



Health Insurance (prudential standard) determination No. 9 of 2023

Prudential Standard HPS 340 Insurance Liability Valuation

Private Health Insurance (Prudential Supervision) Act 2015

I, Helen Rowell, a delegate of APRA, under subsection 92(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* determine *Prudential Standard HPS 340 Insurance Liability Valuation*, in the form set out in the Schedule, which applies to all private health insurers.

This instrument commences on 1 July 2023.

Dated: 24 May 2023

[Signed]

Helen Rowell
Deputy Chair

Interpretation

In this instrument:

APRA means the Australian Prudential Regulation Authority.

private health insurer has the meaning given in section 4 of the Act.

Schedule

Prudential Standard HPS 340 Insurance Liability Valuation, comprises the document commencing on the following page.



Prudential Standard HPS 340

Insurance Liability Valuation

Objectives and key requirements of this Prudential Standard

This Prudential Standard sets out requirements for the valuation of insurance liabilities of a private health insurer.

The ultimate responsibility for the valuation of insurance liabilities rests with the Board of the private health insurer.

A private health insurer must value its insurance liabilities in accordance with the principles and methodology set out in this Prudential Standard.

For the purposes of the capital standards and reporting requirements under the *Financial Sector (Collection of Data) Act 2001* (FSCODA), a private health insurer's insurance liabilities must be valued in accordance with this Prudential Standard.

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Authority

1. This Prudential Standard is made under subsection 92(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* (the Act).

Application and commencement

2. This Prudential Standard applies to all **private health insurers** except where expressly noted otherwise.
3. A private health insurer must apply this Prudential Standard separately to each of its **health benefits funds** and its **general fund**, in addition to the private health insurer as a whole, unless otherwise noted. The term ‘private health insurer’ refers to the private health insurer as a whole. The term ‘fund’ refers to each health benefits fund and the general fund, unless otherwise noted.
4. This Prudential Standard applies to private health insurers from 1 July 2023.

Interpretation

5. Terms that are defined in *Prudential Standard HPS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.

Valuation of insurance liabilities

6. A private health insurer must value its insurance liabilities in accordance with this Prudential Standard. The valuation must then be used for the purpose of:
 - (a) calculating the private health insurer’s **prescribed capital amount** in accordance with the capital standards; and
 - (b) completing the private health insurer’s **yearly statutory accounts** in accordance with reporting standards made under the FSCODA.
7. A private health insurer must determine a value for its outstanding claims liabilities, its premiums liabilities, risk equalisation transfers, other insurance liabilities, and its deferred claims liability for the purpose of this Prudential Standard.
8. Outstanding claims liabilities relate to all claims incurred prior to the reporting date, whether or not they have been reported to the private health insurer. A private health insurer must determine the outstanding claims liabilities on a prospective basis for health insurance business and health-related insurance business. Outstanding claims liabilities are calculated as the sum of:
 - (a) **claims component**;
 - (b) **claims handling expenses**;
 - (c) **risk equalisation** component; and

- (d) the component relating to claims which have been settled but not yet paid at the reporting date

Less the sum of:

- (e) **reinsurance recoverables¹**; and

- (f) **non-reinsurance recoveries.**

9. Premiums liabilities relate to all future claim payments arising from future events post the valuation date that will be insured under the private health insurer's existing policies that have not yet expired including **unclosed business**. Premiums liabilities should exclude risks from policy renewals after the valuation date and allow for expected premium refunds. In respect of premiums liabilities for which **reinsurance** has not yet been purchased, allowance must be made for this reinsurance in the premiums liabilities valuation (refer to Attachment A of this Prudential Standard for further details on the assumptions relating to this reinsurance). Premiums liabilities are to be determined on a prospective basis for health insurance business and health-related insurance business. Premiums liabilities are calculated as the sum of:

- (a) claims component;
- (b) claims handling expenses;
- (c) **policy administration expenses**; and
- (d) risk equalisation component

Less the sum of:

- (e) **expected reinsurance recoveries²**; and
- (f) non-reinsurance recoveries.

10. Risk equalisation transfers are payments to be made or receivables expected from the Risk Equalisation Special Account as at the reporting date. These are amounts that have been accrued but not yet paid/received as at the reporting date arising from risk equalisation on paid claims. Risk Equalisation Special Account has the same meaning as in the Act.
11. Other insurance liabilities are insurance liabilities which are uncertain in value, but not included within outstanding claims liabilities, premiums liabilities, risk equalisation transfers or deferred claims liability as defined by this Prudential Standard. This includes (but is not limited to) loyalty bonuses.

¹ Refer to Attachment A of this Prudential Standard for further details on the assumptions relating to reinsurance recoverables and expected reinsurance recoveries.

² Refer to Attachment A of this Prudential Standard for further details on the assumptions relating to reinsurance recoverables and expected reinsurance recoveries.

12. The deferred claims liability is an insurance liability related to the suspension of non-urgent or non-essential elective surgery or the voluntary decisions by insureds, practitioners or hospitals to defer procedures. The deferred claims liability estimates the costs of these procedures. This liability is specific for COVID-19, however it may be appropriate in other circumstances as defined by APRA.
13. In determining the value for outstanding claims liabilities, premiums liabilities, risk equalisation transfers, other insurance liabilities and the deferred claims liability, an insurer must determine a value for the central estimate and risk margin for health insurance business and health-related insurance business. The insurer must therefore calculate and report separately to APRA, central estimates and risk margins for outstanding claims liabilities, premiums liabilities and risk equalisation transfers.³ An insurer is only required to report the value for other insurance liabilities and the deferred claims liability including the risk margin. However, this should not prevent analysis being undertaken on a basis which is more suitable, taking into account the nature of the data and the particular circumstances of the insurer.
14. Reinsurance recoverables and expected reinsurance recoveries should not be reduced for the risk of non-performance of the reinsurer as the risk of non-performance is considered in *Prudential Standard HPS 114 Capital Adequacy: Asset Risk Charge* (HPS 114).
15. The valuation of each insurance liability reflects the individual circumstances of the private health insurer. In any event, the minimum value of each insurance liability must be the greater of a value that is:
 - (a) determined on a basis that is intended to value the insurance liabilities at a 75 per cent level of sufficiency; and
 - (b) the central estimate plus one half of a standard deviation above the mean for the insurance liabilities.

The central estimate

16. The central estimate is intended to reflect the mean value in the range of possible values for the outcome (that is, the mean of the distribution of probabilistic outcomes). The determination of the central estimate must be based on assumptions as to future experience which are:
 - (a) made using judgement and experience including having regard to the advice of the Appointed Actuary;
 - (b) made having regard to reasonably available statistics and other information; and
 - (c) neither deliberately overstated nor understated.

³ Such reporting is required in statutory reporting (refer to reporting standards made under FSCODA).

17. Where experience is highly volatile, model parameters estimated from the experience can also be volatile. The central estimate must therefore reflect as closely as possible the likely future experience of the insurer. Judgement may be required to limit the volatility of the assumed parameters to that which is justified in terms of the credibility of the experience data.
18. The central estimate will be measured as the sum of the future expected payments. This estimate may be determined on a discounted basis in line with the requirements set out in paragraph 26 and 27 of this standard. This measurement process will involve prospective calculations and modelling techniques, and will require assumptions in respect of the expected future experience, taking into account all factors which are considered to be material to the calculation, including:
 - (a) claims handling expense and policy administration expenses; and
 - (b) claims costs and associated risk equalisation impact.

The risk margin

19. The risk margin is the component of the insurance liabilities that relates to the inherent uncertainty that outcomes are likely to differ from the central estimate. It is aimed at ensuring that the value of the insurance liabilities is established at an appropriate and sufficient level. The risk margin does not relate to the risk associated with the underlying assets, such as asset-liability mismatch risk which is addressed in the Asset Risk Charge (HPS 114).
20. Risk margins must be valued so that each insurance liability of each fund of the private health insurer is not less than the greater of a value that is:
 - (a) determined on a basis that is intended to value the insurance liabilities at a 75 per cent level of sufficiency; and
 - (b) the central estimate plus one half of a standard deviation above the mean for the insurance liabilities.
21. The risk margin must consider the differences in risk profiles between claims settled but not yet paid at the reporting date relative to other expected payments within the outstanding claims. When selecting the methodology and assumptions to be used in determining the risk margin for health insurance business and health-related insurance business, consideration should be given to a range of factors, including:
 - (a) the robustness of the valuation models;
 - (b) the reliability and volume of the available data and other information;
 - (c) past experience of the private health insurer and the private health insurance industry;
 - (d) the particular characteristics of each for each health insurance business and health-related insurance business; and

- (e) the risks of the current environment and the extent to which they are captured in valuation models and data.
- 22. Estimation of a standard deviation above the mean may present technical difficulties when components of the uncertainty in the central estimate do not permit statistical analysis to be undertaken. Estimation of a standard deviation above the mean will generally require both the exercise of judgement and technical analysis.
- 23. The risk margin must not be used as a tool for smoothing the effect of changes in assumptions or valuation methods.
- 24. From year to year, risk margins would generally be a similar percentage of the central estimate for each health insurance business and health-related insurance business, unless there has been a material change in uncertainty. Changes in uncertainty may derive from changes in a number of elements such as the private health insurer's risk profile or volume of business, or external factors (for example, legislative requirements). The Appointed Actuary must document any material changes.
- 25. The risk margin may include an allowance for diversification between health insurance business and health-related insurance business. The Appointed Actuary must clearly document the justification for and method of determining such diversification allowance (which must be assessed on a holistic basis for the fund of the private health insurer).

Discount rates

- 26. The rates to be used in discounting the expected future claims payments of insurance liabilities denominated in Australian currency for a class of business are derived from yields of Commonwealth Government Securities (CGS), as at the calculation date, that relate to the term of the future insurance liability cash flows.
- 27. Where the term of the insurance liabilities denominated in Australian currency does not match the available term of CGS, current observable, objective rates are to be used as a reference point for the purpose of extrapolation. If there are no other suitable instruments, or the Appointed Actuary elects to use an instrument that does not meet this requirement, the Appointed Actuary must justify the reason for using that particular instrument in the insurer's FCR. Adjustments must be made to remove any allowances for credit risk and illiquidity that are implicit in the yields of those instruments.

Methods for valuing insurance liabilities including the central estimate and risk margin

- 28. A method, or methods, must be adopted for valuing a private health insurer's insurance liabilities. Comprehensive actuarial analysis and modelling techniques should be employed, subject to considerations of materiality. The appropriateness of any method, or methods, will depend on:

- (a) the health insurance business and health-related insurance business being considered;
 - (b) the nature, volume and quality of the available data in relation to the experience of the private health insurer and the private health insurance industry;
 - (c) the circumstances of the private health insurer; and
 - (d) the current and expected environment over the valuation period and the extent to which they are captured in valuation models and data.
29. Approximate methods may be used when valuing a private health insurer's insurance liabilities subject to the principles of this Prudential Standard, and where the result is not material or not materially different from that which would result from a full valuation process. The onus for justification of the appropriateness of any valuation method rests with:
- (a) the Board of the private health insurer; and
 - (b) the Appointed Actuary.

Non-reinsurance recoveries

30. Non-reinsurance recoveries are amounts that may be recovered under arrangements other than reinsurance arrangements. The treatment of non-reinsurance recoveries must be consistent with that required by reporting standards made under the FSCODA.

Adjustments and exclusions

31. APRA may, by notice in writing to a private health insurer, adjust or exclude a specific requirement in this Prudential Standard in relation to that private health insurer.

Attachment A - Reinsurance

Estimation of reinsurance recoverables

1. The estimation of the value of the insurance liabilities may be undertaken on a gross basis, with a separate estimate of the value of reinsurance recoveries (that is, amounts expected to be recovered under the private health insurer's reinsurance arrangements), or on a net basis. In either case, the principles of this Prudential Standard must be applied. Where the process is undertaken on a net basis, it is still necessary to value separately the estimates of the claims component gross of any reinsurance recoverables and the reinsurance recoverables and expected reinsurance recoveries.⁴

Documentation of reinsurance arrangements

2. For the purpose of calculating a private health insurer's insurance liabilities, it must be assumed initially that:
 - (a) reinsurance arrangements are executed and legally binding contracts;
 - (b) reinsurance arrangements are 100 per cent placed, that is, there are no gaps in the insurer's reinsurance arrangements; and
 - (c) reinsurance recoverables and expected reinsurance recoveries will be received in full. Where reinsurance arrangements are not executed and legally binding contracts or are not fully placed, or there is a material risk that reinsurance recoverables and expected reinsurance recoveries will not be received from a reinsurer, the private health insurer will either not be able to recognise the reinsurance recoverables and expected reinsurance recoveries or will be required to hold capital against these risks.⁵

Assessment and comment by the Appointed Actuary

3. The Appointed Actuary⁶ must make a specific assessment of and comment on the recoverability of reinsurance recoverables and expected reinsurance recoveries from **non-APRA authorised reinsurers**. The Appointed Actuary must consider all relevant matters, including:
 - (a) quality of information and data available on potential reinsurance recoverables;
 - (b) credit risk;

⁴ This is also required to comply with reporting standards made under the FSCODA.

⁵ Refer to reporting standards made under the FSCODA for recognition of the reinsurance recoverables and expected reinsurance recoveries. Refer to *Prudential Standard HPS 112 Capital Adequacy: Measurement of Capital* and *HPS 110 Capital Adequacy* for detail in respect of capital requirements in relation to these risks.

⁶ If a private health insurer is exempt from the requirement to appoint an actuary, the private health insurer must make the assessment and comment as required by this paragraph.

- (c) willingness to pay;
 - (d) documentation and placement of contracts; and
 - (e) any legal or other issues that may create an impediment to the private health insurer realising the reinsurance asset.
4. Aggregate reinsurance recoverables and expected reinsurance recoveries must be separated into subsets which identify those that derive from documented and non-documented reinsurance arrangements, those that derive from reinsurance arrangements that are fully placed and not fully placed, and those likely to be recoverable and those not likely to be recoverable from reinsurers. In providing this advice, the Appointed Actuary must consider the materiality of reinsurance assets. If they are material, the Appointed Actuary must assess the potential range of amounts not recoverable from reinsurers, based on the uncertainty of individual and aggregate gross losses. For the purposes of HPS 114, the reinsurance recoverables due from non-APRA-authorized reinsurers for each accident year must be identified in the Financial Condition Report.

Treatment of reinsurance expenses

5. APRA maintains a consistent approach in allowing for the cost of all types of reinsurance arrangements. The principle is that APRA requires a private health insurer to ensure in all prudential reporting that reinsurance coverage matches the risk exposures in the underlying portfolio, irrespective of the type of reinsurance contract.
6. For the calculation of premiums liabilities, the premiums liabilities must include the future cost of any reinsurance arrangements required to fully cover the exposure period for premiums liabilities. This may include an additional cost for existing reinsurance contracts where the expense is yet to be recognised under Australian Accounting Standards as well as an additional reinsurance purchase cost for any part of the premiums liabilities not covered by current reinsurance arrangements.⁷ To the extent that a cost for current reinsurance arrangements covering premiums liabilities has already been recognised under Australian Accounting Standards, insurers are not required to also include that same cost in the premiums liabilities.
7. For any part of the current reinsurance arrangements that cover future business that has not been written, that portion of the associated cost of reinsurance cannot be used to reduce premiums liabilities calculated under this Prudential Standard. The cost of reinsurance for future business that has not been written can be used to increase the surplus (or decrease the deficit) in premiums liabilities calculated in accordance with HPS 112 if the reinsurance arrangement is an executed and legally binding contract and if the reinsurance cost has already been recognised under the **Australian Accounting Standard**. This revised surplus (or deficit) is included as part of the capital base.

⁷ See Attachment A, paragraph 8

Allowance for future reinsurance expense

8. The estimation of expected reinsurance recoveries in respect of premiums liabilities for which reinsurance has not yet been purchased can assume that the necessary reinsurance related to those liabilities will be purchased and documented. Allowance must be made for the purchase cost of this future reinsurance expense in the premiums liabilities valuation. This assumption must only be made when:
 - (a) existing reinsurance arrangements are executed and legally binding contracts;
 - (b) the estimated expected reinsurance recoveries relate to the same classes of business that are currently covered by the existing documented reinsurance arrangements; and
 - (c) it is fully expected that the reinsurance will be replaced on similar terms when current arrangements expire.

Estimation undertaken on the combined claims experience of several classes of business

9. The estimation of the value of reinsurance recoverables and expected reinsurance recoveries would normally be undertaken on the basis of each health insurance business and health-related insurance business written by the health insurer. However, there are certain forms of reinsurance where reinsurance recoveries and expected reinsurance recoveries receivable depend on the combined claims experience across classes of business underwritten. In such instances, the estimation will be required to factor in all the individual results for each health insurance business and health-related insurance business covered by the reinsurance arrangements.