

SCHEDULE 3 CAPITAL ADEQUACY STANDARD

PART 1 INTRODUCTION

1. Purpose of capital adequacy standard

Clause 1 of the standard states the provisions of the Act to which the capital adequacy standard relates and the purpose of the standard.

Subclause 1 (2) provides that the capital adequacy reserve to be calculated under the capital adequacy standard is to be an assessment of the financial strength of the fund as an ongoing operation, in particular its ability to remain solvent for at least the next three years.

2. Application

Clause 2 provides that the capital adequacy standard applies to each fund conducted by an insurer.

3. Interpretation

Subclause 3 (1) defines terms used in the standard.

Subclause 3 (2) requires the application of relevant accounting standards in the valuation of assets and liabilities under the standard.

4. Related parties

Clause 4 defines a *related party*. This term is used in Part 9 of the Standard, which specifies the inadmissible assets amount of a fund.

PART 2 CAPITAL ADEQUACY RESERVE

5. Capital adequacy obligation

Clause 5 imposes on an insurer a capital adequacy obligation in relation to each of its health benefits funds.

Subclause 5 (1) provides that an insurer must at all times maintain adequate capital within its health benefits funds by ensuring that the value of the capital of each fund equals or exceeds the capital adequacy reserve for the fund calculated under this standard at the valuation date.

Subclause 5 (2) requires an insurer to disclose its capital adequacy reserve to the Council.

6. Determination

Clause 6 imposes on an insurer a requirement to determine the capital adequacy reserve for each fund.

Subclause 6 (1) requires an insurer to determine the capital adequacy reserve for each of its funds in accordance with the standard.

Subclause 6 (2) specifies the elements of the calculation of the capital adequacy reserve, which in light of the terms of paragraph (b), will be a minimum of \$1.5 million for each fund.

7. Treatment of negative amounts in calculations

Clause 7 provides that an amount or a component of an amount calculated under this standard which results in a negative value will be taken to be zero.

PART 3 PRINCIPLES

8. Asset exposure

Clause 8 requires an insurer to take account of certain asset and investment risks related to the insurer in applying the standard.

9. Integrity of asset risk calculations

Clause 9 requires an insurer to determine whether to increase amounts calculated under this standard to ensure solvency in light of risks associated with diversification, liquidity and credit risks.

10. Discounting of insurance liabilities

Clause 10 provides the basis on which discounting of future claims liabilities is permitted under the standard.

11. Adjustment for taxation

Subclause 11 (1) provides for adjustment of the solvency insurance liabilities amount to account for the impact of taxation.

Subclause 11 (2) provides for adjustment relating to tax benefits arising from increases in liabilities.

PART 4 MATERIALITY

12. Materiality standards

Clause 12 provides a materiality test to enable simplification of valuations that are to be undertaken in the determination of the amounts that comprise the capital adequacy reserve under the standard.

Subclause 12 (1) provides that if an amount is material in accordance with the clause, strict compliance with the standard is required in its calculation for the purposes of determining the capital adequacy reserve of the fund. Where an estimated amount is immaterial under this clause, a reasonable alternative valuation method can be adopted.

Subclauses 12 (2) and 12 (3) specify the method for determining whether amounts are material or immaterial for the purposes of the standard.

Subclause 12 (4) requires an insurer to consider at each reporting date whether detailed valuations are required to demonstrate the continued appropriateness of any alternative valuation methods that have been adopted.

PART 5 CAPITAL ADEQUACY MARGIN

13. Determination of capital adequacy margin

Clause 13 provides the methodology for calculating the capital adequacy margin which is used in the calculation of the capital adequacy insurance liabilities amount and renewal option amount. The margin must be 12.5% or more. While there is no upper limit for the margin, a high value would be around 30%.

Subclause 13 (1) requires an insurer to determine the margin for risk to be used in certain calculations under this standard.

Subclause 13 (2) specifies the method for determining the margin. The margin is calculated by a progressive sum of the minimum capital adequacy margin value (12.5%), the fund size value calculated under subclause (3) and an additional qualitative margin determined in accordance with subclause (5)..

Subclause 13 (3) sets out the method for determining the fund size value, based on the number of hospital SEUs of the fund. A hospital SEU has the same meaning in this standard as in the *Private Health Insurance (Risk Equalisation Policy) Rules 2007*.

Subclause 13 (5) provides broad principles to be applied by the board or equivalent governing body of the insurer to determine the additional qualitative margin for the fund.

PART 6 CAPITAL ADEQUACY INSURANCE LIABILITIES AMOUNT

This Part provides for the calculation of an amount, which forms part of the capital adequacy reserve, to provide for the risks arising from assumptions in valuing the accrued liabilities of the fund.

14. Calculation of capital adequacy insurance liabilities amount

Clause 14 provides for the calculation of the capital adequacy insurance liabilities amount, being the sum of those components set out in clauses 15 and 16.

15. Calculation of capital adequacy health insurance liabilities component

Clause 15 details the three components that when added together, form the capital adequacy health insurance liabilities amount.

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

Clause 16 details the calculation of the capital adequacy health-related insurance liabilities amount.

17. Outstanding claims liability

Clause 17 provides for the calculation of liabilities of a fund in respect of outstanding claims, which is part of the health insurance liabilities component and the health-related insurance liabilities component.

The outstanding claims liability is a central estimate of all outstanding claims liabilities at the valuation date. Historical data must be considered in calculating the outstanding claims liability.

There will be two different outstanding claims liability components calculated for each fund: one for health insurance business of the fund, and one for any health-related insurance business of the fund.

18. Risk equalisation outstanding claims liability

Clause 18 provides for the calculation of the risk equalisation outstanding claims liability, which is part of the risk equalisation outstanding claims component of the capital adequacy health insurance liabilities component.

PART 7 RENEWAL OPTION AMOUNT

19. Calculation of renewal option amount

Clause 19 provides for the calculation of an amount, which forms part of the capital adequacy reserve, to provide for the risks and potential costs associated with policy renewal and the consequences for available capital of the intended business plans of the insurer.

Subclause 19 (1) provides that the amount is to be calculated separately for the health insurance business and health-related business of the fund over a 12-month projection period from the valuation date.

Subclauses 19 (2) to (4) specify the method for calculating the renewal option amount.

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

Subclause 20 (1) provides for the calculation of the projection for health insurance business and health-related insurance business based on the insurer's current business plan.

Subclause 20 (2) specifies the projection method to be applied in cases where the amounts in the business plan has not been determined on a best estimate basis.

Subclauses 20 (3) to 20 (5) set out the method for carrying out the business projection. Subclause (5) specifies various amounts that are to be included in the business projection and the clauses in which the calculation of the amounts is detailed.

21. Earned premium income

Clause 21 sets out the method for the calculation of the projected premium income of a fund to be included in the insurance business projection. Premium income must be based either on the current business plan, or existing premium rates.

22. Benefit claims

Clause 22 sets out the method for the calculation of the projected benefits claims of a fund to be included in the insurance business projection. Projected gross benefits claims are determined by calculating the benefit ratio applicable to the membership of the fund over the effective premium rate for the projection period, with an allowance for options provided to members.

23. Risk equalisation levy and payments

Clause 23 sets out the method for the calculation of risk equalisation levy and payments to be included in the insurance business projection.

24. Administration and other expenses

Clause 24 sets out the method for the calculation of administration and other expenses to be included in the insurance business projection. Administration and other expenses must be calculated in accordance with subclause 24 (1), and then, pursuant to clause 19 multiplied by an amount 50% of the margin.

25. Investment earnings rate

Clause 25 provides the rate of investment earnings to be adopted in the calculation of the insurance business projection.

26. Other business projection

Clause 26 sets out the method for the calculation of a projection for health-related other business conducted by the insurer. The method of calculation is to be based on the same principles that apply to the calculation of the health insurance business and health-related insurance business projection.

PART 8 BUSINESS FUNDING AMOUNT

27. Determination of the business funding amount

Clause 27 provides for the calculation of an amount, which forms part of the capital adequacy reserve, to provide for planned business growth or other relevant business development strategies that are likely to absorb capital and impact on the ability of the fund to meet its solvency obligation over the next three years.

Subclause 27 (2) sets out the method for the calculation of the business funding amount, which includes an amount for new business capital calculated in accordance with subclause (3).

PART 9 INADMISSIBLE ASSETS AMOUNT

28. Calculation of the inadmissible assets amount

Clause 28 provides for the calculation of an amount that forms part of the capital adequacy reserve, to reflect certain asset risks to the fund.

Subclause 28 (1) provides that the inadmissible assets amount is the sum of components that reflect risks associated with:

- holdings in an associated and subsidiary entities; and
- asset concentration.

29. Holdings in associate and subsidiary entities

Clause 29 provides for the calculation of a component that represents the value to a fund of its holdings in associate and subsidiary entities.

Subclause 29 (1) requires an insurer to determine the value of a fund's holdings in associate and subsidiary entities.

Subclause 29 (2) specifies the treatment of minimum capital requirements that regulators may impose upon associate and subsidiary entities.

30. Asset concentration risks component

Clause 30 provides for the calculation of a component that represents the risks to the fund arising from asset or credit concentration risks.

Subclause 30 (1) specifies that the component is the sum of the amounts by which any asset of the fund of a kind listed in subclause (2) exceeds the amount specified in that subclause for that kind of asset. For any other kind of asset, the component is calculated as the amount by which any such asset exceeds 10 per cent of the value of the assets of the fund.

Subclause 30 (2) specifies, for the purposes of the calculation in subclause (1), the relevant amounts for various kinds of assets.

PART 10 RESILIENCE AMOUNT

31. Determination of resilience amount

Clause 31 provides for the calculation of an amount that forms part of the capital adequacy reserve that represents the risk to the assets of a fund associated with the occurrence of shocks to the economic environment.

Subclause 31 (1) specifies the formula for the determination of the resilience amount for a fund.

Subclause 31 (2) prescribes the formulae to be applied to asset values to reflect the economic changes applicable to the assets of the fund that fall within the classes listed in the table.

Subclause 31 (3) defines the diversification factor (DF) which appears in the formulae in the table in subclause (2).

PART 11 SUBORDINATED DEBT AND ALTERNATIVE SOURCES OF CAPITAL

32. Overview

Subclause 32 (1) states the purpose of the Part, which is to specify the terms on which subordinated debt qualifies as subordinated debt within the meaning of the Part and to specify the amount of subordinated debt that may be counted for the purposes of the standard.

Subclause 32 (2) provides that the capital adequacy obligation may be satisfied from either shareholder or member capital or the use of alternative sources of capital support where the obligations to the debtor are subordinate to the other obligations of the fund.

Subclause 32 specifies that it is only subordinated debt within the meaning of the Part that will qualify as an alternative source of capital for the purposes of the standard.

33. Subordinated debt

Clause 33 specifies requirements for debt to be subordinated debt within the meaning of the Part.

Subclause 33 (1) requires proposals to issue or borrow subordinated debt to be approved by the Council before the debt can be taken into account under the standard.

Subclauses 33 (2) to (4) specify further requirements for the approval of subordinated debts and for their continued application under the standard.

34. Amount of subordinated debt to be counted

Clause 34 details the maximum amount of subordinated debt that may be counted for the purposes of the standard.

Subclause 34 (1) provides the maximum amount of subordinated debt that may be counted for the purposes of the standard.

Subclauses 34 (2) and (3) provide a transitional treatment for funds to count for the purposes of this standard subordinated debts that were approved under the previously applicable standards made under the National Health Act.