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## Schedule 3 Capital Adequacy Standard

### Part 1 Introduction

#### 1. Purpose of capital adequacy standard

- (1) The purpose of the capital adequacy standard, established for the purposes of Division 143 of the Act is to ensure, as far as practicable, that there are sufficient assets in a fund conducted by an insurer to provide adequate capital for the conduct of the fund in accordance with this Act and in the interests of the policy holders of the fund.
- (2) The Capital Adequacy Reserve to be calculated under this standard for each fund conducted by an insurer is an assessment of the financial strength of the fund on the basis of an ongoing operation. The Capital Adequacy Reserve must be sufficient for the fund to be expected to remain solvent for at least the next three years after the valuation date, on the basis of assuming future experience during that period in accordance with the best estimate experience underlying the current business plans of the insurer.

#### 2. Application

This standard applies to each fund conducted by an insurer.

#### 3. Interpretation

- (1) In this standard:

**accounting standards** means standards made by the Australian Accounting Standards Board.

**actuary** means the insurer's appointed actuary.

**associate** in relation to an investor means an entity, including an unincorporated entity, over which the investor has significant influence and that is neither a subsidiary of the investor nor an interest in a joint venture.

**authorised deposit-taking institution** means a body corporate in relation to which an authority under subsection 9 (3) of the *Banking Act 1959* is in force.

**average deficit per single equivalent unit (SEU)** for each quarter means the amount determined by the Council for each risk equalisation jurisdiction as the gross deficit for the risk equalisation jurisdiction for that quarter divided by the average number of all SEUs for the risk equalisation jurisdiction for that quarter.

**best estimate** means a best estimate assumption, basis, projection or other best estimate of future experience which is:

- (a) made having regard to reasonably available statistics and other relevant information; and
- (b) not deliberately or carelessly overstated or understated.

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**business funding amount** means the amount calculated in accordance with Part 8 of this standard.

**calculated deficit** for a fund means the sum of the estimated amounts for each risk equalisation jurisdiction determined consistently with paragraph 11 (1) (e) of the *Private Health Insurance (Risk Equalisation Policy) Rules 2007* at the valuation date.

**capital** in relation to a fund means the assets of the fund less the reported liabilities of the fund.

**capital adequacy insurance liabilities amount** means the amount calculated in accordance with Part 6 of this standard.

**capital adequacy requirement** for a fund means the Capital Adequacy Reserve plus the reported liabilities.

**Capital Adequacy Reserve** means the amount determined in accordance with subclause 6 (2) of this standard.

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

**fund** means a health benefits fund.

**gross deficit** means the sum of the estimated amounts for each risk equalisation jurisdiction applicable to the insurer determined consistently with paragraph 11 (1) (b) of the *Private Health Insurance (Risk Equalisation Policy) Rules 2007* at the valuation date.

**health-related insurance business** means health-related business referred to in paragraph 131-15 (1) (b) of the Act where that business is included as business of the fund.

Note: Health-related business referred to in paragraph 131-15 (1) (b) of the Act is the business of undertaking liability, by way of insurance, to indemnify people who are ineligible for Medicare for costs associated with providing treatment, goods or services that are provided to those people in Australia and are provided to manage or prevent diseases, injuries or conditions;

**health-related other business** means health-related business referred to in subsection 131-15 (1) of the Act where that business does not involve insurance but is included as business of the fund.

**inadmissible assets amount** means the amount determined in accordance with Part 9 of this standard.

**investment entity** means an entity whose assets are solely investments, where the sole purpose of the entity is investment activities and where the investor investing in that entity has security directly linked to those assets.

**margin** means the capital adequacy margin determined in accordance with Part 5 of this standard.

**renewal option amount** means the amount calculated in accordance with Part 7 of this standard.

**reported liabilities** means the value of the liabilities of the fund determined at the valuation date in accordance with applicable accounting standards less the amount of subordinated debt that may be counted under clause 34 of this standard .

**repealed solvency or capital adequacy standards** means the solvency standard or capital adequacy standard, as the case may be, established under the *National Health Act 1953* and in force immediately before the commencement of these Rules.

**resilience amount** means the amount determined in accordance with Part 10 of this standard.

**risk equalisation** refers to the statutory pooling arrangements for the Risk Equalisation Trust Fund.

**solvency obligation** has the same meaning as in the solvency standard.

**subordinated debt** for a fund means the amount determined in accordance with Part 11 of this standard.

**subsidiary** means an entity, including an unincorporated entity, that is legally or practically controlled by another entity (known as the **parent**).

**this standard** means the capital adequacy standard established by these Rules.

**valuation date** is the day on which a calculation is carried out for the purposes of compliance with this standard.

- (2) For the purposes of making calculations required by this standard, the value of assets and liabilities of a fund or insurer are to be determined in accordance with relevant accounting standards.
- (3) In this standard, the number of SEUs in respect of a fund is to be calculated by reference to the number of SEUs applying to each category of policy as specified in the *Private Health Insurance (Risk Equalisation Policy) Rules 2007* made under the Act.

#### 4. Related parties

- (1) In this standard, a party is related to an entity if:
  - (a) directly, or indirectly through one or more intermediaries, the party:
    - (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries); or
    - (ii) has an interest in the entity that gives it significant influence over the entity; or
    - (iii) has joint control over the entity; or
  - (b) the party is an associate of the entity; or
  - (c) the party is a joint venture in which the entity is a venturer; or
  - (d) the party is a member of the key management personnel of the entity or its parent; or
  - (e) the party is a close member of the family of an individual referred to in (a) or (d); or
  - (f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

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- (g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.
  - (2) **Close member of the family of an individual** means a family member who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:
    - (a) the individual's domestic partner and children;
    - (b) children of the individual's domestic partner; and
    - (c) dependants of the individual or the individual's domestic partner.

## Part 2 Capital Adequacy Reserve

### 5. Capital adequacy obligation

- (1) An insurer must ensure that at all times the value of the capital of each fund conducted by the insurer equals or exceeds the Capital Adequacy Reserve determined for that fund at the valuation date.
- (2) The Capital Adequacy Reserve must be disclosed to the Council.

Note: The Council will use the Capital Adequacy Reserve as an indicator of the longer term financial position of the insurer.

### 6. Determination

- (1) The insurer must determine in accordance with this standard the Capital Adequacy Reserve for each fund conducted by the insurer.
- (2) The Capital Adequacy Reserve is determined as the greater of:
  - (a) the sum of the following amounts:
    - (i) capital adequacy insurance liabilities amount; plus
    - (ii) renewal option amount; plus
    - (iii) business funding amount; plus
    - (iv) inadmissible assets amount; plus
    - (v) resilience amount; and
  - (b) \$1.5 million.

### 7. Treatment of negative amounts in calculations

If the calculation of any of the amounts set out in subclause 6 (2), or the calculation of any of the components of those amounts under this standard, results in a value less than zero, the amount is to be taken to be zero for the purposes of this standard.

## Part 3 Principles

### 8. Asset exposure

- (1) In assessing asset risks under this standard, the insurer is to:

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- (a) take account of the effective exposure of the fund to various asset classes, regardless of the physical asset holdings of the fund; and
  - (b) consider exposure to counterparty risks, being the risk that another party to a transaction may default on the agreement, relating, but not limited to, futures and options contracts, swaps, hedges, warrants, forward rate and repurchase agreements.
- (2) In the case of investments with an investment entity, the insurer is to consider the exposure of the fund's investments to the underlying assets of the entity.

## **9. Integrity of asset risk calculations**

- (1) In applying this standard the insurer must determine whether the amounts calculated under this standard in respect of asset risks should be increased to provide additional assurance that the fund is able to meet its liabilities as and when they fall due.
- (2) In deciding whether to increase any amount calculated under this standard the insurer must consider the overall portfolio of assets of the fund, in particular the:
- (a) overall diversification of the portfolio, and
  - (b) liquidity of the portfolio, and
  - (c) overall exposure to credit risks, including the fund's exposure to any obligor of low credit standing.

## **10. Discounting of insurance liabilities**

- (1) The determination of insurance liabilities of the fund under this standard may include allowance for the discounting of future claim payments in accordance with the relevant accounting standards.
- (2) For the purposes of this standard, the determination of any discounted insurance liability must adopt a discount rate consistent with, and no greater than, the risk-free rate determined from the market yield available on Commonwealth Government Treasury Bonds for the relevant duration.

## **11. Adjustment for taxation**

- (1) Where an insurer is subject to taxation, allowance must be made for taxation in the determination of the capital adequacy insurance liabilities amount and the renewal option amount.
- (2) To the extent that any increase in the fund's liability provisions would generate a corresponding tax benefit, an insurer is to allow for the tax benefit in respect of the cost of the margins held via an adjustment to the relevant reserve.

## Part 4 Materiality

### 12. Materiality standards

- (1) In calculating the amounts that comprise the Capital Adequacy Reserve for a fund under subclause 6 (2), an insurer:
  - (a) must strictly comply with the valuation methods set out in this standard for any such amount that is material; and
  - (b) may adopt an alternative valuation method to calculate any such amount that is immaterial under this Part.
- (2) The materiality of an amount is determined by dividing a reasonable estimate of the amount by a reasonable estimate of the capital adequacy requirement, expressing the result as a percentage, and then applying to that result the thresholds set out in subclause (3).
- (3) For the purposes of these standards, where the result from subclause (2) in respect of an amount is:
  - (a) 10% or more—the amount is material; and
  - (b) 5% or less—the amount is immaterial.
- (4) Where an insurer adopts an alternative valuation method in accordance with this Part, the insurer must consider at each subsequent reporting date whether detailed valuations need to be performed to demonstrate the continued appropriateness of any alternative valuation methods.

## Part 5 Capital adequacy margin

### 13. Determination of capital adequacy margin

- (1) The insurer must determine in accordance with this clause the capital adequacy margin for the fund, being a margin for risk used in calculations under this standard.
- (2) The capital adequacy margin is determined as the sum of the following amounts:
  - (a) the minimum capital adequacy margin value, being 12.5%; plus
  - (b) the fund size value calculated in accordance with subclause (3); plus
  - (c) the additional qualitative margin as determined by the board or equivalent governing body of the insurer using the principles in subclause (5).

Note: While there is no maximum amount for the capital adequacy margin, a high value for the margin would be around 30%.

- (3) The fund size value is determined as follows:

Factor	Margin
Fund size, defined as the fund's total number of hospital SEUs	
➤ Greater than 199,999	+0%

➤ Less than 200,000 and greater than 19,999	$+ 0\% + 2.5\% \times \left( \frac{200,000 - SEU}{180,000} \right)$
➤ Less than 20,000 and greater than 3,999	$+ 2.5\% + 5.0\% \times \left( \frac{20,000 - SEU}{16,000} \right)$
➤ Less than 4,000	+7.5%

- (4) In the table in subclause (3), *hospital SEU* has the same meaning as in the *Private Health Insurance (Risk Equalisation Policy) Rules 2007*.
- (5) Principles to be applied in the determination of the additional qualitative margin are:
- a fund with a large membership base and history of stable membership, stable utilisation rates and stable unit costs may adopt a small additional margin; and
  - a fund with a small membership base and history of variable membership, variable utilisation rates and variable unit costs must adopt a larger additional margin; and
  - a fund offering products or benefits for which little credible experience is available in respect of utilisation rates and/or unit costs, and where the overall impact of the product or benefits on the fund has a high degree of uncertainty should increase its additional margin following the release of the products or benefits.

## Part 6 Capital adequacy insurance liabilities amount

### 14. Calculation of capital adequacy insurance liabilities amount

- (1) The *capital adequacy insurance liabilities amount* for a fund is the sum of the following components:
- capital adequacy health insurance liabilities component; and
  - capital adequacy health-related insurance liabilities component.

### 15. Calculation of capital adequacy health insurance liabilities component

- (1) The *capital adequacy health insurance liabilities component* for a fund is the sum of the following components calculated in accordance with this standard:
- health insurance outstanding claims component; and
  - risk equalisation outstanding claims component; and
  - risk equalisation accrued liability component.
- (2) The *health insurance outstanding claims component* for a fund is determined as:
- {1 + margin} times the *outstanding claims liability* in relation to the health insurance business of the fund calculated in accordance with clause 17 of this standard; less
  - the liability in respect of outstanding claims in relation to the health insurance business of the fund reflected in the reported liabilities of the fund.

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- (3) The *risk equalisation outstanding claims component* for a fund is the absolute value of the result of multiplying the margin by the risk equalisation outstanding claims liability calculated in accordance with clause 18 of this standard.
  - (4) The *risk equalisation accrued liability component* is the margin multiplied by the calculated deficit of the fund.

## 16. Calculation of capital adequacy health-related insurance liabilities component

- (1) The *capital adequacy health-related insurance liabilities component* for a fund is determined separately for each separate health-related insurance business as:
  - (a)  $\{1 + \text{margin}\}$  times the *outstanding claims liability* in relation to the health-related insurance business of the fund calculated in accordance with clause 17 of this standard; less
  - (b) the liability in respect of outstanding claims in relation to the health-related insurance business of the fund reflected in the reported liabilities of the fund.

## 17. Outstanding claims liability

- (1) The *outstanding claims liability* is the central estimate of the value of the outstanding claims as at the valuation date.
- (2) This component includes an allowance for claims-handling expenses.
- (3) *Outstanding claims* are claims that have been reported and have not yet been settled, claims that have been incurred but not yet reported (*IBNR*), claims that have been incurred but not yet fully settled (*IBNER*) and claims which have been administratively finalised but which may be reopened.
- (4) The outstanding claims liability is to be determined gross of recoveries from the Risk Equalisation Trust Fund.
- (5) The valuation method adopted to determine the outstanding claims liability must take appropriate account of:
  - (a) the historical pattern, over a minimum period of the 12 months immediately prior to the valuation date, of the rate of reporting of claims, the rate of settlement of claims, the development of benefit payments and the impact of refunds of benefit payments; and
  - (b) trends in utilisation rates and unit costs, especially regarding seasonality and other factors which may influence claims lodgement or processing trends; and
  - (c) any special features or changes to the ordinary experience, such as changes in benefit design, claims-handling procedures and the mix of products and insured persons.

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**18. Risk equalisation outstanding claims liability**

- (1) The *risk equalisation outstanding claims liability* for a fund is the amount in respect of the outstanding claims mentioned in clause 17 of this standard, determined as:
  - (a) calculated deficit; less
  - (b) gross deficit.
- (2) The amounts determined in subclause (1) must be determined from a best estimate of the business of the insurer's fund and a best estimate of the risk equalisation trust fund levies for the relevant period.
- (3) The amounts are to be determined taking into account the experience of previous quarters, historical seasonal trends, reasonable assumptions in respect of the claims experience of the industry at the risk equalisation jurisdiction level for the fund and reasonable assumptions in respect of the total insured population of the industry at the risk equalisation jurisdiction level.

**Part 7 Renewal option amount****19. Calculation of renewal option amount**

- (1) The renewal option amount must make provision for the risks and potential costs in providing the right of renewal to policy holders. The renewal option amount is determined based on a separate projection of each health insurance business, health-related insurance business and health-related other business over the 12-month period subsequent to the valuation date (the *projection period*).
- (2) The renewal option amount is determined by the net present value of:
  - (a) the adjusted projected cash outflow; less
  - (b) the value of the projected cash inflows.
- (3) The adjusted projected cash outflow is determined;
  - (a) for each health insurance business and health-related insurance business, by adding the projected monthly cash outflow to the sum of:
    - (i) the product of the projected monthly cash outflow associated with benefit claims and risk equalisation (if applicable) calculated in accordance with this Part and the margin; and
    - (ii) the product of the projected monthly cash outflow associated with state and territory ambulance levies (if applicable) and management expenses calculated in accordance with this Part and 50% of the margin; and
  - (b) for each health-related other business, the projected monthly cash outflow associated with the operation of the business of the fund calculated in accordance with this Part.

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- (4) The rate of interest used for the net present value calculation in subclause (2) is specified in clause 25 of this standard.

**20. Health insurance business and health-related insurance business projection**

- (1) Except for the circumstances described in subclause (3), the required business projection for the health insurance business and each health-related insurance business is the current business plan.
- (2) Where the current business plan has not been determined on a best estimate basis, the business projection adopted for the purposes of the renewal option amount must be a best estimate projection.
- (3) The business projection may be determined either:
- (a) as detailed in subclause (5); or
  - (b) by an actuary.
- (4) Where the renewal option amount is determined by an actuary, the actuary must take into account the requirements of this Part in respect of the individual components of the projection.
- (5) The business projection must allow for the following:
- (a) ***earned premium income*** allowing for:
    - (i) the premium rates reflected in the current business plan; and
    - (ii) the premiums projected to be paid during the projection period; and
    - (iii) in the case of health-related insurance business, the projected premiums ceded to reinsurers; and
    - (iv) the unearned premium liability held at the start of the projection period as income, and the corresponding liability at the end of the period as outgo; and
    - (v) the premium in arrears asset held at the start of the projection period as outgo, and the corresponding asset at the end of the period as income; and
  - (b) ***benefit claims*** allowing for:
    - (i) benefit claims outgo based on the claims assumption specified in clause 22; and
    - (ii) the benefits projected to be paid during the projection period; and
    - (iii) in the case of health-related insurance business, the projected reinsurance recoveries receivable from reinsurers; and
    - (iv) the outstanding claims liability held at the start of the projection period as outgo, and the corresponding liability at the end of the period as income; and
  - (c) administration and all other expense outgo on the expense assumptions specified in clause 24;

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- (d) for the health insurance business, risk equalisation levy and payments from the Risk Equalisation Trust Fund, as specified in clause 23; and
  - (e) investment income at the rate specified in clause 25. This is to be based on the unearned premium and outstanding claims liabilities at the start of the period and projected net cash flows during the period. Investment income on fund surplus at the start of the projection period is to be excluded.

## 21. Earned premium income

- (1) The insurer must make a projection of premium income based on premiums for policies as specified in the current business plan.
- (2) If the current business plan does not make an allowance for future premium increases, the existing premium rates must be used in the projection.
- (3) If current or future premium increases are not immediately applicable to all policy holders, the resulting premium income shortfall is to be allowed for in the projection.

## 22. Benefit claims

- (1) Benefit claims are to be based on the full premium rate irrespective of any actual premium shortfall as this is the basis on which the claims ratios adopted have been specified and determined.
- (2) The projected gross benefit claims are to be determined by applying a benefit ratio to the membership and the effective premium rate over the projection period.
- (3) The *benefit ratio* is the greater of:
  - (a) the equivalent claims ratio used for the purpose of the last premium increase application made in respect of the business; and
  - (b) the equivalent best estimate claims ratio underlying the current business plans of the insurer in respect of the relevant business; and
  - (c) the best estimate ratio of the expected claims and, where applicable, risk equalisation levy and payments from the Risk Equalisation Trust Fund to earned premiums underlying the effective premium rate of the business.
- (4) The cost of any additional options provided to members must also be allowed for, based on the estimated cost of the options.

## 23. Risk equalisation levy and payments

- (1) Risk equalisation levy and payments from the Risk Equalisation Trust Fund are to be determined separately for the renewal option amount.
- (2) In the case of the Risk Equalisation Trust Fund:

- (a) payments from the Risk Equalisation Trust Fund related to actual claims experience must be determined based on the relevant component of the benefit claims projected and the lesser of the best estimate ratio of claims recoveries to gross claims, and the actual ratio observed over the previous 12-month period; and
- (b) levy payments related to membership profiles, are to be based on the best estimate average deficit per SEU for each quarter of the 12-month period.

#### **24. Administration and other expenses**

- (1) Administration and other expenses must be based on the greater of:
  - (a) the best estimate non-claim expenses ratio of the business over the next 12 months; and
  - (b) the actual non-claims expense ratio (adjusted to the projected premium rate) over the previous 12 month period.
- (2) The *non-claims expense ratio* is the ratio of all expense outgoings of a business excluding benefit payments and risk equalisation amounts, to the gross premium income of the business.

#### **25. Investment earnings rate**

The rate of investment earnings to be adopted is to be taken as the market yield available on one year Commonwealth Government Treasury Bonds as at the start date of the projection, less one hundred basis points.

#### **26. Other business projection**

- (1) Except for those circumstances described in subclause (3), the required business projection for each health-related other business is the relevant current business plan.
- (2) Where the relevant current business plan has not been determined on a best estimate basis, the business projection adopted for the purposes of the renewal option amount should be a best estimate projection.
- (3) The business projection may be determined either:
  - (a) as detailed in subclause 20 (5), applying the requirements of this Part to the extent that they are applicable to the health-related other business of the insurer; or
  - (b) by an actuary.
- (4)

### **Part 8 Business funding amount**

#### **27. Determination of the business funding amount**

- (1) The Capital Adequacy Reserve must provide for a reserve in respect of any additional capital likely to be required to ensure that, if experience during

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the next three years is in accordance with the intended business plans of the insurer, the fund will be able to meet the solvency obligation calculated in accordance with the solvency standard, over those three years.

- (2) The ***business funding amount*** is determined as:
  - (a) the additional amount required to ensure that the solvency obligation will be able to be met over the next three years, allowing for any capital released over that period from the existing business of the fund; less
  - (b) new business capital.
- (3) New business capital is the aggregate of:
  - (a) existing, binding arrangements for the external raising of capital specific to the growth of business within the fund; and
  - (b) available capital (existing or emerging) in any other health benefits fund of the insurer which is in excess of the Capital Adequacy Reserve of that fund at that time and can be transferred to the fund; and
  - (c) available capital (existing or emerging) within the insurer but outside the health benefits funds which is in excess of any prudential capital requirement and can be transferred to the fund.

## **Part 9 Inadmissible assets amount**

### **28. Calculation of the inadmissible assets amount**

- (1) The ***inadmissible assets amount*** is the sum of the following components:
  - (a) an amount in respect of holdings in associate and subsidiary entities calculated in accordance with clause 29 of this standard; plus
  - (b) an amount in respect of asset concentration risks calculated in accordance with clause 30 of this standard.
- (2) Where the inadmissible assets amount is reduced by deferred tax provisions or other liabilities relevant to the inadmissible portion of the assets, the reduction must be only to the extent those provisions or liabilities are assessed as likely to be realised.

### **29. Holdings in associate and subsidiary entities component**

- (1) The insurer must determine the value of holdings in associate and subsidiary entities that are assets of the fund.
- (2) Where an associate or subsidiary is a financial institution subject to prudential regulation that requires the maintenance of minimum capital, the insurer must include in the amount to be calculated under this clause an additional amount that reflects the extent that the value on the investment in the entity in the financial statements includes the prudential capital requirement on the entity.

### 30. Asset concentration risks component

- (1) The *asset concentration risks component* for a fund is determined as the amount by which the value of any single asset or credit exposure (with a particular obligor or related party) of the fund exceeds the relevant amount specified in subclause (2) or, if subclause (2) is not applicable, the amount by which the value of the asset exceeds 10% of the value of the assets of the fund.
- (2) For the following assets the relevant amount is:
  - (a) 100% of the value of the assets of the fund, where the asset or credit exposure concerned is:
    - (i) guaranteed by a national government, being the national government of the country in whose currency the liabilities of the fund are denominated; or
    - (ii) guaranteed by an Australian State or Territory government; and
  - (b) the greater of 50% of the value of the assets of the fund and \$5 million, where the asset or credit exposure concerned is:
    - (i) guaranteed by an Australian local government or public sector entity; or
    - (ii) secured by bank bills or deposits with an authorised deposit-taking institution which has net assets of at least \$50 million; and
  - (c) the greater of 25% of the value of the assets of the fund and \$5 million, where the asset or credit exposure concerned is secured by deposits with an authorised deposit-taking institution which has net assets of less than \$50 million and which is not a related party.

## Part 10 Resilience amount

### 31. Determination of resilience amount

- (1) The *resilience amount* for a fund is to be determined in accordance with the following formula—

$$RA = \{ L' \times f \} - L$$

where:

- |    |   |   |
|----|---|---|
| RA | = | resilience amount.  |
| L  | = | The risk adjusted liabilities of the fund determined by application of this standard to reflect the liability risks prior to the prescribed economic changes. That is, L is equal to the reported liabilities of the fund plus the capital adequacy insurance liabilities amount, plus the renewal option amount, plus the business funding amount. |
| L' | = | The value of the liabilities after the prescribed economic changes.   |
| f  | = | A / A'.   |

- A = Value of the assets of the fund less any inadmissible assets amount determined in accordance with this standard, prior to the prescribed economic changes.
- A' = Value of those assets of the fund less any inadmissible assets amount determined in accordance with this standard, after the prescribed economic changes.

(2) The prescribed economic changes are:

	INVESTMENT SECTOR	PRESCRIBED ECONOMIC CHANGE FOR CAPITAL ADEQUACY
1.	Equities	Fall in capital value of (35% x DF)
2.	Property (other than listed property trusts)	Fall in capital value of (25% x DF)
3.	Listed property trusts	Fall in capital value of (25% x DF)
4.	Interest bearing	Rise in yield of (2.5% x DF)
5.	Indexed bonds	Rise in yield of (1.0% x DF)

	CURRENCY	PRESCRIBED EXCHANGE RATE MOVEMENT FOR CAPITAL ADEQUACY
6.	All	15% reduction in value of assets exposed to a denomination other than that of the liabilities.

where *yield* means:

- (a) for interest bearing securities other than irredeemable securities — redemption yield;
- (b) for irredeemable interest bearing securities — running yield; and
- (c) for indexed bonds — real yield.

(3) DF is determined in accordance with the following formula—

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

where:

- E = the proportionate holding of admissible assets in the equity sector times 30%.
- P = the proportionate holding of admissible assets in the property sector times 20%.
- F = the proportionate holding of admissible assets in the cash and fixed interest sector times 1.5% times the average term to maturity, measured in years, for the sector.

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## Part 11 Subordinated debt and alternative sources of capital

### 32. Overview

- (1) The purpose of this Part is to specify:
  - (a) the terms on which debt qualifies as subordinated debt within the meaning of this Part; and
  - (b) the amount of subordinated debt that may be counted for the purposes of this standard.
- (2) The capital adequacy obligation may be satisfied by either:
  - (a) shareholders' or members' funds represented by the disclosed capital of a fund, in terms of the retained earnings and capital held within the fund, that are subordinate to the other obligations of the fund; or
  - (b) the use of alternative sources of capital support for the business of a fund such as subordinated debt, where the obligations to the debt party under the instrument are subordinate to the other obligations of the fund.
- (3) Only subordinated debt within the meaning of this Part will qualify as an alternative source of capital for the purposes of this standard.
- (4) This Part sets out the terms that an instrument or agreement must contain and the requirements that it must satisfy in order to be subordinated debt within the meaning of this Part.

### 33. Subordinated debt

- (1) All proposals to issue or borrow subordinated debt, the purpose of which is, at the time of issue or borrowing, or may be in the future, to contribute to the capital requirements of a health benefits fund, must be submitted to the Council for individual approval if the debt is to be taken into account for the purposes of this standard.
- (2) An instrument or agreement of issue of subordinated debt will be assessed once only, prior to the time of issue. The quantum of the proposed issue and timing for draw down will be important items in that assessment. However, separate requirements limit that quantum, to the extent it is subordinated debt within the meaning of this Part, on a continuous basis into the future.
- (3) A subordinated debt must be created by a debt instrument or agreement which continuously meets the conditions and requirements set out in subclause (4).
- (4) The debt instrument or agreement must provide for the following terms and conditions:
  - (a) it must have a minimum term of 10 years from the commencement of the loan; and
  - (b) there must be no circumstances where repayment may be accelerated or called at the lender's or any third party's option; and

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- (c) 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
  - (d) 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
  - (e) interest payments are not to be payable where the payment of these would cause the fund to breach the capital adequacy obligation; and
  - (f) interest payment obligations may be capitalised and interest may be charged on capitalised interest; and
  - (g) capital repayments are not to be made where the repayment of these would cause the fund to breach the capital adequacy obligation; and
  - (h) delayed capital repayments may be subject to continuing interest charges, on the interest charge and repayment conditions specified in this subclause.

#### **34. Amount of subordinated debt to be counted**

- (1) The maximum amount of subordinated debt that may be counted for the purposes of this standard is the greater of:
  - (a) 50% of the Capital Adequacy Reserve; or
  - (b) if subclause (2) applies, the amount calculated under that clause.
- (2) If an insurer has an Approved Subordinate Debt, in the meaning of that term in the repealed solvency or capital adequacy standards, the maximum amount for that Approved Subordinate Debt that may counted for the purposes of this standard is the lesser of the approved amount and 50% of the sum of the capital adequacy requirement.
- (3) Subclause (2) applies only for an Approved Subordinate Debt that was in existence at the commencement of these Rules and only for so long as the debt complies with the requirements of subclause 33 (4).

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#### **Note**

- 1. All legislative instruments and compilations are registered on the Federal Register of Legislative Instruments kept under the *Legislative Instruments Act 2003*. See [www.frli.gov.au](http://www.frli.gov.au)