility in its experience, if the same fixed margin is used by each fund, the level of sufficiency of those funds will not be consistent across the industry.

PHIAC is developing a basis for setting risk based capital margins, i.e. previously a fixed margin was set for solvency and a margin based on fund SEUs was used for capital adequacy. PHIAC is also assessing the merits of applying a sufficiency requirement to the Capital Standards. This would result in the incorporation of a fund's volatility into the margin so that a consistent level of sufficiency is provided across the industry.

PHIAC intends to review the methodology and basis for determining risk based capital margins, including, whether a more dynamic risk based sufficiency value should be implemented. These margins would apply not only to the technical insurance liabilities of the fund but also to other prudential liabilities such as the renewal option reserve. PHIAC notes that although the rationale for and size of the margins is different, a similar process is required to be undertaken by insurers when applying AASB 1023 in the preparation of their annual accounts.

The introduction of risk based capital margin methodology would affect each insurer and fund differently, and is one area of the review that PHIAC will discuss with each insurer.

3.2 Objective

The solvency/capital adequacy liability aims to identify an amount of capital, necessary to gain assurance that a health benefits fund has sufficient assets to meet its balance sheet liabilities.

3.3 Consultation scope

“PHIAC intends to review the methodology and basis for determination of risk margins ... PHIAC will review the merits of adopting risk margins determined with reference to the underlying experience of the fund that would provide a fixed level of sufficiency”

3.4 Comments from industry

Concerns have been raised regarding the ability of insurers to calculate a risk margin based on a level of sufficiency.

Comments were received as to the volume of historical data needed to develop an appropriate sufficiency margin.

3.5 Main Issues

The issues recognised in the review are covered in detail in Appendix A. In summary the main issues are:

- Risk Margin/ Level of sufficiency
- Minimum margin
- Methodology
- Health related business
- Unearned premium liability
- Time frame
- Accuracy of best estimate

3.6 PHIAC preliminary view

PHIAC’s preliminary view on the structure of the risk capital margin for solvency liabilities is detailed below. Other alternatives considered are covered Appendix A.

3.6.1 Sufficiency-based amount

PHIAC’s preliminary view is that the current 10% solvency risk margin should be replaced by a sufficiency-based amount, such that each insurer would have the same probability of adequacy of its solvency reserve.

3.6.2 Minimum margin-floor

It is recognised that some funds have a very stable experience and are able to account for most of the volatility in their claims experience. It appears that it would be appropriate to allow funds that exhibit minimal volatility to calculate a smaller but not a negligible risk capital margin.

It is PHIAC's view that a negligible risk margin on a best estimate would be imprudent because it would not adequately allow for the possibility of a change in best estimates (parameter and model risk).

3.6.3 Single capital margin

To gain a fixed level of sufficiency across a fund, in theory separate assessments would need to be made of the volatility of each liability and future cash flows including: RETF transfers, outstanding claims processing expenses, outstanding claims health related insurance business, loyalty benefits, etc.

To ease the burden on industry, PHIAC's preferred alternative is to apply a sufficiency amount to the outstanding claims benefit component only. The resulting risk capital margin obtaining the desired level of sufficiency would then be used as the risk margin for all balance sheet insurance liabilities, with the exception of unexpired risk reserve.

Margins that vary across the different liability categories, rather than a proposed single margin, may be considered in any reviews that take place in the future.

3.6.4 Terminating funds and unexpired premium reserves

It is PHIAC's view that the claiming pattern of a fund for ongoing operations is unlikely to be identical to the claiming pattern if the fund is terminating. Hence a margin should be applied to the unexpired premium/risk reserve to accommodate this risk. The margin placed on the unexpired risk reserve should be sufficient to account for the current loss ratios, a risk margin and the potential increase in the loss ratio caused by the termination.

This is further detailed in the *Termination Expense Amount*.

3.6.5 Size of sufficiency amount

PHIAC's preferred alternative is a sufficiency margin of at least 90%. Various levels of sufficiency will be discussed with industry stakeholders and the level will be clarified following this consultation.

3.6.6 Impact on each fund

PHIAC has calculated the volatility of each fund using several methodologies together with information supplied within each insurer's financial condition report. A number of sufficiency levels have been applied to determine the increase or decrease in capital that would be required from each fund, should such a margin be implemented. This information will be supplied to each fund detailing their movement in capital. This will be contained in a separate letter to each insurer.

4 Renewal Option Amount

The current renewal option amount applies a margin to the forecast claims and expenses of a fund over the next 12 months. This amount is based on a minimum 12.5% plus a margin based on a fund's size and a discretionary margin.

4.1 Background

A health benefits fund can not discriminate against existing policyholders seeking to renew their policy. The effect of this is that funds are obligated to continue to pay the claims and other expenses associated with its present policyholders, subject to continual payment of premiums.

While a fund may be currently operating at a surplus, expenses are volatile and can unexpectedly increase to an amount higher than the forecasts predict, which may mean that the fund will incur losses. These losses will need to be financed by the fund's existing capital base until such time as corrective action can become effective.

The renewal option amount aims to provide assurance that there is sufficient capital to cover these potential losses.

Following the review of the Standards in 2002, the scope of the renewal option amount was broadened to be based on expected cash flows consistent with a fund's business plan. The effect of this was that forecasts of new policyholders, management expenses and new products were included in the renewal option amount.

4.2 Objectives

The purpose of the Renewal Option Amount is to ensure that the fund has sufficient reserves to be able to meet adverse claims experience, or an adverse shift in expenses, until such time that corrective action can be implemented.

In this context, corrective action refers to adjustments to the product suite to enable income to be at least as much as expenses.

This reserve is based on the costs associated with an ongoing membership consistent with best estimates throughout the renewal option amount period.

4.3 Consultation scope

“PHIAC will consider whether the current 12 month [projection] period is appropriate and sufficient for a fund to be able to implement decisions and changes to deal with adverse experience”

4.4 Comments from industry

4.4.1 Period of renewal option amount

Included in the comments received was one stating that ‘as the current length of the renewal option amount will inevitably include a premium increase, the period is sufficient to achieve its purpose’.

Some comments indicated that due to the timeframes involved with a rate review an 18 month period would be more appropriate.

4.4.2 Risk margin

Industry comments did not express the view that the capital adequacy margin is inappropriate.

Concerns were raised whether the data available to individual funds would be sufficient for an appropriate margin to be determined for the renewal option amount. It was indicated that an assessment of PHIAC’s data, particularly in relation to the annual premium round, may provide an appropriate amount of data to quantify risks to the industry. However it was noted that this data would also be influenced by the prevailing market conditions and subject to change over time.

Preference was expressed for the sufficiency level of the renewal option amount to be consistent with other aspects of the capital adequacy reserve, and for a consistent level of sufficiency across the industry.

4.4.3 Loyalty benefits

Comments also expressed a desire to have loyalty benefits specifically included in the renewal option amount.

4.5 Main Issues

The issues recognised in the review are covered in detail in Appendix B. In summary the main issues are:

- Forms of corrective action
- Time period for corrective action to become effective.
- Causes of an adverse claims shift. The extent which the exposure to and risk profile of a fund to an adverse shift can be identified.
- The risk margin to be applied
- Potential offsets
- Health-related business
- Accuracy of forecasts.

4.6 PHIAC's preliminary view

PHIAC's preliminary view on the structure of the renewal option amount is detailed below. Other alternatives considered are covered Appendix B.

4.6.1 Length of period to determine renewal option amount

| Event | Time required months |
|---|-----------------------------|
| Instigation of an adverse shift in claims | 0 |
| Differentiating an adverse shift from temporary volatility and ascertaining the extent of the change. | 6 to 9 |
| Preparation of a premium application. Including analysis, and management and Board approval | 1 |
| Period until next premium round | 0 to 12 |
| Period from submission of premium application until effective date | 3.5 |
| Delay effect of rate protection | 1.5 |
| Total | 12 to 27 months |

It is PHIAC's view that the renewal option amount should be based on a period of sufficient length to allow a fund to finance the losses incurred from the onset of an adverse claims shift until the time when corrective action can be effective.

Should corrective action occur at the annual premium round, then this period will be 12 to 27 months.

It is noted that the period until the next premium round would change throughout the year. However, for simplicity and to ensure consistency in time series analysis, PHIAC proposes to have a fixed period for the renewal option amount.

It is recognised that a period of 24 months for the renewal option amount is double the current period and that increasing the period to this extent without adjusting the associated risk margins will greatly add to the size and leverage of the renewal option amount.

However, these factors, by themselves, do not result in a 24 month period being inappropriate. It is PHIAC's view that should corrective action take the form of a premium increase, a 24 month period is appropriate.

4.6.2 Assumptions used in forecasts

The forecasts used to determine the renewal option amount are underpinned by a number of assumptions, particularly regarding membership growth and changes in contribution income. At the time the forecasts are prepared it is not clear whether these assumptions will be realised, which creates a risk that the forecasts will not be appropriate.

While there is a risk with incorporating assumptions of a fund's discretion, PHIAC recognises that there are additional complexities which may increase the capital requirements should anything less than the desired expectations be incorporated into calculating the prudential requirements.

PHIAC will be seeking details of the assumptions inherent in the calculation of future contribution income, including those related to membership and premium changes. This will enable funds to use their own assumptions, while maintaining PHIAC's ability to review its reasonableness.

4.6.3 Risk margin – derivation

PHIAC encourages all funds to continually monitor all potential causes of adverse experience when determining the capital needs of the fund.

PHIAC is currently examining two options for determining an appropriate risk margin.

1. The prescriptive basis would be derived from the accuracy of previous forecasts and a margin based on the historical growth and growth expectations of the fund.
 - This basis would use the difference in previous forecasts and eventual results to obtain a distribution for the expected variance and hence determine a margin. This would create an incentive for funds to ensure that their forecasting methodology is robust. It would be subject to a baseline margin to reflect that accuracy in previous forecasts will not necessarily be repeated in future, and to account for future unexpected changes.
 - Even if forecasts have been extremely accurate, the advent of new membership will inherently result in increased risk that prudence suggests should be accommodated. The margin should therefore recognise forecast changes in membership and recent growth that has not yet been reflected in experience.
2. An alternative being considered is for PHIAC to assess the volatility of previous experience and calculate a risk-margin range based on a certain level of sufficiency. This risk range would be supplied to funds and they would have an option to implement PHIAC's margin or provide details of their methodology which results in a different margin for a given level of sufficiency.

4.6.4 Risk margin – size

It is noted that any change to the current capital adequacy margin will potentially have a significant impact on the total reserving requirement of a fund. Hence changes, similarly to the changes in the risk margin for solvency, will be communicated directly with individual funds.

Comments received from industry did not express the view that the current margin is unreasonable. It is anticipated that any changes made to the capital adequacy margin will not materially increase the total amount required for prudential purposes. Should changes be implemented, they would be accompanied by transitional provisions.

4.6.5 Future liabilities

To gain assurance that the future liabilities of a fund can be met, projected changes in liabilities would be included into the renewal option amount.

4.6.6 Health related business

Due to the different circumstances and risk profiles of health related business PHIAC's preference for the treatment of health related business in the renewal option amount is for a 'hybrid' approach. This involves allowing funds to use a methodology consistent with health insurance business, while providing flexibility to tailor the reserve to the nature of the business line, particularly around corrective action. This would involve being able to adapt the period and margin applied to health related business, to reflect the period for corrective action to become effective and represent the volatility in total expenses.

The current renewal option amount does not include a margin for health related (non-insurance) business. This is not expected to change.

4.6.7 Continual adverse shifts

PHIAC's preferred alternative is not to recognise any negative autocorrelation in determining the required margin for the renewal option amount. This means that the risk margin will not be reduced because of recent increases to benefits and recent changes to forecast claims.

While it is noted that consecutive adverse shifts may have a reduced probability of occurring, negative autocorrelation has minimal supporting evidence and as a result it is PHIAC's view not to incorporate this into determining a risk margin.

5 Termination expense amount

The current Standard requires that the expense amount is calculated as 40% of the total expenses of the fund that are not benefit payments for the prior 12 months.

5.1 Background

In the event an insurer is no longer able or willing to continue operations, the fund may be required to be terminated and placed into run-off. During the termination period the existing insurance policies will continue to remain in force, and benefits and management expenses will have to be paid.

Statutory costs will be incurred as a result of terminating an insurance business in addition to standard management expenses. Section 149 of the PHIA requires specific obligations to be fulfilled, which increase the costs associated with terminating a fund.

Due to the uncertainty of revenue during a termination period, a fund will have a limited scope to offset these costs by future contribution income. As a result this amount is designed to create appropriate capital reserves for a fund to meet these expenses.

5.2 Objective

The expense amount aims to identify the amount of capital necessary for a health benefits fund to meet the administrative costs associated with its termination. The purpose of this amount is to gain assurance that should a fund need to enter runoff, it will have sufficient capital to meet the associated expenses and not leave creditors or policyholders unpaid.

For the purpose of this paper this objective has been broadened to include other costs that may materialise as a result of a fund entering runoff. These relate to the potential changes in the fund's risk profile and financial performance during the termination period.

5.3 Scope of Review

“PHIAC will reassess the calculation of the amount to determine whether a more appropriate method of determining this amount exists”

5.4 Comments from industry

5.4.1 Simplicity

A number of comments were received expressing a strong desire to have a simple calculation for the expense amount.

Previously the calculation of the expense amount allowed for greater flexibility for a fund to determine an appropriate reserve. A number of insurers stated that they found this to be unnecessarily complicated and that their preference is to focus on a methodology that is simple to implement.

5.4.2 Flexibility

Comments were received expressing a strong desire to revert to the principles based methodology, which offered both flexibility and the possibility of simplicity.

It was stated that the current approach does not account for extraordinary changes in management expenses and it does not provide any flexibility in allowing insurers to accommodate the amount to the specific characteristics of the fund.

5.5 Main Issues

The issues recognised in the review are covered in detail in Appendix C. In summary the main issues are:

- Legislative requirements ascribed by Section 149 of the PHIA, including the various events that need to occur during the termination of a health benefits fund and the timeframes involved
- Expenses incurred in the termination of the fund, incorporating costs associated with fulfilling legislative requirements, termination costs of an insurance business and standard management expenses
- Uncertainty of contribution income during the termination period.
- Changes in benefit payments, as advertising a fund is terminating may alter the risk profile and utilisation of a membership
- Treatment of health-related business
- Risks involved with a reliance on a transfer to another fund

5.6 PHIAC's preliminary view

PHIAC's preliminary view on the structure of the expense amount is detailed below. Other alternatives considered are covered in Appendix C.

5.6.1 Health insurance business component

PHIAC's preliminary view is to allow for both a prescriptive and a principles based approach for the determination of this component.

Under this alternative PHIAC would develop a simple formula that can be used as an approximation for the costs associated with the termination of a fund. This would be preceded by an investigation of the costs and risks involved with the termination of a fund, in consultation with industry. It is anticipated that under this approach the approximation would be similar format to that currently applied, i.e. 40% of the last 12 months management expenses.

A principles based approach would also be allowed, whereby insurers can investigate the risks associated with their fund and develop a methodology and an amount based on the outcome. This would be facilitated by structure being provided by PHIAC that outlines a number of specific risks which require to be considered. Insurers would be able to evaluate the risks and apply reserves that are appropriate to a fund's characteristics.

This amount would require details to be provided to PHIAC on all the risks that were considered and the rationale for calculating the final reserve. PHIAC would seek comfort that the expense amount is sufficient for the amount to achieve its objective.

5.6.2 Health related business component

PHIAC's preferred option is to apply a principles based approach to the determination of this component.

The expenses a health-related business would incur during a termination are heavily dependent on the type of the business, specific circumstances and its independence. As such, a principles based amount would enable these factors to be considered and the amount to be tailored to reflect a fund's specificities.

5.6.3 Unexpired risk reserve

Due to the statutory requirements of the PHIA, PHIAC's preferred option is to include a mandatory, additional, three to five month constructive obligation to renew as a component of either the solvency liability or expense amount.

This reserve would reflect a constructive obligation to renew for three to five months on current terms, incorporating a risk margin to allow for the uncertainty of future experience. This period reflects the time between the Council's approval to terminate and the termination day. This would extend the term of the unexpired premium liability currently applicable, although the risk margin applicable would be similar.

This would provide assurance that the fund will have appropriate reserves to weather adverse experience during the period that an insurer is required to offer renewals on all policies (i.e. the three to five months from the Council approving the termination, until the termination date).

Following the termination date, policies in force will not be renewed and will go into 'run-off'. This risk of adverse experience during the period following the termination date is addressed by the unexpired premium liability.

It is PHIAC's view that it is not appropriate to assume that the historical claiming pattern will be representative of the experience during a termination period. A fund being terminated is exposed to the possibility of an increased risk profile. This risk involves the younger, low risk members leaving early; and a higher utilisation rate as members seek to undertake procedures prior to termination and to maximise policy limits. Should either of these risks materialise, the claiming pattern during the termination period will be greater than previously experienced. This increased pattern will need to be met from a fund's existing capital.

An assessment of an appropriate risk margin for this reserve remains ongoing; however preliminary results suggest that the risk margin applicable would be greater than the current solvency margin of 10%.

| Summary of legislative requirements | Time required months |
|--|-----------------------------|
| PHIAC approves termination | 0 |
| Fund formally notifies its members that fund is terminating | Up to 2 |
| Termination date. - This is required to be at 90 days after the insurer finishes giving notice. - The day in which the fund is no longer required, or able to renew policies. - Date which policies enter run-off | At least 3 |
| Total period in which a fund is obligated to offer renewals on all policies | 3 to 5 months |

6 Resilience Amount

An Insurer must recognise the risk associated with asset value volatility and hold an amount such that the obligation of each fund would still be able to be met following an adverse systemic market movement.

6.1 Background

The resilience amount is designed to identify the extent to which the assets of a fund are exposed to changes in value due to economic shocks that are not matched by changes in value of the liabilities of the fund.

The methodology underpinning the operation of the resilience amount has changed little since the inception of the Capital Standards, whereas the investment portfolios of insurers have changed considerably. The investment profile of most health benefits funds continues to be fairly conservative.

The Resilience Amount is defined in the legislation through the use of a formula. The formula considers shocks associated with:

- Equities
- Property (other than listed property trusts)
- Listed property trusts
- Interest bearing assets
- Indexed bonds and
- International currency

Inadmissible assets are not included in the calculation. The calculation is consistent across all funds.

6.2 Objective

The resilience amount is an intermediate component in the determination of the Solvency Reserve and the Capital Adequacy Reserve, which reflects the risks of the fund in respect of any mismatching of asset and liability exposures.

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.

6.3 Consultation scope

“PHIAC will review the methodology employed in the Capital Standards with a view to ensuring that the resilience amount is consistent with current best practice methodologies.”

6.4 Comments from industry

No comments were received from the industry on this issue.

6.5 Main Issues

The issues recognised in the review are covered in detail in Appendix D. In summary the main issues are:

- Investments, hedging and derivatives
- International/domestic developments
- Options available for regulation.

6.6 PHIAC’s preliminary view

PHIAC’s preliminary view on the structure of the Resilience Amount is detailed below. Other alternatives considered are covered Appendix D.

PHIAC’s view is that the resilience amount should specifically recognise:

- Derivatives
- Hedging instruments
- Assets in which there is a thin market

In principle PHIAC is reviewing the merits of aligning the treatment of market risk to best practice financial regulations. Details will be assessed during the next phase of the review.

7 Credit/Counterparty Risk

The inadmissible assets methodology is broadly based on asset type and counterparty credit risk (credit rating of counterparty and liquidity of assets). The current methodology may not adequately distinguish between assets with different risk profiles - as reflected by the credit characteristics of the asset.

7.1 Background

The inadmissible assets amount of the Capital Standards is designed to reflect the following matters:

- Certain assets are disclosed in the financial statements at a value which may be dependent on the ongoing operation of the business. On the cessation of business, the value of those assets would likely be less. (Solvency Standard only).
- 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 (i.e. using the same capital for both entities).
- 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.

7.2 Consultation scope

“PHIAC will review the inadmissible assets methodology to assess the merits of including reference to specific credit characteristics for all assets”

7.3 Comments from industry

One insurer believes that “assets that need to be treated as inadmissible should involve an assessment of all assets and categorising of those assets. As health insurers need to be able to invest reserves to provide additional returns, the fund indicated that the funds should be further regulated so as to avoid the unnecessary exposure to risk and capital loss. This would require a review of the various categories of assets and increasing the types of assets that might be treated as inadmissible.”

PHIAC concurs with the view that more information needs to be provided in relation to investments to disclose risk, including counterparty and credit risk.

7.4 Main Issues

The issues recognised in the review are covered in detail in Appendix E. In summary the main issues are:

- Risk characteristics for all assets
- International/domestic developments

- Options available for regulation
- Look through approach to underlying assets.

7.5 PHIAC's preliminary view

PHIAC's preliminary view on the structure of the treatment of counterparty risk is detailed below. Other alternatives considered are covered Appendix F.

PHIAC believes that the Standards can be amended to better align the credit risk considerations of the Capital Standards with those of insurers that are used to drive investment decisions.

The assessment on the treatments of credit and counterparty risk for the purposes of the Standards remain ongoing. Considerations include:

- Introduce a credit risk regime that is based on investment ratings provided by third party ratings agencies. This could involve the application of a margin to investments and/or changes to concentration limits
- Broaden the existing classifications in the current Standards to improve compliance
- Broadening the role of the appointed actuary to require a certification that these risks have been addressed appropriately within the insurer
- A combination of the above.

8 Liquidity risk

8.1 Background

The fair value of an asset depends on the price that a willing buyer will pay, but there is a risk that there may not be willing buyers in an emergency or crisis, and insufficient time to find them. Liquidity risk is greater for some assets than for others. Best practice business strategy is to have in place a policy to manage the risk associated with liquidating assets.

8.2 Consultation scope

“PHIAC will assess the merits of including more formal asset/liability matching principles within the Capital Standards.”

8.3 Comments from industry

Two funds agreed that liquidity risk should form part of the overall framework for assessing capital adequacy, noting that:

- it is not only listed investments and cash which are liquid, but that there are established markets or liquidity mechanisms for certain other investments;
- the resilience factors applied to various assets are reflective of their comparative liquidity and so if a separate liquidity risk margin is introduced then the resilience measures may need to be adjusted; and
- as the capital adequacy standard relates to an ongoing fund, there is a requirement for a fund to maintain no more than an appropriate spread of maturities for its assets to match (within reason) the maturity profile of its liabilities.

Another stakeholder has suggested that PHIAC consider whether stock lending and short selling of investments is appropriate by Health Funds.

8.4 Main Issues

The issues recognised in the review are covered in detail in Appendix F. In summary the main issues are:

- Impact of short term cash flows
- Marketability of assets
- Asset-liability management

8.5 PHIAC's preliminary view

PHIAC's preliminary view on the structure of the treatment of liquidity risk is detailed below. Other alternatives considered are covered in Appendix G.

PHIAC believes that funds should develop their own investment policies that should include the management of liquidity risk. PHIAC recognises that the industry's risk profile is generally conservative, however PHIAC is also aware that the industry's risk profile may change and that the capital standards needs to be flexible in its approach to liquidity risk.

PHIAC's preliminary view is to incorporate liquidity risk into the Standards, through the inclusion of principles. These principles are intended to be broad in nature and require that consideration be given to the liquidity needs and risks of a fund.

9 Asset identification and classification

The capital standards need to ensure all assets are identified and classified appropriately, whether the assets are recorded on the balance sheet or off the balance sheet. The existing categories are very broad and do not cover all possibilities. Further, there is uncertainty within the industry as to classification of various assets.

9.1 Background

The degree of sophistication in the investment activities of funds has grown substantially since the inception of the Capital Standards. The Capital Standards have retained a focus on the traditional investment activities of funds. PHIAC believes there is a growing need for greater specificity in the Capital Standards to deal with asset valuation and classification issues.

9.2 Consultation scope

“PHIAC will review the methodology in the capital standards with a view to providing greater guidance for the treatment of a broad range of investment vehicles, including derivatives”

9.3 Comments from industry

No industry comments were received on this issue.

9.4 PHIAC’s preliminary view

PHIAC considers the need to expand or broaden the asset classes within the capital standards to cover a wide range of assets. In principle, PHIAC is reviewing the merits of determining how insurers would classify and treat options, warrants and derivatives within the capital standards.

The expansion would include incorporating the following into the standards.

- Guarantees
- Contingencies
- Other off balance sheet exposures.

Currently, the capital standards classifies ADI’s with more than \$50m in assets and related or unrelated ADI’s with assets of less than \$50m in assets. PHIAC considers that the classification of ADI’s should more drawn more broadly to identify and categorise the characteristics of an investment. The \$50m threshold was provided to ensure that large credit unions be treated similarly to major banks. PHIAC needs to ensure that this threshold is still relevant.

10 Asset valuation principles

Prudential values: Is there and should there be a difference between the methods of asset valuation for accounting and prudential reporting purposes?

10.1 Background Information

The degree of sophistication in the investment activities of funds has grown substantially since the inception of the Capital Standards. The Capital Standards have retained a focus on the traditional investment activities of funds. PHIAC believes there is a growing need for greater specificity in the Capital Standards to deal with asset valuation issues.

10.2 Consultation scope

“There are a number of asset valuation issues related to liquidity considerations that have been identified by PHIAC as needing review, particularly in valuing non-liquid assets, such as:

- *Thin market valuations and off market assets*
- *Owner-occupied buildings*
- *Strata-titled property”*

10.3 Comments from industry

There is a general concern that to accommodate these issues the Capital Standards will become unnecessarily complicated, but with no material impact on the capital required to be held.

One insurer expressed concern regarding owner occupied buildings, noting that an insurer who owns rather than rents, may have lower management expenses as well as lost investment revenue.

One insurer expressed the opinion that concern regarding valuation of these buildings where market demand is low or sale prospects uncertain as being unwarranted. There are existing obligations on the directors to ensure that assets are carried within the insurer’s balance sheet at an amount not greater than their net recoverable amount. To facilitate this consideration, independent valuations would be periodically performed and received by an independent property consultant. These valuations need to reflect the market circumstances and property conditions prevailing at the time of the valuation, thereby negating the need to have additional valuation requirements through the prudential standards.

Other insurers believed that it is appropriate for owner occupied buildings to be included as admissible assets of a fund as long as full allowance for a market based rental is included in the expenses of the fund and the renewal option reserve calculations. PHIAC does not agree with this proposal, as this would be difficult for the insurer to determine and not reflective of the business plan.

Several insurers supported the view that strata titled property should be considered as multiple investments for valuation and legal purposes as they can be sold individually and therefore should be treated as multiple assets. This view fails to recognise concentration risk issues. An adjustment is necessary to recognise their reduced liquidity in that a sale of one unit will reduce demand in that location for a unit of the same type, and therefore the total sale timeframe will be protracted. PHIAC considers that this adjustment would be appropriate through the fair value process or through the inadmissible reserve.

Several insurers identified no problem with two or more funds sharing assets provided that:

- there is absolute clarity as to their respective shares of each and every such asset, and
- that there are no constraints on any fund initiating the sale of any shared asset in order to access its proportion of the proceeds.

A stakeholder in the industry identified an inconsistency between the methods of asset valuation for accounting and prudential reporting purposes. The asset values reported in accordance with the accounting standards could possibly set “base asset values” for prudential reporting with adjustments made by the resilience or inadmissible reserves functions.

10.4 PHIAC’s preliminary view

Accounting standards allow for assets to be reported at a value that does not necessarily reflect the current market price, for example should an asset be reported at maturity value. PHIAC is concerned that in a solvency situation, an asset may not be realised for the value recorded in a fund’s balance sheet.

PHIAC will be seeking to gain more detail as to the methodology used to value an asset, and particularly any difference between reported and market value.

An alternative approach is for funds to start with the accounting fair value with the capital standards specifying explicit provisions for treatment under the capital or solvency standards, such as where thin markets exist or where a building is occupied by the fund.

Example 1: Where a building is occupied by the fund, its value for capital adequacy would recognise that it is occupied. However for solvency purposes, the building should be valued assuming there is no tenant.

Example 2: A strata title building owned by the fund and occupied as a head office should be treated differently from strata title offices in the same building leased to a range of arms-length tenants.

In all cases the substance of the investments should prevail over their form.

11 Use of capital/ Business funding amount

11.1 Background

The Business Funding Amount originally served as ‘a provision for planned business growth and other relevant business development strategies that are likely to absorb existing capital resources, with the intention of securing solvency of the Fund over a prescribed period of three years’.

In the review of the Standards in 2002, the projections for planned business growth became a component of the renewal option amount. As a result, the business funding amount became based on business plans outside of the renewal option amount and to ensure that the fund is able to meet the solvency reserve over the next three years.

11.2 Objective

The objective of the business funding amount is to provide a reserve in respect of any additional capital likely to be required in the fulfilment of a fund’s business plan, outside of the renewal option amount. Further, it is intended to ensure that the fund will be able to meet the solvency obligation calculated in accordance with the solvency reserve over the next three years.

Specifically this amount relates to identifying capital likely to be required to achieve a fund’s business plan, and to ensure that the fund is and will be able to meet the solvency standard.

PHIAC is assessing the merits of expanding the scope of the business funding amount to incorporate existing capital that will subsequently cease to be available for prudential purposes.

11.3 Consultation scope

“PHIAC will assess the requirements of the business funding reserve to determine whether the principles applied require greater scope or detail in considering future capital needs of a fund.”

11.4 Comments from industry

11.4.1 Inclusion of business plans

A concern was raised that a fund would be unlikely to ever hold such a reserve: “If a fund was projecting that they would breach solvency within three years under their current, best-estimate business plan, then we would expect those plans would be reviewed and modified to ensure that future solvency requirements continued to be met. We believe that management would be unlikely to present an unfavourable scenario to the Board as the primary business model, and that if they did, a sound Board would be unlikely to accept the business plan.”

11.4.2 Capital injection from a parent company

Comments were received noting that there are benefits from operating in a group structure which should be incorporated into the Standards, such as the fund is able to receive capital injections from the parent and the insurer has access to the group's resources and expertise.

11.4.3 Capital management plan

Some comments outlined that risks to the solvency of the fund and capital needs of insurers are clarified internally in capital management plans.

11.5 Main Issues

The issues recognised in the review are covered in detail in Appendix G. In summary the main issues are:

- Business operating plans
- Return on equity
- Donations and other capital reductions
- Time period
- Ensuring Solvency
- Capital available from a parent company.

11.6 PHIAC preliminary view

PHIAC's preliminary view on the structure of the business funding amount is detailed below. Other alternatives considered are covered in Appendix I.

11.6.1 Business operating plans

It is PHIAC's view that general expenses associated with growth of the health benefits fund business should be incorporated into planned future management expenses and hence into the renewal option amount.

PHIAC is considering whether a separate line could be included specifically stating the costs of such endeavours to increase the transparency of the capital needs of these projects.

11.6.2 Inclusion of returns of equity, donations and other expenses

Dividends that have been announced are required to be paid; hence this capital will not be available to meet other liabilities. However, this should be incorporated into the liabilities and balance sheet of a fund.

Inclusion of future returns of equity, donations and other expenses are a component of the broader business plan and a core component of a capital management plan. As a business plan is continually revised, changes can be made to reduce the outflow associated with these matters, hence they may no longer require capital. PHIAC is continuing to review whether such items can legitimately be included in the Business Funding amount.

11.6.3 Ensuring solvency

An objective of the capital adequacy reserve is to ensure that the fund will remain solvent. For a fund to be compliant with the solvency requirement, the fund must currently have assets that are at least equal to the solvency reserve. It is PHIAAC's view that capital adequacy should continue to be at least equal to the current solvency reserve, and that the Business Funding amount is the appropriate place to hold any prudential capital required for this purpose.

11.6.4 Time period

To achieve a consistent approach across the capital management and strategic plans, PHIAAC's preferred alternative is to retain the current three year period for the Business Funding Amount.

12 Subordinated debt

Currently an amount of subordinated debt is able to be treated as capital for the purposes of the prudential standards, should certain conditions be met.

12.1 Background

Representations made to PHIAC suggest that the current restrictions on subordinated debt arrangements are too restrictive and the current qualification criterion does not justify the cost and effort of seeking such a source of capital.

In addition, the current criterion on subordinated debt to qualify as capital can result in difficulties for a not-for-profit insurer to gain sufficient capital to commence operations – the use of subordinated debt for this purpose may be the only practicable source of capital for such an insurer.

12.2 Objective

To ensure that there is a practicable framework that enables an insurer to implement an appropriate balance between internally and externally sourced capital of each health benefits fund.

12.3 Consultation scope

“PHIAC will review the subordinated debt arrangements to ensure that there is a practicable framework that enables an insurer to implement an appropriate balance between internally and externally sourced capital of each health benefits fund”

12.4 Comments from industry

A number of comments were received advising that the current arrangement is too restrictive to justify the cost and effort of seeking such a source of capital. Comments centered on increasing the amount that can be treated as capital for the purpose of the Standards.

It was noted that subordinated debt can be a cheaper form of capital than ordinary equity or share capital.

A number of alternatives were suggested including increasing the amount to:

- a gearing ratio of 50%, debt/equity, using total equity
- a gearing ratio of 33% to 40%, using total equity, while employing stronger restrictions on the transfer of assets out of the health fund.

Comments were received expressing that hybrid instruments should be classified as capital for the prudential standards.

12.5 Main Issues

The issues recognised in the review are covered in detail in Appendix J. In summary the main issues are:

- Legislation
- Amount allowable
- Conditions on approved subordinated debt
- Treatment of non approved subordinated debt
- Treatment of diminishing term to maturity
- Registration of new funds.

12.6 PHIAC's preliminary view

PHIAC's preliminary view on the structure of the Subordinated Debt is detailed below. Other alternatives considered are covered Appendix H.

12.6.1 Amount allowable

It is PHIAC's preferred alternative to continue to impose an upper bound on the amount of subordinated debt that can be treated as capital for the Standards. This amount should be more than currently allowable, and it should incorporate the assets a fund has above the regulatory requirements.

It is PHIAC's view to change the limit on subordinated debt to be 50% of the capital available to meet the Capital Standards requirements for an established fund.

12.6.2 Conditions on subordinated debt

It is PHIAC's view that the current terms and conditions will continue for subordinated debt to be approved and considered as capital.

12.6.3 Treatment of non-approved subordinated debt

For subordinated debt to be treated as capital for the purposes of the Standards, PHIAC will need to have confidence that the amounts owing will not adversely affect the policyholders. Subordinated debt that is not approved will result in difficulty for PHIAC in gaining this assurance.

PHIAC's view on the treatment of non-approved subordinated debt remains unchanged from recent years. Currently PHIAC's view is to not allow non-approved subordinated debt to be considered as capital for the Standards.

12.6.4 Treatment of diminishing term to maturity

To reflect the repayment of principal, PHIAC's view is that a liability should be accrued as the time to maturity diminishes. Given the relatively low levels of profitability in the industry, particularly if a fund has a large amount of subordinated debt, this period should be at least

five years and the proportion that is treated as capital should decrease in a straight line over this period.

12.6.5 Registration of new funds

A fund that seeks to commence operations as a mutual has limited options to raise the necessary regulatory capital. In this circumstance subordinated debt may be the only practical means in which a fund can obtain capital.

PHIAC's preliminary view is for PHIAC to be able to exercise discretion in determining a limit on subordinated debt for funds commencing operations.

12.6.6 Solvency and capital adequacy

The two Capital Standards aim to identify capital in two different situations; hence it can be argued that the treatment should be different. However it is noted that two different treatments for the Standards would result in additional complications. Considering PHIAC's preference for simpler standards, it is PHIAC's preference to treat subordinated debt consistently between solvency and capital adequacy.

12.6.7 Interest payments

The conditions on interest payments stipulate that the interest rate can be adjusted based on default or after five years from the commencement of the loan.

In addition, interest payments on subordinated debt that are based on a floating rate can be subject to considerable volatility. Should the floating rate increase, this can be a considerable increase in the expenses of a fund.

While interest payments are a risk, it does not directly affect the policyholders which the Capital Standards are designed to protect. It is PHIAC's view that specific requirements incorporating interest payments will not be included in the Standards.

13 Minimum capital adequacy requirements

The current Capital Standards apply a minimum capital adequacy requirement of \$1.5million for all funds in the industry.

13.1 Background

This amount was implemented in 2001 and has not been amended since this time.

PHIAC is examining the specific risks to which funds and funds commencing operations are exposed in order to review whether this amount remains appropriate. The focus is on risks that are not proportional to the size of operations and may not be directly addressed through other aspects of the Capital Standards.

13.2 Objectives

The minimum capital amount is intended to provide assurance that a fund has sufficient reserves to address the risks associated with continuing operations.

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. This requirement serves to identify specific and non specific risks that are not addressed elsewhere.

13.3 Consultation scope

“PHIAC will review this amount to determine whether the amount remains appropriate and whether an adjustment mechanism should be introduced to ensure this amount remains appropriate into the future”

13.4 Comments from industry

Comments were received that indicated that the amount is arbitrary and should not be based directly on risk. However, it was noted that any revision of the minimum capital requirement needs to be justified.

13.5 Main Issues

The issues recognised in the review are covered in detail in Appendix I. In summary the main issues are:

- Exposure of funds commencing operations
- Vulnerability of funds that do not have a large membership base

- Amount of capital currently held by small funds
- Liability risks
- Barrier to entry
- Adjustments for inflation.

13.6 PHIAC's preliminary view

PHIAC's preliminary view on the structure of the minimum capital amount is detailed below. Other alternatives considered are covered Appendix K.

13.6.1 Amount to be held

It is PHIAC's view that \$1.5 million may not be sufficient to weather adverse experience in a fund commencing operations or a small fund. While \$10 million (the minimum for a shareholder fund of a life insurance company) is considered to be higher than necessary, PHIAC's preferred alternative is in the range of \$2 to \$5 million.

PHIAC is considering a number of methodologies to calculate this amount to achieve its objective. These include:

- Increase the amount to a specific figure between \$2 and \$5 million
- Introducing a fixed baseline amount, in which other reserves are additional to the minimum.
- Considering separately a reserve which calculates an amount to provide assurance against risks that are non proportional to the size of operations or not directly addressed by the Standards.

13.6.2 Liability risk

It is PHIAC's view that given the nature of the risks a fund commencing operations is exposed to, the minimum capital amount be placed on the liability components or on the renewal option amount, rather than the whole Solvency or Capital Adequacy reserve. This would provide assurance that should a new fund have an aggressive investment strategy, additional reserves will be held for the various asset risks that the fund is exposed to, alongside the liability reserves for risks of commencing operations.

13.6.3 Adjustments for inflation

Considering the constant increase in the dollar amount of these risks, it is PHIAC's preliminary view that the minimum capital requirement be indexed. For simplicity purposes this would be not be applied annually, but rather at an interval that provides a simple figure, e.g. a 10% increase every three years, should the amount be indexed to CPI.

14 Contagion risk

Contagion risks are currently partly covered by the inadmissible asset requirements.

14.1 Background

Many insurers operate multiple businesses under a variety of arrangements:

- within the health benefits fund,
- outside the health benefits fund,
- through subsidiaries and/or
- as part of a larger group.

All such arrangements can give rise to reputation and contagion risks for the health benefits fund and can lead to a loss of value.

14.2 Consultation scope

“PHIAC will consider the effects of contagion risk and in particular:

- *the degree of disclosure and transparency, and*
- *whether there is a need for specific capital requirements”*

14.3 Comments from industry

One insurer addressed the issue of health benefits fund capital and contagion risk by looking at whether insurers are ‘for-profit’ and/or parts of a multi-business arrangement: “Not-for-profit insurers cannot take capital out of the health benefits fund but they are similarly limited in their ability to inject additional capital at a crucial time to counteract sudden adverse experience. Similarly stand alone insurers, while immune from contagion, have reduced access to the sort of expertise and ‘independent’ internal scrutiny of their activities which can be afforded by the corporate governance processes within group structures. If PHIAC is to make provision for potential exposure, it must also recognise the existence of identifiable and committed risk mitigation”.

PHIAC considers that funds should identify and document contagion risks noting that each fund has different operational risks, and therefore, different contagion risks.

A stakeholder to the industry noted that funds may be allowed to hold some capital outside the health benefits fund. PHIAC suggests that this is an area that needs to be closely monitored. It is important to ensure that the capital is not “double-counted” as prudential capital for more than one entity, particularly for friendly societies.

14.4 Main Issues

The issues recognised in the review are covered in detail in Appendix J. In summary the main issues are:

- Definition of contagion risks
- Impact on funds and insurers
- Director independence
- International/domestic developments.

14.5 PHIAC's preliminary view

PHIAC's preliminary view on the structure for the treatment of contagion risk is detailed below. Other alternatives considered are covered Appendix J.

PHIAC would prefer that insurers assess and address contagion risks as part of the risk management process. This process may be extended with an overarching prudential requirement to prepare capital management plans that incorporates the consideration of contagion risks. The next chapter considers the capital management plan framework.

The concept of director independence is a concern for PHIAC, however it is outside the scope of this review. PHIAC would prefer the development and implementation of a structure to accommodate independence be conducted separately from the review of the capital standards.

PHIAC refers insurers and other stakeholders to separate work on the subject of independence and governance, which will shortly be available on the PHIAC website.

15 Capital management planning

15.1 Background

Insurers should have an appropriate strategy and plan to clearly define their source and intended use of capital. This is particularly important when adverse conditions prevail and there is need for capital adjustments and financial realignment.

15.2 Consultation scope

“Are there emerging techniques of risk assessment or capital management which should be considered for inclusion in the capital standards?” – Terms of reference

15.3 Comments from industry

Some comments on capital management plans were received in the context of other specific issues (e.g. see “Use of capital” – section 11). Generally these comments supported the practical value to an insurer of a disciplined capital management plan.

15.4 Main Issues

The issues recognised in the review are covered in detail in Appendix K. In summary the main issues surround the issue of when an insurer should develop formally instituted capital management plans.

15.5 PHIAC preliminary view

PHIAC’s preliminary view on the structure for the treatment of contagion risk is detailed below. Other alternatives considered are covered Appendix K.

PHIAC believes that regulation governing the development and introduction of formal capital management mechanisms is necessary to ensure that insurers consider the broad range of risks inherent in their business and the risk/capital relationship that is critical to the sound financial management of the insurer.

PHIAC would prefer the development and implementation of capital planning requirements to be conducted separately from the review of the capital standards.

Appendices

A. Liability Risk Margins

Specific Issues

Risk margin/level of sufficiency

An integral component of the solvency/capital adequacy liability is the risk margin that is applied to liabilities to create the prudential reserve. Currently the Standards apply a fixed margin to a fund's balance sheet insurance liabilities. The objective of this is to provide greater assurance that the amount reserved will be sufficient to meet the fund's eventual liabilities in a solvency or capital adequacy situation.

PHIAC is concerned that the current fixed margin provides an inconsistent level of sufficiency across the industry and may not be the most prudent approach - particularly in the context where the objective of the risk margin is to provide assurance that the amount held will be sufficient to meet the eventual liabilities.

PHIAC recently obtained claims data from each fund to assess the level of sufficiency provided by the current fixed margin. The assessment of this data has confirmed that the current standards provide an inconsistent level of sufficiency across the industry.

To address this, PHIAC is reviewing the merits of implementing margins that would be based on providing a designated level of sufficiency to all funds. This will incorporate the volatility commensurate with the risk to which each fund is exposed, thereby resulting in a margin that is tailored to the underlying risk and uncertainty of that fund.

If the margin is based on a level of sufficiency, then funds with larger amounts of uncertainty will be required to hold more capital than funds with lower levels of risk.

Appropriate level for a sufficiency margin

It is prudent to adopt a higher level of sufficiency from a regulatory perspective. If a margin based on a sufficiency level of 80% be adopted, the reserve will be insufficient to meet the liability 20% of the time. A higher level of sufficiency should provide greater assurance to the fund's policyholders.

It is recognised that the amount of capital required for higher levels of sufficiency increases non-linearly. That is, the amount of reserves required to increase the level of sufficiency from 80% to 95% is substantially larger than to increase sufficiency from 50% to 65%.

Further, it is recognised that funds may have costs associated with raising and holding capital. As a result, PHIAC is cognisant of determining an appropriately prudent reserve.

As claims in private health insurance are not subject to the extent of volatility seen in other insurance industries, a higher level of sufficiency can be obtained from a smaller capital reserve. This is being considered in determining appropriate risk margins.

The solvency and capital adequacy reserve have different purposes and aim to accommodate risks in different scenarios. These are discussed separately below.

Solvency

In the event that solvency of the fund is at risk, and outstanding claims are substantially higher than the prudential reserve, there is limited scope that the shortfall in reserves can be covered by lower future claims or contribution income. The shortfall will need to be met from the fund's existing free capital, which suggests that it is important to ensure that the level of capital required to be held for solvency purposes is sufficient to cover the eventual liabilities.

Capital adequacy

If the fund is continuing to write business, it can be argued that there is more scope for higher than anticipated outstanding claims to be retrieved by future lower claims or higher contribution income.

However, in the ongoing scenarios there is increased uncertainty as to the best estimate of this provision. The provision is based on current experience, which may change in the future. Hence a capital adequacy margin may need to be reflective of the fluidity of the underlining experience.

Health related insurance business

The liabilities associated with health related insurance business are similarly subject to uncertainty and for prudential purposes the liabilities should be subject to a risk margin. Currently the Standards apply a consistent risk margin to all insurance liabilities. However this does not result in a consistent level of sufficiency across the fund.

To obtain a consistent level of sufficiency across the fund and the industry, funds would need to apply varying risk margins to these liabilities. Due to varying levels of volatility it is likely that a fund may need to use different risk margins for the different components of health related insurance business.

Risk equalisation trust fund

Future transfers from and to the risk equalisation pool are incorporated into the fund's balance sheet, both in outstanding and incurred claims. These amounts are an estimate of the expected future cash flows from the trust fund, based on the gross deficit of the industry and the age based breakdown of outstanding claims. As the amounts are estimates, they are subject to uncertainty. To gain assurance that the amount will be sufficient to meet the eventual liability a risk margin will need to be incorporated.

To obtain a fixed level of sufficiency a margin may need to be calculated based on the volatility and the accuracy of this calculation. It is noted that the amount is partially dependent on the eventual amount of outstanding claims.

Loyalty benefits

Loyalty benefits are estimated as at the date the financial statements are prepared. In the circumstance that loyalty benefits result in extra benefits as opposed to reduced premiums, there can be volatility in the eventual value of this provision. This volatility will be specific to

the loyalty benefits and hence may not be comparable to other risk margins of the fund. To address this, separate margins may, in theory, be required.

Further, the estimation will be based on the fund's previous experience and drawing rates. In the situation where the fund is being terminated, the fund's previous loyalty benefits payments may not be an appropriate estimate for future payments.

Unearned premium liability

Similarly, the unexpired premium liability involves risk and the Standards currently apply a 10% margin to this amount. The risks to which the unearned premium liability is exposed are not identical to the outstanding claims liabilities, particularly as it is based on events that have yet to occur.

A risk margin can be determined from the volatility in the fund's previous experience. However PHIAC is concerned that the previous experience may not be an appropriate estimation for the unearned premium liability in a solvency situation, i.e. the fund being terminated.

It is likely that during the termination period, the fund's claiming pattern will not be identical to the fund's experience that was underpinned by ongoing operations.

There is some limited data available to suggest that a fund's membership will not continue to accrue claim costs in a similar pattern to that previously experienced. Hence assuming that the future experience will not be affected by the announcement to terminate the fund may not be appropriate.

Specifically PHIAC has two main concerns in relation to the future claiming pattern of a membership in a solvency situation; that of the potential for a change in utilisation and possibility of adverse selection as members leave the fund. This is discussed further in the Termination Expense Amount.

Minimum margin-floor

The volatility of a fund and subsequent risk margin will be based on a fund's experience. Depending on the period chosen to assess a fund's volatility, the level of volatility calculated may be materially different. Further, should a fund have recent experience that has been stable, a fund's sufficiency margin may be calculated to be very small or even negligible.

While recent experience may have been stable, it is difficult to confirm that future experience will not have any volatility. Therefore a balance must be reached in which applying a sufficiency margin does not result in a negligible risk margin and that margin incorporates volatility apparent in the longer term.

The margin must be able to accommodate unexpected volatility and recognise that future claims may not be as stable as previous experience and this may require a minimum risk margin.

Timeframe

The calculation of a sufficiency margin involves the assessment of historical experience and applying statistical/actuarial techniques to this data. This raises the issue of the amount of data that would be required for an appropriate estimate of volatility to be derived.

The assessment of a given data set can result in vastly different sufficiency margins depending on the amount of data used. For example, determining a sufficiency margin based on the last 12 months of experience will generally result in a different margin than if experience over the last four years is used.

Methodology

Volatility of liabilities

To facilitate investigating the merits of a sufficiency margin, PHIAC has requested aggregate claims data from all funds for the last four years. This data has enabled PHIAC to assess the volatility in outstanding claims and the level of sufficiency obtained for funds as a result of the current fixed margin. The methods PHIAC has employed to assess this are detailed below.

Bootstrapping

A stochastic simulation has been performed on the aggregated claims triangle by using the technique of bootstrapping the Pearson residual from a standard chain ladder methodology for evaluating outstanding claims. This simulation was run 10,000 times and results in a distribution from which both sufficiency and volatility can be assessed.

Based on the methods used extensively in the insurance literature (see England, P. & Verrall, R., 1999 Analytic and bootstrap estimates of prediction errors in claims reserving *Insurance: Mathematics and Economics* 25 (1999) 281-293) this technique was used to confirm that the current methodology produces inconsistent levels of sufficiency across the industry. Further, this new method provides a value for each fund's volatility in the fund's claiming pattern and enables the determination of a risk margin necessary to provide a given level of sufficiency.

Monte Carlo Simulation

The other model PHIAC is currently using is based on a Monte Carlo simulation of the historical claims pattern and which can be applied to any claims reserving methodology. This model is not restricted to the chain ladder methodology and measures the prediction error directly and thereby deduces each fund's volatility.

Stochastic methods

In applying stochastic models, it is recognised that the appropriate application is dependent on the ability to identify and remove the effect of explanatory factors, such as trend, seasonality, membership growth, CPI, processing lags and average burning rates, which would otherwise contribute to measurement error. Where the factors are not predictable and cannot be forecast, they would be included as a component to the overall volatility of a fund's experience. The Monte Carlo simulation model measures this overall volatility.

PHIAC expects that the volatility measured by the fund itself may be less than that determined by PHIAC, as each fund will have certain information available to it on the nature and timing of the claims pattern. If this deviation becomes significant, PHIAC will request further information to ensure that the margins for risk are appropriate.

Standard chain ladder method

It is important to note that PHIAC advocates the use of a standard chain ladder method, or any other methodology, to determine a best estimate for outstanding claims. The development of an appropriate methodology to calculate outstanding claims and other insurance liabilities is a matter for each fund and their appointed actuary.

It is recognised that some of the fluctuations in the claims data may have been predicted and therefore should not contribute to increased risk margins justifiable. However considering the information PHIAC has available and that a number of funds in the industry have limited resources, PHIAC decided to pursue a simple methodology that makes limited assumptions in measuring volatility.

Options Considered

Principles based

Multiple margins

An alternative is for PHIAC to set a certain level of sufficiency to apply to all balance sheet liabilities to obtain the necessary risk margin. Funds would be encouraged to model their own data through the application of a set of common principles that takes the specifics of each fund into account and that can explain the volatility in its experience. Each fund can then apply a methodology to determine a prudential risk margin that results in a consistent level of sufficiency for:

- Outstanding claims – health insurance business, including
 - Benefit component
 - Administrative component
 - Risk equalisation component
- Outstanding claims – health related insurance business, including
 - Benefit component
 - Administrative component
 - Reinsurance component
- Risk equalisation transfers
- Loyalty bonuses
- Unearned premium liability

It is recognised that each of these items and components may not have identical volatility, and a risk margin would need to be tailored to the experience of each component to obtain a consistent level of sufficiency.

This can result in a substantial amount of work which may not result in a material difference for a small fund, especially for smaller amounts such as loyalty bonuses or the administrative component of health related insurance business.

Single margin

The largest component of the insurance liabilities relates to the outstanding claims liability benefit. An alternative is to determine a margin to obtain a designated level of sufficiency on this liability and use this volatility as an approximation for the volatility of other insurance liabilities. All insurance liabilities within a fund would then be subject to the same risk margin.

Minimum margin-floor

To provide assurance against unexpected volatility and to recognise that future events may not be as stable as previous experience, there may be justification to require a minimum risk margin or floor. This margin could be based on the current solvency risk margin or on the volatility exhibited by some of the more stable funds and then broadly applied to the industry. It should cover the risk of changes to expected levels of experience for each fund.

Size of sufficiency margin

The development of the Standards in 2000 intended that ‘for statutory solvency purposes, it would be expected that the liability provision would provide a very high probability of ultimately proving adequate’. The 10% risk margin for solvency was based on achieving a 97.5% level of sufficiency over a one year period.

It is anticipated that the sufficiency margin for solvency purposes will be based on providing a high probability of adequacy. Alternatives include sufficiency margins between 80 – 99.5%.

Risk-margin range based on PHIAC’s view of sufficiency

An alternative to implementing a principles based margin for sufficiency is for PHIAC to determine a risk-margin range for each fund. This range would be reviewed on an annual basis and supplied to funds to be incorporated into the calculation of the prudential requirements. The risk margin range could be calculated by PHIAC to achieve a certain level of sufficiency and be based on information in the PHIAC returns.

It is recognised that PHIAC’s risk margin may be different from those calculated within funds, as a consequence of internal risk determination by the fund. However in providing such a range, this alternative has the advantage that it would require minimal expertise from funds to be implemented, and it would increase the industry transparency of margins.

Fixed margin

An alternative is to implement a fixed margin to this reserve. This margin could be the applied uniformly across the industry or applied on the basis of a simple calculation, for example the number of SEU’s.

Combination of sufficiency and fixed margin

A combination of a sufficiency and fixed margin could be implemented. This would result in liabilities effectively having two risk margins, a margin based on a level of sufficiency and then an additional fixed component. It is noted that this approach is currently utilised in APRA general insurance standards for outstanding claims.

B. Renewal Option Amount

Specific Issues

Forms of corrective action

Corrective action refers to measures implemented by an insurer to improve current operating performance, specifically to reduce losses and obtain at least a breakeven financial performance.

There are five primary measures that a fund can implement to address underwriting losses. These are:

- Changing the benefits offered by particular products
- Closing products
- Discontinuing products
- Reducing management expenses
- Increasing the premiums on products.

Implementing any of the first four measures will often not address fully the losses, and in many cases some premium increase will also be required for the product in question.

For a fund's premium to be adjusted, an application must be made to the Department for approval by the Minister. While technically premium adjustments may occur at any time, in practice they occur once a year. To protect the interests of policyholders and to minimise political risk, for the purposes of the Standards premium changes are assumed to occur in the annual premium round. This means that corrective action is assumed to be implemented on 1 April each year.

Timeframe for corrective action to become effective

The current renewal option amount applies a 12 month timeframe for an adverse claims shift. While a 12 month period does include a premium round, it may not allow sufficient time for an adverse claims shift to be identified and for corrective action to become effective.

It is PHIAC's view that the period should be of sufficient length to accommodate the losses incurred from the instigation of a claims shift, until corrective action can be implemented. The appropriate length of time for the renewal option amount is driven by the length of time involved in the steps to implement corrective action. These steps are detailed below.

Identifying adverse claims shift

The initial stage of correcting an adverse claims shift is identifying that a permanent shift in claims has occurred and to identify the extent of the shift.

Benefits are inherently volatile and will rarely exactly equal projections. It can be difficult to identify a permanent adverse claims shift, from temporary adverse experience unless there has been a sustained period of increased benefits payments.

Should a fund incur a quarter of high claims it is unlikely that they will immediately seek to increase premiums. Generally a fund would seek to confirm whether the current high levels of claims will continue.

The effect of this is that one or two quarters of higher than expected claims may be categorised as temporary rather than a permanent claims shift, particularly for smaller more volatile funds. Hence it may take three or more quarters to appropriately identify an adverse claims shift.

Should three quarters of data be necessary to confirm adverse experience, this will result in the fund's capital being diminished by nine months of losses before it identifies that a permanent claims shift has occurred.

It is noted that the time period to identify this will depend on the nature of the benefit growth and the specific situation, but is likely to be in the range 6 – 9 months.

Preparation of premium application

Following the confirmation of an adverse claims shift, a premium application will need to be prepared outlining appropriate price increases. This will require approval by the fund's appointed actuary, senior management and the fund's board.

To prepare this report and gain approval from the fund's board will take a period of time, presumably at least a month.

Period until next pricing round

Following approval by the fund's board, the application will be need to be submitted to Department and be approved by the Minister for Health and Ageing.

It is anticipated that the premium adjustment will occur in the standard premium round which is submitted to the Department every December. Hence the time between gaining approval by the fund's board to take corrective action, and formally submitting to the Department can be a considerable period of time, from 0 to 12 months.

Should the applications no longer be accepted for the current premium round, it could be 12 months until another application can be lodged. During this period, the fund will continue to incur losses, which will result in the fund's reserves diminishing.

Period until implementation

Pricing applications are submitted to the Department in every December, however they are not implemented until 1 April the following year. For this four month period a fund's prices will not change and the fund will continue to incur losses.

Rate Protection

As most funds offer rate protection, there will be a delay between the implementation of the revised premiums and a change in a funds performance. It is noted that the average private health insurance policy is prepaid by approximately 44 days¹. Hence, in a capital adequacy

¹ 2006/7 PHIAC Annual Report

situation, a fund will need to finance losses from existing capital until the corrective action becomes effective. On average this is 44 days of revenue at the old premium rate.

Aggregate timeframe

It may therefore take up to 27 months for a fund to identify an adverse claims shift and then implement corrective action. Should an adverse shift be recognised in six months as opposed to nine, it may still take up to 24 months until a premium change can be effective.

| Event | Time required months |
|---|-----------------------------|
| On set of an adverse shift in claims | 0 |
| Differentiating an adverse shift from temporary volatility and ascertaining the extent of the change. | 6 to 9 |
| Preparation of a premium application. Including analysis, and management and Board approval | 1 |
| Period until next premium round | 0 to 12 |
| Period from submission of premium application until effective date | 3.5 |
| Delay effect of rate protection | 1.5 |
| Total | 12 to 27 months |

Premium rounds required

The above components are calculated on the basis of corrective action occurring in the next pricing round. However there is a risk that the approved changes to premium income may not be sufficient to return the fund to a positive underwriting performance.

Should this occur the fund may require additional reserves to meet these losses into the longer term. However, should corrective action no longer occur at the annual premium round, it creates additional complexities regarding how the additional reserves could be funded.

Causes of an adverse claims shift

A large increase in benefits can generally be attributed to an underlying cause. Identification of the cause/s of an adverse claims shift will assist in identifying the potential size of the shift and the likelihood that such a shift has occurred.

The main underlying causes of volatility and increased claiming patterns are outlined below.

Membership growth

A fund that gains new members, particularly at a rapid rate, cannot be assured that the new members have a claiming pattern that is consistent with the current membership.

There is a risk that the new members may claim substantially more than current experience suggests. Should the difference in claiming pattern be substantial, the fund may start incurring losses. Further, the extent of these losses will increase should membership continue to grow,

particularly at a rapid rate. The faster a fund grows, the larger the possible losses in dollar terms and the faster the reserves may reduce.

New products

A product that has been in existence for a number of years with a stable membership, has a large amount of recorded experience that can be relied upon to estimate future claims.

A product that has been recently developed will not have the same level of historical data. Hence there is a risk that the price set may not be sufficient to cover expenses and thereby incur losses. Should the losses of a new product be substantial, this can dramatically affect the entire fund.

Funds that develop new products are exposed to the risk that the products will not be appropriately priced.

High product transfers

A product is generally priced according to anticipated claims, which are partly based on historical experience. Members transferring from other products within the fund can create similar issues to a fund obtaining new members. While data exists on their experience, it is uncertain that their claiming pattern in a new product will be identical to experience in a different policy. The new product will generate a different amount of revenue, provide different benefits and consequentially incur different benefit payments.

Should this result in the claiming pattern of the product being substantially different from previous experience, the fund may incur losses for this type of policy. If the products become sufficiently large, it will affect the entirety of the fund.

Changing risk profile

As mentioned above, forecast claims are heavily based on previous experience and the risk profile of the fund. However the risk profile of a fund is dynamic and can change despite a lack of new members or products.

As members progressively age, generally the claims of the fund will similarly increase. It is noted that the average claims per SEU increases almost exponentially past the age of 50. This progressive change can result in a fund incurring substantially higher claims than previously experienced. Further, this can continue into the future if the demographics of the fund continue to be responsible for increased benefit growth, despite risk equalisation support.

A number of other environmental and sociological issues can also result in the change of a fund's risk profile. This change may result in substantial increases in benefits which could require premium adjustments.

Reduction of excess, expiration of waiting periods

A number of funds offer policies where the benefits available change over the course of the policy, such as the expiration of waiting periods and the reduction in excesses. As more procedures become available, the amount that funds pay for a claim increases, thereby increasing the total amount of benefits that the fund incurs.

As a result the extent to which a policy is not appropriately priced may not be apparent until waiting periods have expired and excess payments have reduced.

This is particularly the case with new products or new members joining a product, as the underlying claiming pattern will not be comprehensively known until sufficient experience has been observed. Sufficient experience requires observed experience following the reduction of excesses and the expiration of waiting periods. This may take up to three or four years.

Should the underlying claiming pattern not be appropriately estimated, benefit payments could suddenly increase and potentially result in considerable losses.

Loyalty benefits

Loyalty benefits provide extra value to the members after a period of time, either through extra benefits or reductions in premiums. To offset this, reserves are accrued in anticipation of the future extra value.

There is a risk that the reserves may not reflect sufficiently the eventual future experience, and the cost of loyalty benefits becomes substantially more than the reserve. The result of having inappropriately priced loyalty benefits or underestimated reserves is that the policies may operate at a loss.

As it can take a number of years to incur loyalty benefits, inappropriate pricing may not be identified until after these benefits are being utilised.

This can be particularly relevant for health insurance contracts as the policies may continue to be in force in perpetuity.

Fund volatility

A fund can exhibit a volatile claiming pattern that is not necessarily associated with any of the above factors. A volatile claiming pattern can stem from a membership being small or ageing, comparatively weak benefit controls, contracting arrangements or the membership itself maybe inherently unpredictable.

Volatility in future claims will generally result in increases in benefits which may result in substantial losses for a prolonged period. Hence the volatility of a fund's previous experience can be an indicator of future uncertainty and increases in claims.

Industry factors

Increases in claims can occur as a result of changes to the broader industry. Sudden increases in utilisation rates, new procedures becoming more popular, increased costs of prostheses, other medical advancements, and hospital contracts that are more expensive than anticipated are some of the events that can cause a rapid increase in costs that affect the whole industry.

The volatility in the health industry will continue for the foreseeable future and is often a source of large increases in claims. This is particularly the case should a fund have a high exposure to one or more of these risks.

Risk Margin to be applied

The current renewal option amount applies a margin to the forecast claims and expenses of a fund. This amount is based on a minimum 12.5% in addition to a margin based on a fund's size and a discretionary margin.

While the risk to which a fund is exposed is partially dependent on the size of its policyholder base, PHIAC is reviewing the basis for the capital adequacy margin to determine whether a more appropriate margin can be applied to reflect a fund's exposure to risk.

Industry comments did not express that the capital adequacy margin is inappropriate and it is anticipated that the size of the amount will may not significantly change.

The size of the risk margin used for the calculation of the renewal option amount will have a significant impact on the size of required reserves. Should the margins be changed, the potential effects will be discussed directly with individual funds.

Minimum sufficiency margin

Depending on the methodology used to determine the volatility and likelihood of adverse experience, some funds may calculate a very low or negligible risk margin. In this situation, a sufficiency margin would result in minimal assurance that fund has sufficient reserves to accommodate any unexpected volatility in claims.

PHIAC is concerned that the application of a sufficiency margin in isolation may not be consistent with achieving the objectives of the renewal option amount. Hence a minimum risk margin may need to be implemented.

Potential offsets

The objective of the renewal option amount is to gain assurance that a fund will be able to absorb adverse experience for a sufficient period until corrective action can be implemented. In absorbing adverse experience, a fund may be able to match negative cash flows in an area of the business with positive cash flows in another. This is discussed further below, in relation firstly to business components, and then timing.

Business components

The renewal option amount applies a risk margin to cash flows of each line of business and calculates the net present value of the aggregated loss that eventuates. This gives rise to the situation where the risk margin may not result in a loss in all components. In some cases, the fund may continue to report an operating surplus in health related business, for example.

This suggests that a profitable component of the renewal option amount could potentially be used to offset other renewal option components or other liabilities.

In this scenario a profitable health related business could potentially be used to effectively subsidise the health insurance business, which would reduce the losses and thereby the reserve required.

However, there are a number of risks should these offsets be recognised in determining capital margins. These include the timing of cash flows and various other risks attached to the

health related business. Should circumstances change, the fund may not be able to realise the projected profits of health related business lines.

It is noted that there is an argument for allowing the components of the renewal option amount to reduce the reserve, however it is also noted that there are substantial risks in permitting this to occur.

Currently the renewal option amount does not allow for the cross subsidisation of components.

Timing

In the current calculation of the renewal option amount, the cash losses experienced in a fund can be offset by profits in future months. PHIAC is concerned that in the realisation of this situation, current losses may not be able to be offset by future profits, and that this results in a severe liquidity pressures.

It is difficult to offset current losses with future profits that have yet to be obtained.

Health related business

The renewal option amount serves to provide an amount of reserves for the fund to be able to weather adverse experience. While the dominant purpose of a fund is dedicated to health insurance business, many funds operate health related business; either health related insurance business and/or other health related business. This means that adverse experience in health related business can similarly result in losses that affect the whole fund.

Should adverse experience occur, the fund will require reserves to absorb these losses for sufficient time until corrective action can be implemented.

The effects of adverse experience on the fund can be similar to that of health insurance business; however the circumstances and risks differ. This is especially the case for non-insurance health related business.

Accuracy of forecasts

The calculation of the renewal option amount is based on the fund's forecasts; hence the appropriateness of the amount is, partially, based on the accuracy of a fund's projections.

It is recognised that forecasts rarely exactly equate to actual results. The stochastic nature of forecasts, results in difficulty in stating a precise estimate of future events. However, part of the reason for the deviation from forecasts can arise due to the underlying assumptions.

Considering that the structure of this reserve is built on a fund's projections, should a fund be able to explain and forecast the 'uncertainty' in experience, the lower the level of effective volatility the fund will display.

Should a fund's forecasts have a high degree of accuracy, it could be argued that a smaller risk margin would be appropriate, despite apparent volatility in results.

Premium increase

In its current form the renewal option amount incorporates a premium increase of the fund's choosing. However considering the sovereign risk associated with the premium round, a fund may be limited in the pricing increases that it can implement. Incorporating a key assumption about the likely premium increase into the calculation of this reserve does involve risk.

Future liabilities

In addition to being able to meet benefit payments and expenses throughout the renewal option period, it will also be necessary for a fund to be able to meet future liabilities. In the current form the renewal option amount only incorporates the liability for outstanding claims. This is not necessarily reflective of all the liabilities that may require reserving, particularly liabilities for loyalty benefits and subordinated debt.

Continual adverse shifts – static or dynamic

Should an adverse claims shift occur and be recognised by the fund, this adverse shift/ new claiming pattern would then be incorporated into the fund's projections. Effectively the previous claims inclusive of the risk margin would become the revised best estimate for future benefits.

In this circumstance the renewal option amount would apply another margin to the forecasts, effectively increasing the impact of the adverse shift by the increase in the reserve required.

Views have been expressed that a fund which has recently incurred an adverse claims shift may have a reduced risk of a further adverse shift reoccurring in the near future. As depending on the source of the adverse shift, it may be that a new product has revealed its underlying risk profile and that as a result of the shift had brought the risk profile to a market equivalent. Hence there is a reduced risk of this reoccurring. The question is whether such a reduction in risk should be used in determining an appropriate margin.

Once experience for a new product has been obtained, there is less uncertainty, but this reflects the need for additional reserves when introducing new products rather than assuming the claims experience is negatively autocorrelated (i.e. is more likely to go down after a period of higher claims – and vice versa). PHIAC has no reliable evidence to suggest such autocorrelation. PHIAC's data suggests that a fund that has recently incurred large increases in benefits is not immune from a further large increase in claims and that in some cases it is an indication of further uncertainty and may reflect an increased underlying trend.

Other expenses

Throughout the renewal option amount period, the fund will incur other expenses associated with the fund that are not incorporated into management expenses. As these costs are not incorporated into management expenses they are not currently considered as a component of the renewal option amount.

The renewal option amount is intended to provide for the total expenses the fund under adverse scenarios. Expenses such as interest payments on subordinated debt are costs that will be incurred during the renewal option amount period; hence it may be appropriate to include the volatility of these payments into the calculation of this amount if they are not fixed.

Options Considered

Timeframe for renewal option amount

The length of time to be included in the determination of the renewal option amount needs to include the time for adverse experience to be identified and corrective action to be effective for:

- Health insurance business
- Health related insurance business
- Health related business.

Due to the difference risk profiles of these business lines it may be that different approaches are implemented to address this risk.

Principle based

The timeframe detailed earlier in this section details the period required to implement a premium increase in the annual pricing round following the instigation of an adverse claims shift. Under a principle based approach, funds would independently calculate a sufficient time period for the renewal option amount. This period would be based on the fund's view of the timeframe in which corrective action could be identified and implemented.

However, should this alternative be pursued, PHIAC is concerned that different time periods would be chosen across the industry which may not be appropriate for the nature of a fund.

Prescriptive

Following consultation an appropriate period for the renewal option amount is derived. This period will then be a requirement in the calculation of the amount.

Premium changes

There is a risk that a proposed premium increase outlined in renewal option amount is not implemented. As a result, should a fund be factoring a large increase in premiums into the renewal option amount that does not become effective, the reserve will not be sufficient to meet the desired objective.

Principle based

To allow funds to include a premium adjustment in the forecasts that they reasonably believe will be implemented.

Maximum percentage

An upper limit could be placed on the increase in premiums the fund is able to incorporate into the renewal option amount. For example, funds could be restricted to a premium increase of no more than 4.8% into the forecasts of contribution income. This percentage could be adapted over time.

Risk margin – derivation

As mentioned above, an adverse claims shift can originate from a number of different areas, the specificities of a fund will influence its exposure to these factors.

PHIAC would recommend considering all of the factors listed above in determining central estimates for forecasts, and that these risks be included as part of a broader capital management plan. However PHIAC recognises that the inclusion of these risks into a risk margin is a matter of judgement.

The assessment of an appropriate methodology for the renewal option amount remains ongoing. Methods currently being considered include:

Principles based

Supply funds with a broad set of principles that allow a risk margin be tailored to the fund's view of the risks to which the fund is exposed.

Hybrid based

An alternative is to implement a framework that is a combination of fixed and discretionary components. This approach would enable funds to accommodate the details of their risk profile within a framework that results in consistency across the industry.

This alternative would be broadly consistent with the current methodology to calculate the capital adequacy margin.

Prescriptive margin - 'historical weighted mean'

PHIAC could instead supply a risk-margin range detailing specific issues that need to be incorporated and provide a baseline onto which the principle margin is built.

A method PHIAC is considering is a 'historical weighted margin', whereby the margin is based on the volatility of each fund's claiming history.

This margin would be derived from the claims triangles PHIAC has recently obtained. This is the same data with which PHIAC is assessing the merit of a sufficiency margin for outstanding claims for both Solvency and Capital Adequacy liabilities.

The volatility of claims can be assessed based on the historical experience as ascribed in the claims triangles. This information can be de-trended and de-seasonalised to assess the residual volatility. This volatility would be applied to future forecasts and the projected volatility will result in a margin for a given sufficiency.

Other alternative methods of determining the appropriate margin are anticipated during the process of follow-up discussions and Industry response to this report.

Prescriptive margin – based on membership changes and accuracy of forecasts

Membership changes will inherently change the risk profile of the fund and thereby create additional uncertainty around the forecasts. An alternative PHIAC is considering is to have a margin partially based on current and/or forecast growth. Such a margin would reflect the increased risk that a fund seeking to grow its membership is exposed.

Further, membership growth can be representative of new products, either in a new or existing market. Implementing a margin based on current and/or forecast growth will also provide an approximation for some of the risks associated with new products.

The accuracy of the fund's forecasts could be incorporated to determining a risk margin. Forecasts supplied in the renewal option amount could be compared to subsequent PHIAC 2 data or claims triangles to calculate the accuracy of a fund's forecasts. The accuracy of a fund's forecasts could then contribute to the required margin. This margin could provide a level of sufficiency as to the forecasts being reflective of actual experience.

This would provide an incentive for funds to place increased emphasis on their forecasting ability and to identify future changes in financial performance. This would reflect inherent and unexpected volatility in a fund's experience.

Risk margin – size

It is noted that any change to the current capital adequacy margin will potentially have a significant impact on the total reserving requirements of a fund. Changes will be discussed directly with individual funds.

Comments received from industry did not express that the current margin is unreasonable.

It is anticipated that any changes made to the capital adequacy margin will not materially increase the total reserve.

Health related business

Method consistent with health insurance business

Currently the time period and risk margin that is applied to health related insurance business is consistent to that of health insurance business.

While it is noted the risk profile of these businesses are not identical, the risks have some similarities. Therefore, one alternative is to implement the methodology used for health insurance business for health related insurance business.

It is noted that the health related component of the renewal option amount will generally not generate a substantial increase in a fund's prudential reserve. Hence the costs of implementing another approach may be disproportionate to the benefits gained.

Principle based approach

While the risks may be similar to health insurance business, as noted above they are not identical, hence the principles underpinning the renewal option amount could be provided to insurers. This would enable insurers to determine the appropriate reserve for the non-health insurance business for the renewal option amount.

Hybrid

Should a fund seek to apply a principles based approach, PHIAC would seek assurance that the principles have been implemented appropriately. PHIAC could provide an option for funds to either implement the same methodology as health insurance business or apply a principles based methodology.

Future liabilities

To gain assurance that the future liabilities of the fund can be met, changes in liabilities could be included in the renewal option amount.

Continual adverse shifts – static or dynamic margin

A static approach to adverse claims would result in the capital adequacy margin being continually applied to a fund's forecasts regardless of the recent revisions.

A dynamic approach would incorporate recent changes in claiming patterns and allow for the potential reduction in risk. However as noted above PHIAC has no reliable data to suggest that an adverse shift would reduce the risk to a fund ("negative auto-correlation") and as such it would not be appropriate to reduce the risk margin based on the volatility of recent experience.

C. Termination Expense Amount

In this appendix “Expense” refers to both management costs and claim costs.

Specific Issues

Legislative requirements

Section 149 of the PHIA details specific events that must occur during the termination of a health benefits fund. These events ascribe endeavours that impact the fund’s operations, have costs associated directly with them and detail the length of the termination period.

The legislative requirements include:

- *Section 149-1:*
 - *A private health insurer may apply to the Council, in the *approved form, for approval of the termination of each of its *health benefits funds. (section 149-1)*
- *Section 149-10*
 - *The Council must approve the termination if it is satisfied that:*
 - a) *the insurer is not in the process of being wound up; and*
 - b) *each of its *health benefits funds meets the *solvency standard; and*
 - c) *in relation to each of the funds, termination of the fund will not result in unfairness to the *policy holders of the fund, when those policy holders are viewed as a group;*
- *Section 149-20*
 - 1) *A private health insurer must not, after being notified under subsection 149-10(2) that termination of its *health benefits funds has been approved:*
 - a) *enter into an insurance policy that is *referable to any of its funds with a person who is not already a *holder of such a policy; or*
 - 2) *The insurer must, within 60 days after being notified under subsection 149-10(2) that termination of its *health benefits funds has been approved:*
 - a) *give a written notice, stating the day (the **termination day**) from which it will not renew insurance policies that are *referable to any of its funds, to:*
 - b) *each *policy holder of any of its funds; and*
 - c) *the Council; and*
 - d) *notify the termination day in a national newspaper, or in a newspaper circulating in each jurisdiction where the insurer has its registered office or carries on business.*

The termination day must not be earlier than 90 days after the insurer finishes giving notices under this subsection.

3. *The insurer must not, on or after the *termination day, renew any insurance policies that are *referable to any of those funds.*
4. *The insurer must accept any valid claim for benefits under an insurance policy that is or was *referable to any of those funds if the claim is made before the end of the period of 12 months following the expiry of the last policy that was referable to any of those funds.*

The requirements of the PHIA need to be incorporated in the determination of the Expense Amount.

Aggregated timeframe for termination

Section 149 of the PHIA states that the Council must approve an application to terminate a fund if it is satisfied the health benefits fund meets the Solvency Standard. To ensure approval is granted, a fund needs to be compliant with the Solvency Standard at the time the application is approved. The Solvency Standard and expense amount ensure that no creditors will remain outstanding and therefore the expense amount should include matters that occur after the termination is approved.

The general timeline for the legislative requirements in the termination period as follows:

| | Months | Total |
|--|------------|-------|
| The Council approves the termination of the fund | 0 | 0 |
| Notice provided to members of termination date | up to 2 | 2 |
| Termination date | at least 3 | 5 |
| Policies remaining force | up to 12 | 17 |
| Payment of outstanding claims | 12 | 29 |

The time period from the Council approving the application to terminate the fund until the expiration of legislative obligations is potentially 29 months, although the great majority of liabilities would be discharged well before then.

To provide assurance that creditors will not remain outstanding, the costs and potential effects associated with these individual components need to be accommodated. These are outlined below.

Effects of legislative requirements

Policies in force

The PHIA stipulates that an insurer must renew existing policies prior to the termination date. All policyholders must be notified within 60 days of the Council approving the termination and the termination date must be at least 90 days after all of the members have been notified.

The effect of this is that all policies currently in force are able to be renewed for up to 150 days after the Council has approved the termination. During this 150 day period the fund will incur on-going management expenses similar to those incurred prior to the application to terminate.

For the 150 days after the Council's approval the insurer will cease to renew policies and the fund will enter into run off. Policies renewed prior to the termination date will remain in force until their expiration.

Most funds offer annual policies, hence should an annual policy be renewed immediately before the termination date the fund will continue to have these policies in force for 12 months following the termination date, or up to 17 months following the Council's approval.

PHIAC recognises that following the termination date, the number of policies in force will quickly diminish, as the average unexpired duration of a private health insurance policy is approximately 44 days. While this means that the majority of policies are monthly and will be out of force within 30 days, the annual policies will continue to be in force well beyond the 44 days.

The PHIA states that an insurer must accept a valid claim if it is made within 12 months of the expiration of the last policy. The result of this is that a fund will need to be operational and pay claims for at least 12 months after the expiration of the last policy.

The combination of these factors is that the fund can be required to operate for up to 29 months after the Council has approved the termination. For most of that time however only a skeleton operation would remain.

Acceptance of new policyholders

It is only after the Council has approved the termination of a fund that the insurer must stop accepting new policyholders. Prior to the Council approving the application, the insurer will not be able to refuse applications by new policyholders. This has the potential to result in a disparity between the number of policyholders outlined in the application and the number of policyholders at the time the application is approved.

In the event that a fund is incurring losses at the time the application is made, additional members may result in increasing the actual amount of the losses, thereby the capital held by the fund will diminish at a more rapid rate.

PHIAC notes that a decision by a Board to terminate the fund will generally coincide with the cessation of all marketing efforts and result in minimal increases in membership. However this may not be true in all instances or necessarily effective.

Impacts on expenses

Management expenses for termination period

The timeframe ascribed by the PHIA can result in benefits being paid for up to 29 months following the Council granting approval for termination of a fund. During this time, costs will be incurred in operating the fund. These include costs associated with rent, salaries, overheads, IT systems, payroll, accounting and other expenses involved with the daily management of the fund.

It is recognised that a proportion of the management expenses are variable and will reduce as the number of policies diminish. However, a significant proportion of these costs will continue to be incurred as they are fixed and not directly proportional to the number of policyholders.

Management expenses sufficient to operate the fund for up to 29 months should be incorporated into the expense amount calculation.

Materialisation of redundancy payments

In a termination it is anticipated that employees of an insurer would be made redundant during the termination period. This would result in the materialisation of a liability to meet the redundancy payments. This amount would be dependent on the number of employees, their length of service and the employee's salary. In assessing future creditors, allowances should be made for redundancy payments.

Communicating with providers and policyholders

A terminating fund will need to contact the fund's stakeholders to advise that the fund is to be terminated. This will involve mail outs to all stakeholders, specifically to policyholders and providers, and may result in a large number of queries from policyholders requesting information and details on the effects on their policy. The fund's policyholders are also likely to transfer to another fund during the termination period. The costs associated with processing these matters and sending large mail outs would be outside normal business operations and hence will need to be funded in addition to business as usual activities.

Advertising costs

Section 149-20(b) the PHIA requires a terminating health benefits fund:

“notify the termination day in a national newspaper, or in a newspaper circulating in each jurisdiction where the insurer has its registered office or carries on business.”

Advertising nationally will impose costs in addition to standard operations and may require additional reserves.

Early termination of leases

A fund terminating its operations will terminate any leasing and contracting agreements. These contracts can be for a number of years and potentially have substantial penalties for early termination.

The amount of these penalties will be dependent on the number of leases held, the time remaining on them and the respective early termination clauses. For a fund that acquires a large proportion of their furnishings, infrastructure and premises via leasing arrangements, early termination penalties could be substantial.

These early termination costs and associated legal expenses should be considered in determining the expense amount.

External manager

A fund contemplating going into run-off because of a poor financial position may require the appointment of an external manager to effect the termination. The appointment of an external manager will require payment over a potentially 29 month period.

It is PHIAC's view that the expense amount should be sufficient to accommodate the costs of an external manager and this will be dependent on a fund's size and complexity. This should be a consideration in the determination of this amount.

External staff

An external manager may require contract staff to complete the termination process additional to or as a replacement for current fund personnel.

Retention of existing staff

A fund terminating will have limited opportunities for long term employment.

While the total staff required will be less than full operations, a number of tasks will continue to require significant technical and operational expertise such as IT, accounting, communicating with key stakeholders and other managerial matters.

Personnel in such positions may require retention payments to remain with the fund for the remainder of its operations. This may or may not offset the need for redundancy payments.

Inflation

Over 29 months, the expenses incurred are likely to increase at the rate of inflation at least. Provisions for this should be considered in determining an appropriate reserve.

Interest will generally be earned on the fund's reserves which may partially offset inflationary pressures. In this case investment income partially reserved for inflationary expectations must be incorporated into the calculation of a net present value.

Business continuity costs

Throughout the termination period various events can occur that may require the enactment of a business continuity or disaster recover plan, such as loss of head office, technical failures or regional disasters.

To return to operational capacity, the restoration of core functions may require capital.

Refunding policies

Following the publication of the fund being terminated, many policyholders may seek immediate transfer of their policies. This will require administrative expenses as the requests will need to be taken, processed and the refunds paid. These costs are in addition to normal business activities. The immediate liquidation of assets may incur additional costs and may result in a reduction in the total amount received. This matter is addressed as part of liquidity risk.

Impacts on contribution income

Maximum contribution income

Immediately after the Council has approved the application to terminate, the fund will not be able to accept new policyholders, nor is the fund able to allow its current membership to change products, notably to a more expensive product. Further it is doubtful whether premium adjustments during the termination period will be available.

In effect the maximum contribution income that a fund can receive during the termination is limited to current levels; contribution income above present receipts is not possible. However policyholders can immediately leave the fund severely reducing the contribution income over the course of the termination.

Minimum contribution income

While contribution income can not be more than recent experience, it can be substantially less. PHIAC publicly notifying that it has approved the termination of a fund may result in instant reductions to the number of policyholders. Contributors may not wish to remain with the fund until the expiration of their current policy and seek to immediately cancel their policy and withdraw from the fund.

A reduction in policyholders will significantly reduce contribution income over the termination period. As a result, historical and forecasts levels of contribution income may not be an appropriate estimate for income throughout the termination period (this is also discussed in the Impact on claims section below). This should be considered in determining appropriate reserves as levels of contribution income during a termination period are extremely uncertain.

Impacts on claims

Adverse selection

Once the announcement of the termination has been made, it is reasonable to assume that policyholders will start to leave the fund. Experience indicates that those likely to leave the fund initially will generally be policyholders who are not averse to changing funds, are not about to undergo a medical procedure and have easy access to information about other private health insurers. These policyholders are likely to have a lower risk profile, which can have substantial effects on the fund's loss ratios, financial performance and hence reserves for the termination period.

Higher utilisation

A fund informing its policyholders that only procedures completed by the expiration of their current policy will be paid may result in members increasing their utilisation of procedures that may otherwise have been postponed, or policyholders seeking to maximise their annual limits by utilising more benefits than historical data suggests.

The claiming experience of a fund is based on historical data and may not be representative of benefits in a termination period.

Health related business

Termination of health related business

Section 134-10 (1) of the PHIA states that the dominant purpose of the fund must relate to its health insurance business, however, this is not the only business that funds are able to operate. A number of funds operate health related business, such as hospitals and dental/optical centres and health related insurance business, such as overseas student health cover.

Should the dominant component of a business be terminated, the smaller, health related component of the business will generally also be terminated.

This is particularly the case if the health related business is dependent on the operations of the health insurance business. For example, all customers of a dental centre may use the facility as a result of having a health insurance policy with the parent. Should the health insurance policies be terminated, there is a risk is that the centre's customers may be severely reduced, to the possible detriment of the health related business.

In the event that health related business is terminated, costs would be incurred similar to the termination costs of the health insurance business.

Independent termination of health related business

Should the health related business be terminated but the health insurance business continue to operate, then costs will be incurred. To meet these costs a reserve would be needed to enable the fund to pay the expenses associated with the termination of the health related business without adversely affecting the fund.

It is noted that should a health related business be relatively independent from the health insurance business, there may still be contagion risks that arise from the termination of either the health insurance or related business. As a result, the magnitude of the contagion risk may require the size of non-claim reserving requirements to be reviewed.

The total amount that will be incurred to terminate a health related business will be dependent on the businesses characteristics, notably the:

- size and complexity
- reliance on the health insurance business's policyholders
- operational independence
- assets and liabilities
- number of employees
- current contracting arrangements
- current operating performance
- health related insurance business.

As the costs of terminating a health related business vary depending on the specifics of the fund, if practicable these differences should be incorporated into the expense amount.

Currently, the Standards apply the same methodology for reserving an expense amount for health related business as health insurance business, i.e. 40% of non-claims expenses. As a

result, a fund with a health related business is required to hold a substantial amount of reserves to meet the potential future costs of terminating this component of the business.

Assets of health related business

Should the net tangible assets of the health related business be considered as realisable assets in for solvency purposes, this assumes that these assets would be liquidated and the health related business terminated should the fund be terminated.

Transfer of the fund

The aim of the expense amount is to have no creditors outstanding if a fund is no longer able to independently operate.

Should the insurer be able to transfer the operations of a fund to another insurer, this will greatly reduce the costs incurred. The fund would be able to continue operating and a lot of the costs associated with termination would not eventuate. Some expenses would be required to affect a transfer; however they might comprise only a proportion of the expenses of a termination. Considering the current market, the costs involved with organic growth and previous mergers in the industry, a transfer of the fund is a more likely outcome.

In the event of a transfer, it is PHIAC's view the policyholders of the acquiring fund should not be disadvantaged by the transfer. The fund being acquired should have sufficient reserves to be able to affect the transfer without adversely affecting the prudential position of the acquiring fund.

In this scenario, some of the costs associated with a fund ceasing to operate would reduce. However a reserve would still be required to meet the costs associated with effecting the merger so that the acquiring funds policyholders are not disadvantaged.

PHIAC recognises that this scenario is dependent on an insurer being willing and able to acquire another fund. PHIAC cannot be certain this will occur and therefore this will not be considered in determining the expense amount.

Options considered

Health insurance business and health related business

Prescriptive approach

In consultation with the industry, PHIAC could investigate the amount required to ensure that a fund will be able to accommodate all of the expenses associated with termination of a fund. This would be heavily influenced by the specifics of each individual fund so two funds of the same size may not have identical expense amounts.

PHIAC could apply an approximation in a similar format to that currently applied, i.e. 40% of the last 12 months management expenses.

Principle approach

PHIAC could apply a principle based approach to the value of the expense amount. Under this approach a structure would be provided that outlines a number of specific risks which

require reserves. Funds would be able to interpret the risks and calculate reserves that are appropriate to a fund's characteristics.

This approach would require details to be provided to PHIAC on the all the risks that were considered and the rationale for calculating the final reserve. PHIAC would seek a sense of comfort that the expense amount is sufficient to achieve its objective.

Hybrid approach

PHIAC applies both approaches and gives each fund the option as to which they prefer.

A methodology would be supplied to allow for a simple approach that is easy to implement. As an alternative funds that prefer a more flexible, principles based approach could apply to PHIAC to use their own methodology in the calculation of this amount.

Unexpired risk reserve

As mentioned above, higher than anticipated claims may occur during the termination period.

A fund must continue to offer to renew all policies from PHIAC approving a termination, until the termination date. Should increases in claims occur, appropriate reserves will be required.

This reserve would reflect a constructive obligation to renew, for three to five months on current terms, incorporating a risk margin to allow for the uncertainty of future experience. This period reflects the time between the Council's approval to terminate and the termination day. This would extend the term of the unexpired premium liability currently applicable, although the risk margin applicable would be similar. For annual premium policies, the projected claims could occur up to 17 months into the future, including the unexpired premium liability.

PHIAC could apply an additional five month constructive obligation to renew, subject to a risk margin, as a mandatory component of either the expense or solvency liability.

This would be in addition to the unexpired premium component of contributions in advance.

Risk margin

For the unexpired risk reserve to achieve its objective, a methodology would need to be applied to accommodate the increased risk and uncertainty in benefits. An alternative is to continue a similar methodology for the current unearned premium reserve, i.e. utilise the forecast loss ratio and a risk margin.

This risk margin would incorporate the potential impact of higher utilisation rates, adverse selection and adverse experience. As a result of the increased risk, it is PHIAC's view that the current margin of 10% may not be sufficient to reflect the increased uncertainty of claims during a termination period.

D. Resilience Amount

Specific Issues

An insurer must recognise the risk associated with asset value volatility and hold an amount such that the obligation of each fund would still be able to be met following an adverse systemic market movement.

The resilience amount categories include shocks associated with equities, property (other than listed property trusts), listed property trusts, interest bearing assets, indexed bonds and international currency. These categories are not considered broad enough nor does there appear to be categories for all types of investments. Since the inception of these capital standards, industry stakeholders have sought clarification on where to classify certain investments.

PHIAC believes that the standards can be amended to simplify the classification of investments and their market shocks. This may have the benefit of providing clarity regarding the treatment of investment vehicles, such as derivatives and hedging instruments.

Market Risk

The resilience amount is established to provide an amount of capital in respect of market risk. Market risk includes exposure to unanticipated movements in financial variables or to movements in the actual or implied volatility of asset prices and options and comprises:

- interest rate risk (including variations in market credit spreads)
- equity, real estate and other asset risks - risk of losses resulting from movements of market values of equities and other assets
- currency risk - risk of losses resulting from movements in exchange rates
- related credit risk - in coordinating its exposure to market risk an insurer may increase its exposure to counterparty credit risk.

Market risk has direct implications for a health benefit fund's asset-liability matching capacity. The matching of assets and liabilities has two dimensions:

- 1) An insurer needs to ensure that it continues to have assets in excess of liabilities as market variables and credit risks fluctuate (solvency dimension covered by the resilience amount).
- 2) The ability of an insurer to have enough funds available to meet payments of policy benefits and other obligations as they fall due (liquidity dimension discussed later).

Impact on Pricing

Insurance products and investment vehicles are continually being introduced, redesigned, replaced, expanded or updated. Where relevant, an insurer's ALM process should ensure that the pricing, product development and investment departments work closely together. Features offered to policyholders must be well understood so that products are priced properly and the accompanying investment strategy is appropriate. In particular, well defined investment benchmarks and strategies should be established.

Methods used to monitor and assess market risk

There are several different methods available to monitor and assess market risk, such as cash flow monitoring, scenario testing or stress testing. It is recommended that these be considered by the insurer and the actuary, if not performed already. This may be more appropriate for larger health benefit funds.

Derivatives

In the last five to ten years, there has been a broadening in insurers use of different types of investments, including derivatives and hybrid investments. Australia has large and active markets in all derivatives markets. The Capital Standards could be improved to include the effect of derivatives to ensure consideration is given to the full range of market-related shocks. The Capital Standards could also be improved with consideration given to time horizons given different investments have different maturities and risks.

Where funds may be called upon to make a cash payment to support a margin call on a derivative position, this margin call risk may need to be assessed by the fund and included in the balance sheet. One approach is to include the value of both the “long” and “short” positions as assets and liabilities and to apply resilience “shocks” to both.

Thin markets

The market shocks associated with a thin market are usually characterised by extreme and frequent movements. PHIAC is concerned that in the resilience amount this situation has not been contemplated.

International/Domestic developments

The IAIS proposes that insurers should disclose how they tackle these two dimensions of asset-liability matching. An insurer should disclose qualitative information explaining the appropriateness of its investments in matching its liabilities. The explanation should take into account the ability to realise its investments quickly if necessary without substantial loss in value, and the sensitivities of these investments to fluctuations in key types of market variables (including interest rate, exchange rate, and equity price indices) and credit risks. Where company-wide risk management models are used, an insurer should disclose qualitative information about such models, types of the parameters used and how they are calibrated, the performance of the model over time, and model testing and validation methodologies.

The technical approach to monitor and report market risk for ADI’s includes both quantitative and qualitative requirements, with a regular independent review of the risk management system and overall risk management process. The general insurance industry requires a risk management framework covering balance sheet and market risk, whereas the life insurance industry requires a risk management framework covering asset and liability management risk

Options Considered

- Expand current components to include derivatives and other hybrid investments
- Alignment with best regulatory practices

E. Credit/Counterparty risk

A key consideration of the inadmissible assets amount is the exposure of insurers to credit risk, also described as counterparty risk. The extant standards include for consideration a number of broad counterparty categories that describe the extent to which the health benefits fund can be exposed to counterparty risk before needing to guard against that exposure by holding capital against it.

A conclusion reached by PHIAC after review of several years of returns submitted by insurers is that compliance with the capital standards in the assessment of counterparty assessment can be improved. Review of the returns has revealed that the mechanism for assessment of counterparty risk is poorly matched to the nature and range of asset investment decisions of insurers (which are not as simplistic as in years past), nor a good match to the risk based investment strategies employed by most insurers today.

Further confounding technical adherence to the standards are insurers' difficulties in identifying specific counterparty exposures in investments such as pooled fund investment vehicles, other investments which are based on indices or complex investment products that are difficult to 'look through'.

International/Domestic developments

The IAIS propounds a regime under which insurers need to disclose information about their exposure to currency risk, interest rate risk, credit risk, liquidity risk and concentration risk. In regard to the disclosure of credit risk, the IAIS proposes consideration of risk indicators that include:

- The nature of loans (residential mortgage, commercial, other private loans, or other commercial loans and degree of securitisation)
- Property characteristics (residential, commercial, industrial – geographical location - investment or own occupation)
- Receivables - age and obligor
- Debt securities – by issuer and credit rating
- Derivatives by type and market.

In addition, an insurer should disclose the aggregate credit risk arising from off-balance sheet exposures.

Options Considered

Options regarding credit and counterparty risk include:

- Introduce a credit risk regime that is based on investment ratings provided by third party ratings agencies. This could involve the application of a margin to investments and/or changes to concentration limits
- Broaden the existing classifications in the current Standards to improve compliance
- Broadening the role of the appointed actuary to require a certification that these risks have been addressed appropriately within the insurer.

F. Liquidity Risk

The nature of insurance activities means that the timing and the amount of cash outflows are uncertain. This uncertainty may affect the ability of an insurer to meet its obligations to policy holders or may require an insurer to incur additional costs, for example, through the forced sale of assets.

An important, though often overlooked, feature of the current Capital Standards is consideration of a fund's ability to match the cash flows generated from its assets to the liabilities of the fund as they fall due.

While this principle requires consideration of the convertibility of any asset of a health benefits fund, there are a number of specific circumstances in which the consideration is brought to the fore;

- When considering the recoverable values of assets in run-off circumstances
- Where assets are specialised, unique or would otherwise be traded in a market which is not active (thinly traded or low volume markets) or may not exist until a conversion of the asset is attempted
- Where assets are concentrated and convertibility can be compromised by the availability of other assets (eg. In some strata title complexes)
- Where conversion is restricted, such as when a lien over the asset exists.

Valuation methodology

Asset valuation methodologies are governed by accounting standards. While the values determined in accordance with accounting standards are the basis of the capital standards application, the assumed circumstances under which the assets are valued vary between the accounting and capital standards, particularly the solvency standard – where accounting standards are based on a going concern basis, the solvency standard views values from a run-off perspective, potentially requiring conversion of assets in a shorter timeframe and different circumstances than those considered by the accounting standards.

Run-off circumstances

In order to meet the financial obligations to policyholders in the circumstances of a run-off of a health benefits fund, most insurers would be required to convert large portions of its asset portfolio to cash in a relatively short period of time. The shortness of the period for conversion might lead to impairment of the asset value.

While this circumstance is currently contemplated in respect of certain assets in the extant solvency standard, PHIAC believes that consideration of the assets to which impairment might apply can and should be broadened and that the potential for value impairment at conversion should be recognised and require capital to be held against the impairment.

Thin Markets

A thin market is characterised by low activity, lacking in depth or volume which can indicate a lack of demand or supply for that asset. The effect of a thin market for any particular asset should be considered as part of the value assessment.

Where thin markets exist, PHIAC believes that recognition of the potential for value impairment at conversion should be recognised and require capital to be held against the impairment.

Concentrated assets

The extant standards allow for concentrated assets such as strata titled property assets to be considered as separate and uncorrelated for the purpose of value considerations. A concentration of similar assets might impair the value of those assets if conversion occurs simultaneously.

Restricted Conversion

The value of an asset and its capacity for conversion can be impaired by restrictions over its use such as liens and rights agreements. PHIAC believes that the existence of any restriction over an asset and any impairment in value stemming from those restrictions should be considered for the purposes of the capital standards.

International/Domestic developments

The IAIS espouses the development of formal ALM methodologies by insurers. Increasingly, regulators in Australia and abroad are introducing more formalised ALM methods into prudential standards.

Options Considered

Options to increase awareness and consideration of Asset-Liability Management (ALM) principles (including liquidity) include:

- Enhancing consideration of liquidity issues within the standards through expansion of the extant principles based approach
- Requiring a certain percentage or value (based on insurance liabilities) to be held in highly liquid assets
- Mandating a maximum duration for investments, to provide greater assurance that non-cash assets can be converted at value within an appropriate time frame
- Requiring insurers to develop a formal ALM strategy
- Requiring independent advice from the insurers' appointed actuary to be obtained in regard to the organisations practices and procedures in place to ensure cash flows are available to meet liabilities.

G. Use of capital/ business funding amount

Specific Issues

Below are some of the specific matters that can result in a decrease in the capital available to a fund and a discussion of some of the issues involved in incorporating such amounts.

Business operating plans

Business operating plans may involve a number of projects. These projects will generally require capital for the project to be undertaken and hence will reduce the reserves of the fund in the short run. Such projects include:

- Marketing campaigns
- Business projects
- Internal restructures
- IT upgrades.

Should the business plan include any of these, the capital required to fund these projects will not be available to meet the liabilities of the fund. Subsequently should this capital not be separately identified it will result in conflicting demands for capital and may result in the reserves not being sufficient.

Return to Providers of Equity

Business plans may include providing a return to the fund's shareholders. Generally this is in the form of a dividend, however it is noted that other forms of returns to capital providers can be made.

The capital that has been earmarked for future dividends may not be available to meet liabilities. Thereby, it could be separately identified and excluded from available assets.

It is noted that companies, and particularly listed companies, aim to provide a regular, consistent returns to their shareholder/s. As a result, providing future returns on equity is a key component of meeting future business plans and objectives. Should a fund not meet an expected return on equity, this can have repercussions for the organisation. Anticipated future dividends may be included as a component of the business funding amount.

Donations and other capital reductions

The capital of a fund can be reduced through means other than dividend payments, such as capital reductions and other payments such donations or research that are not directly related to generating the fund's income. While donations are voluntary, a fund may have made a commitment to regularly provide a payment. Should research and development or other endeavours be incorporated into a fund's business plan, such payments will be required and the corresponding capital will not be available for prudential purposes.

Time period

Costs associated with business plans will always be incurred as business plans develop and evolve. This raises the issue of an appropriate period of time in which to incorporate these reductions of capital.

The current Standards apply a timeframe of three years to this amount, with the objective of ensuring solvency over this period.

Ensuring solvency

The objective of this amount is also to ensure solvency into the future. This is based on a number of factors, particularly the ability to meet the solvency standard at the present time. To meet the solvency reserve, capital adequacy needs to be at least equal to solvency.

Legislative requirements

Section 137-10(5) of the PHIA states that:

Despite subsection (2), if a private health insurer is *registered as a for profit insurer, the *assets of a *health benefits fund conducted by the insurer may be applied for any purpose, except an application of the assets that is inconsistent with:

- (a) *the *solvency standard; or*
- (b) *the *capital adequacy standard; or*
- (c) *a *solvency direction or *capital adequacy direction given to the insurer.*

A for profit fund is legislatively obligated to not issue a dividend should it result in a breach of the above matters.

Options Considered

Business funding amount

The value of future business projects could be included as a net present value in a component of the business funding amount. This could incorporate additional provisioning for business plans and identify the capital needs of the fund.

Renewal option amount

Expenses associated with general business operations, such as major projects and marketing initiatives generally are classified as part of management expenses. Project expenses could be incorporated into forecast management expenses in the renewal option amount.

Alternatively a separate line could be incorporated into the renewal option amount to include project specific expenses.

Payment of Return on equity

Anticipated return on equity

A fund may incorporate future payments of returns on equity into its business plan. These payments would be identified throughout the period of the business funding amount and consequently reserved against.

Declared dividends

Returns on equity are only required to be paid following its public announcement. Prior to the announcement, the amount of the payment can be changed or eliminated. Should adverse experience eventuate, a decision can be made to suspend the payments.

Dividends that have been declared should be appropriately identified as a liability on a fund's balance sheet and thereby excluded from a fund's capital.

Donations and other capital reductions

Donations, research and development, and other expenses outside of management expenses would be consistent with achieving the fund's business plan. An alternative is to include the associated costs and capital needs into the business funding amount.

Ensuring solvency

An objective of the capital adequacy requirement is to ensure that the fund will remain solvent. To remain solvent the fund must have sufficient assets to comply with the solvency requirement. Hence the capital adequacy reserve should equate to being at least equal to solvency reserve. The Business Funding amount is a suitable reserve to hold this amount.

Time period

The time period relates to the length of time in advance to incorporate forecast reductions in capital.

Three years

An alternative for the business funding amount is to retain the current time period of three years. This time frame has not resulted in major issues and it is noted that comments from the industry did not express any concern or comments regarding the period for this amount.

Three years will be consistent with the proposed Capital Management Plan.

12 months

While a three year timeframe has not received any adverse comments, forecasting for such a period can be problematic. Assumptions will inevitably change over this period which may have significant implications on forecasts, future business plans and future returns on equity. A 12 month period is likely to have less variability.

A shorter period of consideration may be required.

Renewal option amount period

The time frame applied could be that of the renewal option amount. This would provide a consistent approach across the capital adequacy reserve and create a definitive period to which the entire capital adequacy reserve relates.

H. Treatment of Subordinated Debt

Specific issues

Legislation

The Act places specific restrictions on the uses of health benefit fund assets. Section 137-10 of the Act details these measures, which is included below.

137-10 Expenditure and application of health benefits funds

*(4) A private health insurer must not borrow money for the purposes of the business of a *health benefits fund except in accordance with the Private Health Insurance (Health Benefits Fund Administration) Rules.*

Current Capital Standards effectively allow for half of a fund's the prudential reserves to be backed by subordinated debt.

Amount to be categorised as capital

A major issue for subordinated debt is the amount that is considered to be capital for the purposes of the standards. If this amount is considered too low, it may not be worthwhile for funds to seek to subordinated debt as the costs involved may be too high to make the issue worthwhile. However, if the allowable amount is increased, funds may be encouraged to issue substantial amounts of subordinated debt without adequate regard to the future risks involved. Notably these risks include the volatility of interest payments and the repayment of principle.

Conditions on approved subordinated debt

A measure to reduce the amount of risk a fund is exposed to is to impose restrictions on the issue.

To gain approval of subordinated debt, specific terms and conditions must be met. These conditions will need to be detailed in the contract to ensure that the subordinated debt meets the designated criteria and reduces the risks to the policyholders.

The Standards currently place the following terms and conditions on subordinated debt.

- *it must have a minimum term of 10 years from the commencement of the loan; and*
- *there must be no circumstances where repayment may be accelerated or called at the lender's or any third party's option; and*
- *interest charged under the instrument or agreement may only be fixed or floating by reference to a benchmark interest rate. The basis for the calculation of interest must be set on a defined non-escalating basis for minimum periods of five years under the instrument or agreement; and*
- *interest bases may include default rate escalation, subject to a maximum of 2% escalation, or where interest is charged at a lower rate when it is paid within a*

defined period, the lower rate must not be more than 2% less than the highest interest rate payable under the instrument or agreement; and

- *interest payments are not to be payable where the payment of these would cause the fund to breach the solvency obligation; and*
- *interest payment obligations may be capitalized and interest may be charged on capitalized interest; and*
- *capital repayments are not to be made where the repayment of these would cause the fund to breach its solvency or capital adequacy obligations; and*
- *delayed capital repayments may be subject to continuing interest charges, on the interest charge and repayment conditions specified in this subclause.*

The review of the Standards can place additional conditions on subordinated debt, remove current restrictions, or continue the current terms.

Treatment of non-approved subordinated debt

While PHIAC would encourage all funds to issue only approved subordinated debt, funds may nevertheless issue debt that does not meet the criteria of ‘approved subordinated debt’. Due to the different terms and conditions on the subordinated debt, it is exposed to a different level of risk and consequently will require treatment under the Standards. Specifically this relates to whether a proportion of non-approved subordinated debt will be treated as capital or whether the entire amount should be treated as a liability under the Standards.

Treatment of diminishing term to maturity

While subordinated debt is subordinate to other creditors, unless the fund seeks to be terminated the debt will need to be repaid upon maturity.

To repay a large loan will require planning to ensure that sufficient capital is available to be able to honour these commitments. A fund may not be able to accommodate the instant realisation of a loan immediately prior to the maturity date, hence the diminishing time to maturity may need to be taken into account. This will also provide assurance that should the fund seek to continue operations, the debt will be able to be repaid.

Registration of new funds

Funds that enter the industry have limited alternatives through which capital can be gained to meet the minimum capital requirement. For a fund that is not able to gain shareholder equity, debt and receipts from members may be the only means available to raise finance. Under the current treatment of subordinated debt, a new fund would be required to meet half of capital requirements from shareholder equity or member contributions. This can result in difficulty for a new fund in raising the required level of capital, potentially limiting new entrants.

Solvency and capital adequacy

Solvency and capital adequacy are based on two different situations. Consequently the capital needs of a fund in each situation differ. The treatment of subordinated debt may not be able to reflect the differences of each standard.

Marketability

It is recognised that placing additional terms and conditions on the issue of subordinated debt can increase the risk to the purchaser. This increase in risk may result in the fund being required to pay a higher interest rate than would generally be applicable for this debt.

While stringent terms and conditions will reduce some of the risk to the fund, consideration should be given to the implications on the market and the fund from imposing such conditions.

Interest payments

Depending on the structure of the contract, the subordinated debt may require periodic interest payments. These interest payments will be an expense. These payments will need to be accounted for in the future cash flows or reserves of the fund. To reflect this cash flow, it could be incorporated into the Standards.

Risk of interest payments

In addition to the periodic payments of interest, the interest rate may not be fixed. As a result, the interest payments can increase to a level that is higher than forecasts and higher than the rate at which cash flows and reserves were calculated.

Transparency

It is PHIAC's aim to have the approval process and treatment of subordinated debt as transparent as possible. It is anticipated that the treatment and conditions placed on this debt will be documented as part of the Capital Standards and hence publicly available.

Options considered

Amount allowable

Retain current treatment

The current treatment could be retained, allowing approved subordinated debt to compromise half of the capital requirements.

APRA's Approach

APRA allows approved subordinated debt to comprise 50% of the capital adequacy requirement plus 100% of assets above the prudential requirements.

PHIAC could adopt a similar approach for determining the admissible amount of subordinated debt for the standards.

Principles based

Allow funds to issue a level of subordinated debt that is consistent with their business plan. This alternative would provide no formal restrictions on the amount of subordinated debt that can count as capital for the Standards.

Another variation

Should subordinated debt have a maximum limit placed on the level that can be treated as capital for the Standards, it could broadly have two components: a percentage of the capital requirement and a percentage of the fund's excess assets. Various combinations could apply for the percentage of the standards and the fund's excess assets.

Conditions on subordinated debt***Retain current terms and conditions***

To reduce the risks associated with subordinated debt, the terms and conditions that are currently applicable could continue to remain in force.

Additions to current terms and conditions

Additional terms and conditions could be placed on existing measures to further reduce the risks associated with subordinated debt. Additional terms and conditions being considered include explicitly stating that interest payments are not able to be made should the payment result in a breach of the Capital Adequacy Standard.

Removal of current terms and conditions

Terms and conditions could be removed. This would make it easier for funds to borrow subordinated debt and potentially negotiate a more favourable interest rate.

Treatment of non-approved subordinated debt***Treatment as a liability***

Subordinated debt that is not approved will be exposed to more risk than debt which can be approved. The terms and conditions on the debt will be assumed to be inconsistent with the approval criteria and generally, not be subject to the same control measures.

This risk particularly arises from situations wherein payments are required, but this would breach the fund's solvency in terms of the Capital Standards, and also from variation in interest rates.

Due to the uncertainty of the debt for the purposes of the Standards, an alternative is to not treat any non approved subordinated as capital.

Treatment as a portion of approved subordinated debt

While subordinated debt that is not approved will not be subject to the same conditions, there are broad criteria that will be followed and it will generally remain subordinate to other creditors.

An alternative is to incorporate a proportion of non approved subordinated debt as approved subordinated debt for the purposes of the Standards. An example of this could be including 50% of the 'non-approved' subordinated debt as capital.

Treatment of diminishing term to maturity

It is expected that the principal will be repaid upon maturity. To recognise this obligation, the amount considered to be capital for the standards could be partially based on the time to maturity. This would diminish the amount of capital supplied by subordinated debt to reflect that it will need to be repaid.

Type of increase

As the duration to maturity diminishes, the amount considered to be capital would decrease. The rate at which this decrease could be applied is through a number of means, including:

- Straight line/ linear
- Exponential
- Logarithmic

Each of these alternatives would have different effects on the capital of a fund.

Timeframe

Should the proportion considered to be capital be dependent on the term to maturity, amortisation of the debt will be required. Some of the alternatives include:

- 1 year
- 2 years
- 3 years
- 5 years
- 10 years

It is PHIAC's view that the period should allow sufficient time to enable the fund to accrue appropriate reserves to cater for the repayment of principle.

Principles based

An alternative is to provide principles that enable funds to determine the appropriate level of capital. This would provide flexibility that would result in consistency with the fund's business plan and the treatment of the debt under the Standards.

Solvency and capital adequacy time to maturity

The treatment of the time to maturity and a fund's ability to repay the principle is an issue for a fund. However a fund's capital needs vary according to whether the fund is seeking to continue operations.

To reflect the different capital needs of a solvency and capital adequacy situation, an alternative is to apply different treatments under Solvency and Capital Adequacy to the repayment of principle.

General Insurance Prudential Standard

It is noted that APRA's GPS 110 changes the amount of tier 2 capital based on the term to maturity in the following manner.

| Term to maturity | Admissible amount |
|-------------------------|--------------------------|
| 5 years | 100% |
| 4 years | 80% |
| 3 years | 60% |
| 2 years | 40% |
| 1 year | 20% |

Registration of new funds

Enable increased limit

The limit on approved subordinated debt could be increased to allow not-for-profit funds entering the market some flexibility in establishing the initial capital requirements. Allowing a fund to be initially funded largely or entirely by subordinated debt is an alternative to address this issue.

Enabling funds to be financed by subordinated debt would reduce the barriers to entry and thereby foster competition.

In this circumstance, it may be that additional terms and conditions are placed on subordinated debt for new funds. Alternatively, PHIAC could use discretion in changing the limit for subordinated debt in particular circumstances.

Interest payments

The interest payments on subordinated debt are an obligation of the fund so it may be appropriate to include these payments as a component of the Standards.

It is noted that should the interest payments be included as a component of the Standards, the condition pertaining to the whether repayments can be made may need amending.

Incorporation into renewal option amount

The interest payments could be incorporated into the renewal option amount, thereby having a provision for meeting future interest payments.

Retain current treatment

An alternative is to retain the status quo.

It is noted that there is an obligation for the fund to meet the interest payments; however it is subordinated to other creditors. To include the interest payments into the Standards reserve will increase the prudential reserves and expand the scope of the Standards to include the interests of debt holders.

I. Minimum capital adequacy requirements

Specific issues

The objective of this reserve is to provide assurance that a fund has adequate reserves should the fund:

- be commencing operations
- have a small membership so that the risks it has exposure to is not commensurate with the amount required in accordance with the Capital Standards.

Fund commencing operations

A business commencing operations is exposed to a large number of risks including risks due to the nature of insurance, particularly in a community rated environment and the uncertainty surrounding future benefit experience.

While an insurer is required to submit best estimate financial projections as part of the registration process, PHIAC needs to gain assurance that a fund can demonstrate that it has sufficient capital in its early stages of operation to be able to continue operating even under adverse circumstances.

Specifically, PHIAC is seeking to gain assurance that should some of these risks materialise, a fund that has commenced operations will be able to continue operating without the need for subordinated debt or a further equity injection.

Some of the risks which a fund commencing operations is exposed to are detailed below.

Higher risk profile

The largest risk that a new fund is exposed to is, arguably, that the demographic and risk profile of the fund is not known. While a fund may have a strategic plan to target a particular segment of the market, there is a substantial risk that a fund's profile may not be consistent with the risk profile used for benefit forecasts and therefore premiums. A fund commencing operations has a limited ability to gain assurance that the premiums being charged will be appropriate for the eventual membership.

In an industry where pricing is heavily regulated, should a new fund gain an older membership than anticipated, the membership will generally claim more. This would result in higher benefit payments than budgeted and consequently the fund premium structure may be inappropriate. The premiums will remain inappropriate until corrective action can be implemented.

Increased claiming pattern

While a fund may be able to achieve a demographic profile consistent with its strategic plan, there is a risk that the members may have a higher claiming pattern than the profile would generally suggest. Similar to a fund incurring a higher risk profile than anticipated, a fund that gains a membership with an increased claiming pattern will require corrective action. There may be a time delay in implementing corrective action which will require adequate reserving.

Further, a new fund's claiming pattern will not be known for a period of time, generally at least two or three years. As a result a new fund will continue to incur benefits that are uncertain for at least this period. Should the claiming pattern continually deteriorate, a fund may require reserves to absorb high claims.

This would continue until sufficient experience has been obtained so that future benefits can be estimated with confidence and, therefore, priced appropriately.

New members immediately claiming

A fund commencing operations will generally gain members that are both new to private health insurance or who have transferred from another fund. A primary difference between the two groups is that new members will serve waiting periods and possibly be subject to lifetime health cover loadings. The serving of waiting periods allows the fund to build reserves prior to paying claims.

Should the members that transfer to the fund from other insurers immediately undergo high cost procedures, such as hip replacements or coronary care, the premium reserves may not be sufficient to meet these costs and they will need to be met from the fund's initial capital.

Emergency procedures

New members are subject to waiting periods but not all procedures have waiting periods. Should a member not have a pre-existing ailment, these procedures generally will not have waiting periods associated with them. Consequently a fund can incur substantial costs associated with this treatment. Should a small fund receive a few of these large claims, it will require significant reserves to meet these costs.

While it is noted the impact of this may be reduced by the high costs claims pool, it remains a sizeable amount and this may affect the liquidity of the fund in the interim.

Lower than anticipated membership

The projections of a fund commencing operations will include assumptions regarding policyholders and growth. As a result there is a risk that the actual take up is not consistent with the estimates and it may be substantially lower. The fund may be subject to higher volatility stemming from a smaller membership base.

Should membership rates not increase at rates expected in the projections, the fund may incur higher management costs. This is particularly a risk for small private health insurers as a number of the costs are fixed.

If membership never reaches the expected levels, contingencies may be needed to accommodate a different membership structure than anticipated.

Increased marketing expenses

If there is lower than anticipated membership, the fund may seek to grow this membership to a level consistent with the business plan. This may involve the revision of the fund's business plan and the implementation of campaigns to entice new members, which will incur costs.

Business continuity events

A small new fund is susceptible to business continuity and disaster recovery events. However should such an event occur in a fund commencing operations, there will be limited scope for obtaining additional capital to meet the expenses associated with such an event.

It may be necessary to include an allowance into the minimum capital amount for such events.

Larger increase in membership

A larger than expected increase in membership will expose the fund to more risk than anticipated and budgeted. The risks associated with high membership growth are further detailed in the section on the renewal option amount; however the fund will at least be required to meet increased reserving requirements based on a higher membership. Depending on the period and extent of the increase there may be limited sources of capital available to finance the increase in reserving requirements after the commencement of operations.

Small funds continuing operations

A small fund is similarly exposed to a large number of risks. While these risks are not identical to a fund commencing operations, an objective of the Capital Standards is to gain assurance that should some of the risks to which a small fund is exposed materialise, the fund will be able to absorb these risks to continue operations.

Temporary volatility in claims

A fund with a small membership base will generally be more volatile and susceptible to a small number of large claims. Should a small fund receive a small number of high claims this may significantly increase the benefits paid for that period. To meet these higher than anticipated claims, the fund may be required to utilise the reserves.

It is noted that providing assurance against higher than forecast claims is an objective of the renewal option amount, however this amount focuses on a relatively small permanent increase in claims rather than a substantial temporary increase. The risks associated with temporary increases in claims are not necessarily addressed by the renewal option amount.

Large increase in members

Should a small fund increase its membership, there is a risk that while the increase may be small in actual numbers, it may comprise a significant proportion of a fund's total membership. The private health insurance industry has a number of funds in which an increase of a couple of hundred or couple of thousand policyholders can be a significant increase in the total coverage of a fund.

Significant growth in policyholders may result in a small fund profoundly changing its risk profile, exposing the fund to a substantial amount of risks.

This risk is particularly relevant given the website hosted by the Private Health Insurance Ombudsman comparing all funds in the industry, which may lead to some new funds gaining many new members in categories where they are particularly competitive – and possibly most keenly priced.

Amount of capital currently held by small not-for-profit funds

It is noted that small not-for-profit funds have limited means to increase their asset base and reserves. As a result any changes to the amount of capital required for the minimum capital amount may substantially impact small funds. Consideration will be given to the impact of such changes should this occur.

Liability or Asset risks?

Under the current Standards, a static minimum is applied to the entire capital adequacy reserve. As a result two small funds that have identical claiming and expense structures may be required to hold the same amount of capital, despite one fund being exposed to a higher level of asset risk. Amending the minimum capital requirement so that it relates only to the liability components would eliminate this anomaly.

Barrier to entry

PHIAC recognises that increasing a minimum capital amount can be viewed as a barrier to entry, thereby discouraging potential entrants and competition.

PHIAC is cognisant that there are a number of inherent risks in commencing a health benefits fund which require capital. It is not in the policyholders or industry's interests to allow a fund to commence operations should it not be able to provide assurance that it will be able to continue to meet the benefits of its policyholders.

Adjustments for inflation

The aim of this amount is to provide assurance against a number of financial risks. While applying a static amount provides a simplistic approach, the dollar amount of the risks will continually increase.

As a result of the increasing costs, consideration may need to be given to indexing the minimum capital amount.

Options considered

Minimum amount

It is recognised that the minimum capital requirement should be reflective of the risk to the fund and represent the inherent volatility in the industry. While private health insurance is unique in the specific risks faced by insurers, there are risks that are common to other industries. The approaches of the Australian General and Life Insurance are stated below.

Life Insurance

APRA applies a minimum capital amount of \$10 million, for the shareholder fund of a life insurance company to commence and continue operations.

General Insurance

The General Insurance Standards apply a minimum capital requirement of \$5 million.

It is also noted APRA's practice note on Capital Management for general insurers (GPG 110), outlines that for category D or E insurer with an MCR of less than \$4million, APRA envisages that the insurer would hold 1.5 times the MCR.

Retain current amount

The current minimum capital amount for the capital adequacy reserve is \$1.5 million and has been in effect since January 2001. The experience of the Standards has not shown this amount to be deficient and hence an alternative is to retain the current amount.

Indexation

The amount could be indexed to CPI or Health CPI. To promote simplicity, this could be increased intermittently, such as increasing the reserve by 10% every three years as opposed to 3% per year.

Alternatively the consumer price index (CPI) since the Standards came into effect in January 2001 has been approximately 22%² over the 7 years to December 2007. Hence the current amount could be adjusted to about \$1.85 million to allow for inflation.

Alternatively, the health CPI could be utilised as a measure of rising health costs.

Derivation of another amount

Another value could be calculated for the minimum capital amount. Alternatives include:

- a minimum amount for the renewal option amount base on a given increase in membership
- incorporating a large increase in management expenses into the renewal option amount
- three months of claims based on a given membership
- \$2 to \$5 million.

² Reserve Bank of Australia

J. Contagion Risk

Specific issues

Definitions

Contagion risk is a sub-set of inherent risk and has three elements:

- Internally – within the economic entity, where a health benefits fund is vulnerable to financial or reputation damage by virtue of its association with other members of the economic group that may suffer some form of risk event. For a private health insurer, this contagion risk may occur where the health benefits fund conducts health related businesses within the fund and/or where the insurer has a business outside the health benefits fund within the economic entity.
- Externally – outside the health benefits fund or economic entity often referred to as psychological contagion risk, where another entity has the same structure and/or reliance on products within the industry.
- Hybrid - across associated businesses and business interests, being a hybrid of the above.

Impact of Contagion Risks on Health Funds

PHIAC has considered contagion risks in view of the Capital Standards and have identified the following in relation to internal contagion risk:

- Although PHIAC may not be aware of the financial impact of internal contagion risk for a fund, there are a number of mechanisms available to PHIAC (including review of the PHIAC 2 return, review of the statutory accounts, insurer reviews and knowledge of the business structure) to allow PHIAC to determine the extent the fund and/or economic entity needs to assess or disclose contagion risk.
- PHIAC believes that it is the insurer and/or economic entity's responsibility to determine the degree of disclosure to PHIAC of the contagion risk, given the size, structure and complexity of the business. This might be done through a risk management process.
- Internal contagion risks are more likely to arise in relation to for-profit funds as these insurers often exhibit a wider range of diversified interests other than just health related businesses, and are more likely to exist within a broader economic entity.
- Loans to related entities are identified and are excluded in the Capital Standards via inclusion in the inadmissible assets reserve. Contagion risk reaches further than related loans. A related entity's inability to repay loans would not necessarily affect the fund's calculations for the Capital Standards immediately.

External contagion risks should not be ignored by health benefit funds regardless of whether the fund is for-profit or not-for-profit. If there are issues regarding the reputation of products/services within the industry then funds should consider this risk as part of the risk assessment process and have processes in place to deal with this risk event. This may be part of the risk management assessment or even in the business continuity plan.

Reputation risk may be by way of group contagion or the result of the insurer's own actions. In the latter case, the risk is more in the nature of reputation consequences of other risk events than a risk event in its own right. Either way, the potential impact needs to be taken into account in assessing overall capital adequacy. In quantifying the impact of a damaging operational failure, for example, the cost of the resulting damage to the insurer's franchise or other business may far exceed the direct cost of the operational risk event itself. The insurer will need to make a judgment as to whether the capital risk is adequate to cover the reputation consequences of credit, market and operational risk events.

Other factors for the insurers to consider in relation to contagion risk (whether internal or external):

- have the companies considered the impact of loans?
- the loss of key related business or even related assets?
- are there policies regarding loans between entities?
- have risk management plans been developed and strategies identified for these risks?
- have conflicts of interest been addressed regarding the sharing of key personnel and board members?

The above qualitative risk factors, such as corporate governance, senior management quality, risk management systems and control processes, and external factors such as business cycles and the macroeconomic environment should be considered regularly by the insurer.

Example one

A health benefits fund conducts a health related business, such as a private hospital. The private hospital's customers are predominantly members of the health insurer. There is an infection epidemic within the hospital and as a result, key personnel are more focused on the management and running of the private hospital. The health insurer cannot run on skeleton staff. Both the private hospital and the health insurer run into financial difficulty. The Board indicates that the decline was attributable to the infection epidemic, which eventually affected both businesses.

Example two

A health insurer operates a business, with a parent company and associates. The associates are not necessarily operating in the health sector, but share a common name, such as Reindeer. One of the associated entities runs into financial difficulty and the trade name is published in all the media. The publicity affects all revenue in the conglomerate including the health benefits fund. The health benefits fund may be affected through:

- the loss of reputation;
- potential loss of members, particularly healthy members;
- loss of management and board focus on the health benefits fund;
- transfer of health benefits staff to the troubled entity;
- the requirement for the health benefits fund to lend funds to assist the ailing associate resulting in the Capital Standards not being met.

Director Independence

Group structures can also give rise to conflicts of interest at Board and senior management levels. Demands between the private health insurer and other entities at a group level may not always be consistent and can compromise a director's ability to exercise independent judgement. This has the potential to undermine an insurer's ability to make decisions that are in the best interests of the fund it operates.

International/Domestic developments

While PHIAC regulates the private health insurance industry, APRA regulates a number of industries in the financial services sector. APRA issues various guidelines and requirements across each industry it regulates. Common requirements include the need to have a minimum amount of capital (ADIs, insurance companies and superannuation trustees) and for the industries to consider inherent risks, the effectiveness of management and controls in controlling and mitigating these risks and the extent of capital support to meet unexpected losses.

APRA suggests that ADIs undertake stress or scenario testing, including cyclical downturn to determine whether the capital held is adequate.

On the international front, the Financial Services Authority (FSA) in the UK considers internally contagion risk in so far as activities are carried on within the same firm, but not where there is a combination of activities within the same group³.

Options considered

Principles Based:

- Develop of a framework of prudential supervision for conglomerates that include a health benefits fund. This framework can be applied to ensure that a group and its regulated members have sufficient resources to absorb unexpected losses and continue to operate in a sound and viable manner. To minimise the prospect of a health benefits fund being held hostage to the misfortunes of the remainder of the group, the framework will require a conglomerate group to adopt a group-wide perspective to risk management and capital adequacy consistent with the BASEL II approaches:
 - Establishing a system of limits with respect to related entities to ensure that the fund and the conglomerate group are limited in the extent to which they are exposed to potential instability in related entities;
 - Take account of the costs involved in the practical implementation of any changes to related entity requirements;
 - Respond to the different exposures within groups by adopting a model that is not "one-size fits all"; and
 - Align requirements with similar industries and international best practice.

³ Financial Services Authority – Policy – Integrated Prudential Sourcebook for Insurers, December 2005

- Continue as is. The current prudential standards are designed to insulate funds and, if necessary, to allow them to be wound down in an orderly and timely way without loss to customers and counterparties.
- Where funds have business interests outside the fund these are generally disclosed in the statutory accounts but not in the financial condition report. Actuaries should assess contagion risk in the financial condition report where applicable and advise the fund and ultimately, PHIAC, whether there is a need for specific capital requirements in respect of this risk. Contagion risk could be considered as part of the insurance liability valuation and/or discretionary margin. PHIAC could provide guidance on what the Financial Condition Report should consider to the Australian Institute of Actuaries.
- Funds and economic entities need to identify, qualify and quantify (if possible) contagion risk as part of the risk management assessment process.

Rules Based:

- While it is important that the conglomerate group as a whole has enough capital, the location of that capital is also important. As PHIAC's responsibility is to protect the consumers of private health insurance policies, PHIAC must ensure that sufficient capital resides within the fund itself. Where equity has been invested in another entity within the group, that equity should not be regarded as available to support the activities of the fund, to avoid double counting. Accordingly, a rigorous approach to the measurement of capital of individual fund(s) within a group is essential. This may be done through strengthening the inadmissible assets.

Contagion risks may also be addressed as part of the larger overarching prudential requirement within the areas of capital management as a component within a capital management plan. This may have a principle or rules based methodology.

K. Capital Management Planning

Specific Issues

Standard/Rules

It is an obvious consequence of the extant standards that not all risk exposures of insurers are considered. The standards focus principally on those areas that relate principally to the assets and liabilities stemming from the insurance and health related business aspects of an insurers operations, but as noted earlier in this paper, not on broader risk areas such as operational, sovereign, liquidity, IT and financial off balance sheet risks.

PHIAC strongly believes that insurers should develop strategies and operational mechanisms to allow for non-specific risks in capital, and has encouraged, insurers to develop formally instituted capital management plans.

PHIAC's view is similar to that of other regulators, both within Australia and without, in that an insurers capital management plan should set out the insurer's strategy for setting, allocating and monitoring the capital needs of the health benefits fund (at least) conducted by it. The plan should also identify compliance and monitoring processes and detail communication protocols.

PHIAC is considering whether requirements for the development and implementation of capital management plans should be incorporated into the capital standards, or be deferred to form a separate set of standards requirements, pursued in a timeframe specific to needs.

Options Considered

PHIAC has considered a number of options in relation to capital management plans:

- Not impose a capital management requirement for insurers. This option is not favoured as it might allow a necessary discipline for insurers to be overlooked, with potential financial impacts for the insurer and policyholders.
- Impose a capital management requirement as part of the capital standards. This option is not preferred as the capital standards do not address all risks faced by an insurer, either overly complicating the capital standards or introducing a specific focus on certain risks that would undermine the broad perspective contemplated for capital management planning
- Develop and introduce capital management requirements as an overarching principle based standard.