

Health Insurance (prudential standard) determinations No. 2 of 2023

REPLACEMENT EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Private Health Insurance (Prudential Supervision) Act 2015, section 92

Under subsection 92(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* (the Act), APRA has power to determine prudential standards, in writing, in relation to prudential matters to be complied with by private health insurers. Under subsection 92(5) of the Act, APRA may, in writing, vary or revoke a prudential standard that applies to private health insurers.

On 24 May 2023, APRA made Health Insurance (prudential standard) determination No. 2 of 2023, which revokes *Prudential Standard HPS 110 Capital Adequacy* made under Health Insurance (prudential standard) determination No. 3 of 2015 and determines a new *Prudential Standard HPS 110 Capital Adequacy* (HPS 110).

The instrument commences on 1 July 2023.

1. Background

Capital standards are an important tool to support the objectives of APRA's prudential framework. They are intended to ensure that an insurer has sufficient financial resources available to meet its financial promises to policy holders despite adverse conditions. APRA's capital standards determine the minimum regulatory capital requirement for an insurer, taking into account the nature of the risks an insurer is exposed to in its business.

Since assuming prudential regulatory responsibility for the private health insurance industry in 2015, APRA has progressively reviewed and updated the prudential policy framework. APRA's review of the capital framework represents the third and final phase of that systematic process.

The review of the private health insurance capital framework revealed that, in a number of respects, the former capital framework was less robust than the requirements applied to other Australian insurance sectors and did not appropriately reflect the risks faced by insurers.

The new private health insurance capital framework seeks to address these concerns by ensuring there is an appropriate level of financial resilience and protection for policyholders through:

- **improved risk sensitivity** of the capital standards to better reflect the risks faced by private health insurers;
- **reduced discretion** available to private health insurers to determine their capital requirements, so as to narrow the differences between insurers with similar business models and profiles; and
- **alignment** with the structure of the life and general insurance capital framework, where appropriate. This reflects APRA's overall approach to capital quality and adequacy and is consistent with international best practice.

The changes to the private health insurance capital framework also incorporate changes to APRA's insurance capital framework due to the new *Accounting Standard AASB 17 Insurance*

Contracts (AASB 17). This ensures alignment between the prudential and accounting requirements and reduces cost and complexity for industry from otherwise needing to manage and report on diverging frameworks.

2. Purpose and operation of the instrument

The purpose of this instrument is to revoke the existing HPS 110 and replace it with a new version of HPS 110.

HPS 110 requires a private health insurer to maintain an adequate level and quality of capital commensurate with the scale, nature and complexity of its business and risk profile. A private health insurer is also required to have a documented Internal Capital Adequacy Assessment Process (ICAAP), comply with any supervisory adjustment to capital imposed by APRA, obtain APRA's written consent before reducing its capital, and inform APRA of any significant adverse changes to its capital position.

Under HPS 110, a private health insurer is required to maintain required levels of capital and determine its prescribed capital amount (PCA) having regard to a range of risk factors that may adversely impact the insurer's ability to meet its obligations. These factors include insurance risk, asset risk, asset concentration risk and operational risk.

Exercise of discretion by APRA

Under subsection 92(4) of the Act, a prudential standard may provide for APRA to exercise powers and discretions under the standard, including (but not limited to) discretions to approve, impose, adjust or exclude specific prudential requirements in relation to a particular private health insurer.

HPS 110 includes powers that may be exercised by APRA that involve an element of discretion. They include powers to adjust the calculation of regulatory capital requirements and the amount of regulatory capital required (Capital Adjustment Powers), and to adjust or exclude a provision of the standard.

APRA considers a wide range of factors when exercising its discretion under prudential standards, including the considerations set out in the Act and the *Australian Prudential Regulation Authority Act 1998*. The need to apply discretion is driven by entity specific issues and circumstances which are not adequately addressed by the generally applicable provisions of the prudential standards.

Capital adjustment powers

Under paragraph 40 of HPS 110, APRA may adjust any aspect of the PCA calculation for a particular fund if APRA is of the view that the prescribed capital amount does not produce an appropriate outcome in respect of the fund, or a private health insurer has used inappropriate judgement or estimation in calculating the prescribed capital amount. APRA's capital framework sets out how an insurer calculates its capital requirement; some of these calculations require judgement and estimation. To ensure that a private health insurer is adequately capitalised and policy holders are protected, both the inputs and the outcome of this calculation must produce a suitable and sound prudential outcome, given that particular private health insurer's specific circumstances. That is, a private health insurer's judgements and estimations are key determinants of whether sufficient capital is held for unexpected losses the private health insurer may experience in running its business. It is important that a private health

insurer's prescribed capital amount is "appropriate", and that "appropriate judgements or estimation" have been used in determining the amount. In this context, "appropriate" means that the capital requirements are commensurate to the risks posed to policy holders.

Under paragraph 41 of HPS 110, APRA may determine a supervisory adjustment to the prudential capital requirement of a fund or private health insurer if APRA is of the view that there are prudential reasons for doing so. Where APRA is not satisfied that the prudential outcome is suitable and sound, it may exercise its power to adjust a private health insurer's capital requirements. Prudential reasons for adjusting capital requirements for a private health insurer encompass any reason relating to risks to policy holders that have not been adequately mitigated by capital requirements determined by the prudential standards.

Examples of inappropriate judgements or estimations include unreliable valuation of liabilities or over-estimations of future performance. Other prudential reasons to apply an adjustment could include weaknesses in operational risk management, such as deficiencies in cyber risk management.

The purpose of these powers is primarily to ensure that the prudential requirements are:

- (i) proportionate and can be adjusted when the standard quantification would result in overly onerous requirements (paragraph 40); and
- (ii) risk-sensitive and can be adjusted when a material risk is not adequately reflected in the standard quantification of capital requirements (paragraph 41).

A capital adjustment might be determined on APRA's initiative taking into account APRA's assessment of how effectively a private health insurer manages the risks inherent in their business. Alternatively, an adjustment might be considered by APRA at the request of a private health insurer, where the private health insurer is able to show that the prescribed capital amount calculation is not appropriately aligned to its specific risk profile. An adjustment could result in capital requirements increasing or decreasing.

Capital adjustments will draw on relevant information sources and analytical tools, including APRA risk assessment and supervisory models. APRA's guidance in *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110), as it exists from time to time, on its approach to supervisory adjustments to capital requirements includes a non-exhaustive list of when a capital adjustment might be considered.¹

Factors contemplated in CPG 110 include:

- the capital calculations required under the standards do not adequately address entity-specific risks;
- the entity's business model, strategy or organisational structure is regarded as highly risky or hard to assess;
- the entity is newly licensed or has materially changed its business mix;
- the entity has material weaknesses in its governance or risk management framework;
- the entity has failed to comply with prudential requirements;
- the entity's capital management processes are inadequate;
- APRA has concerns about the quality of capital that the entity holds; and
- the entity has failed to restore its capital levels in accordance with its internal process.

¹ CPG 110 is available on APRA's website at www.apra.gov.au/industries/32/standards#category-305.

Adjust and exclude powers

Paragraph 52 of HPS 110 provides for APRA to adjust or exclude a specific prudential requirement in relation to a particular private health insurer. APRA will exercise this power if it is satisfied that the exclusion or adjustment of the specific requirement will achieve a better prudential outcome than if it remained in its original form. In other cases, an adjustment or exclusion may be necessary to give APRA comfort that the prudential requirements apply appropriately to protect policy holders (for example when action may need to be taken urgently and with certainty that the insurer will comply with the adjusted requirements). Other considerations include efficiency, competition, contestability, competitive neutrality and regulatory burden, including comparisons with the entity's peer group.

A decision to exercise the powers under a prudential standard is subject to a robust decision-making framework which is documented in APRA's internal policies. This framework supports APRA in fulfilling its mandate by limiting decision making to those senior APRA officers with the appropriate experience and skill to exercise prudent judgement. The framework also requires decision makers to seek advice from internal experts.

The adjust and exclude power is exercised following discussion with the relevant private health insurer about its appropriateness and the impact it may have on the entity.

Review of decisions

Decisions made by APRA exercising its powers under the Act are not subject to merits review. APRA considers decisions made by APRA exercising discretions under its prudential standards should not be subject to merits review as they are financial decisions with a significant public interest element.

A breach of a prudential standard is also a breach of the Act, as the Act provides that a private health insurer must comply with the prudential standard. However, there are no penalties prescribed for such breaches. Instead, a private health insurer's breach of a provision in the Act is grounds for APRA to make further, substantive decisions under the Act.

Documents incorporated by reference

Under paragraph 14(1)(a) of the *Legislation Act 2003*, the prudential standard incorporates by reference as in force from time to time:

- Acts of Parliament and associated delegated legislation;
- Prudential Standards determined by APRA under subsection 92(1) of the Act; and
- Reporting Standards determined by APRA under subsection 13(1) of the *Financial Sector (Collection of Data) Act 2001*.

which are available on the Federal Register of Legislation at www.legislation.gov.au.

3. Consultation

This and other prudential standards, forming the new private health insurance capital framework, are the product of extensive consultation with the industry and other key stakeholders. Submissions were received from, and discussions held with, private health insurers, industry bodies and other government agencies.

Submissions were largely supportive of aligning the private health insurance capital framework with the requirements for life and general insurers. Key areas of feedback from submissions included the treatment of the deferred claims liability within the capital framework, the allowance for management actions, and the design of the insurance risk charge. Insurers also raised the scale of the increase in minimum regulatory capital requirements and the impact this could have on premiums.

A number of public discussion and response papers were released during and following the consultation periods with draft standards accompanying the December 2021 response paper:

- November 2018: Letter *Roadmap for APRA's review of the private health insurance capital framework*;
- December 2019: Discussion Paper *Private Health Insurance Capital Standards Review*;
- December 2021: Response Paper *A proposed new capital framework for Private Health Insurance*;
- December 2021: Quantitative Impact Study;
- December 2021: Response Paper *Integrating AASB 17 into the capital and reporting framework for insurers and updates to the LAGIC framework*;
- April 2022: Letter *Integrating AASB17 into the Capital and reporting framework for insurers and updates to private health insurer capital framework*;
- September 2022: Response paper *Finalising the review of the Private Health Insurance Capital Framework*; and
- September 2022: Response Paper *Finalisation of the integration of AASB 17 into the capital and reporting frameworks for insurers and updates to the LAGIC framework*.

APRA is satisfied the consultation was appropriate and reasonably practicable.

4. Impact Analysis

In making the new prudential standards, including HPS 110, APRA has followed a process which satisfies the requirements of the Office of Impact Analysis (OIA). APRA has followed a similar process to that required for a Regulation Impact Statement which satisfies the OIA's requirements. APRA's policy development process is evidenced in Attachment A of the Response Paper *Finalising the review of the Private Health Insurance Capital Framework*. An extract of Attachment A has been lodged as supporting material.

5. Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment to this Explanatory Statement.

ATTACHMENT

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

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This legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instrument listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the legislative instrument

The purpose of the legislative instrument is to revoke *Prudential Standard HPS 110 Capital Adequacy* made under Health Insurance determination No. 3 of 2015 and determine a new *Prudential Standard HPS 110 Capital Adequacy*.

Human rights implications

APRA has assessed the legislative instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the legislative instrument is compatible with human rights.

Conclusion

This legislative instrument is compatible with human rights as it does not raise any human rights issues.