Regulatory Impact Analysis

This attachment sets out APRA's regulatory impact analysis. Consistent with the Australian Government Guide to Regulation, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS). APRA's evaluation of the impact of policy changes to the PHI capital framework is summarised below.

In its December 2019 discussion paper, *Private Health Insurance Capital Standards Review,* APRA set out in detail the problem that required attention and why regulatory action was needed to solve it. APRA views the existing PHI capital framework to be less robust than the capital requirements that apply in other insurance sectors in Australia.

In APRA's view, the current PHI capital framework does not appropriately reflect the risks faced by insurers, with inadequate consideration of extreme adverse events. Capital standards are a critical foundation to support the objectives of APRA's prudential framework, and in turn deliver better outcomes for the Australian community. APRA's standards ensure that private health insurers hold sufficient capital, maintaining an appropriate level of resilience so that they can survive periods of stress and continue to provide protection for policy holders.

APRA's review set out to make enhancements to the PHI capital framework, including:

- improving the risk sensitivity of the capital standards to better reflect the nature of risks faced by private health insurers;
- limiting differences in capital requirements due to insurer discretion, improving consistency and comparability between insurers in the adequacy of capital held; and
- alignment with the life and general insurance (LAGIC) capital framework, which reflects APRA's overall approach to insurer capital and is consistent with international best practice.

APRA's 2019 discussion paper also identified the need to address the interaction between the PHI capital standards, and the introduction of the Australian Accounting Board's new standard AASB 17, which adjusts the accounting treatment of insurance contracts. APRA's capital and reporting framework is based on the existing accounting standard. The introduction of the new accounting standard means APRA will need to update its capital and reporting framework. APRA's objective in doing so has been to align the treatment of capital and reporting requirements with the new standard, with departures as needed to ensure sound prudential outcomes. This will assist in minimising the regulatory burden on industry by reducing the mismatch between the new accounting standard and APRA's requirements.

APRA has undertaken two rounds of public consultation in reviewing the PHI capital framework and has engaged with a variety of stakeholders, including private health insurers, industry bodies and other regulators.[1] The consultation commenced with the release of

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[1] APRA's consultation on revisions to the PHI capital framework, along with non-confidential industry submissions can be found here: Review of the private health insurance capital framework | APRA

APRA's December 2019 discussion paper which described APRA's proposed high level structure for revisions to the PHI capital framework. Industry feedback to this paper helped shape the capital review.

In APRA's response paper in December 2021, *A proposed new capital framework for Private Health Insurance*, APRA clarified and amended its proposals in a number of areas, following the consideration of issues raised by stakeholders. An industry consultation session in February 2022 provided insurers with further opportunity to raise issues and provide preliminary feedback on the draft standards. The finalised framework includes a number of additional changes as a result of incorporating industry feedback.

Summary of policy options

APRA has considered three broad policy options for the reforms to the PHI capital framework. These policy options are set out in the table below. Within Option 3 APRA considered a range of specific approaches, including a number that were raised by stakeholders through the consultation process.

Option	Description
Option 1: No change to existing capital framework	Make no revisions to prudential requirements nor provide additional guidance to address weaknesses in the existing framework or incorporate updates driven by the introduction of AASB 17.
Option 2: Refreshing the existing capital framework	Incorporate changes driven by the new accounting standard, AASB 17 and update the existing capital framework in isolation, without reference to APRA's approach in other sectors.
Option 3: Consider greater alignment with the capital requirements of the life and general insurance industries and incorporate AASB 17 where appropriate	Align APRA's capital framework for private health insurance with other insurance sectors where appropriate and incorporate changes driven by the new accounting standard AASB 17.

Assessment of regulatory costs

As part of the consultation process, APRA invited submissions on additional regulatory costs that could be incurred as a result of the three policy options under consideration. Respondents were invited to use the Australian Government's Burden Measurement Tool to assess regulatory costs. APRA has considered all relevant compliance and administration costs, including both upfront and ongoing costs, in estimating the regulatory cost of each option.

Option 1: No change to existing framework

Under Option 1, there would be no change to APRA's existing prudential requirements, and no revisions would be made to incorporate the introduction of the new accounting standard AASB 17. If this option were adopted, it is likely that private health insurers would be more financially vulnerable to stress events and adverse financial impacts, with capital requirements that are not fully reflective of their risk profile.

This option would not give rise to any additional compliance costs associated with implementing revised requirements. However, capital requirements are a core component of APRA's supervision, and taking no action to address weaknesses observed in the current PHI capital framework would detract from insurer resilience and compromise policy holder protection.

Failing to incorporate changes driven by the introduction of AASB 17 would also create additional regulatory burden for insurers, as it would require them to maintain multiple sets of accounts to satisfy both accounting and prudential needs. This would increase compliance costs for private health insurers in the medium and long term when the new accounting standard comes into effect in 2023.

On balance, APRA considers there to be a long-term net cost associated with Option 1. While there are no upfront compliance costs associated with this option, not making these enhancements and failing to incorporate updates driven by the introduction of AASB 17 would result in a heightened compliance burden for industry on an ongoing basis. This is primarily driven by the need for insurers to maintain dual reporting systems to satisfy both prudential capital and accounting requirements.

Option 2: Refreshing the existing capital framework

Under this option, APRA would incorporate the changes driven by the new accounting standard AASB 17, and update the existing capital framework in isolation without reference to the capital frameworks applied in the other insurance sectors regulated by APRA. This option could remove outdated provisions in *Prudential Standard HPS 100 Solvency Standard* (HPS 100) and *Prudential Standard HPS 110 Capital Adequacy* (HPS 110), but would still set lower minimum capital requirements than other APRA regulated sectors.

This option is expected to involve implementation costs for insurers, as material changes to the framework would need to be made to address APRA's concerns. Implementation costs would include the cost of management time needed to adopt the changes, system updates, and time to develop internal policies and enhance internal capital management processes. However, it is expected that private health insurers would still have lower minimum capital requirements than other APRA regulated sectors as the standards would not require private health insurers to meet the 99.5% probability of sufficiency set as a baseline for capital standards for other insurance industries.

While this approach may address some deficiencies with the current framework and provide for alignment with AASB 17, it would not fully address APRA's objectives. The treatment of capital for private health insurers would not align with the approach in other APRA regulated insurance industries, and therefore provide a less robust level of protection for PHI policy holders. This approach would also present ongoing comparability issues for insurers operating across different insurance sectors within group structures and leave APRA's capital standards for private health insurers out of step with international best practice.

While APRA would incorporate changes to reflect the introduction of AASB 17, the approach taken would be inconsistent with other industries. It would introduce additional complexity for key stakeholders in understanding and comparing insurer results.

Annual regulatory costs, averaged over 10 years

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Change in costs	Business	Community organisations	Individuals	Total change in costs
Total, by sector ($m)	1.3	Nil	Nil	1.3

Option 3: Consider greater alignment with the capital requirements of the life and general insurance industries and incorporate AASB 17 where appropriate

Under Option 3, prudential requirements for private health insurers would be revised to respond to the weaknesses identified in the current framework and align with other insurance sectors where appropriate. This would also bring PHI capital standards into line with international best practice.

Under this approach, the revisions to prudential requirements would significantly enhance insurer resilience and policy holder protection. This would be achieved by enhancing the risk sensitivity of the capital standards and enable private health insurers to optimise their business and capital management strategies. Introducing greater alignment in the capital frameworks across insurance industries will also facilitate improved comparability and the use of consistent terminology and accounting standards.

Option 3 is expected to have similar costs, yet slightly higher, to Option 2 with a higher net benefit. APRA would be directly addressing the weaknesses observed in the current capital framework with reference to a proven prudent and risk sensitive approach, aligned to international standards. This would ensure the PHI capital standards are fit for purpose and appropriate for the longer term by applying a demonstrated robust capital framework, which has operated successfully over a long period.

APRA anticipates that this option will also reduce the likelihood of future changes being needed to address issues not identified at implementation, as APRA's existing LAGIC framework is tried and tested.

Using the Significant Financial Institution and Non-Significant Financial Institution distinction in the prudential standards, APRA is offering smaller insurers a two-year transition to meet the new International Capital Adequacy Assessment Process (ICAAP) requirements, as well as a two-year exemption from the reporting requirements under *Reporting Standard HRS 104 – Forecasts and Targets* (HRS 104). A two-year transition to meet the new Prescribed Capital Amount (PCA) and capital base requirements is also available for all insurers. These transitional arrangements will enable the implementation costs to be spread over a longer period of time.

Annual regulatory costs, averaged over 10 years				
Change in costs	Business	Community organisations	Individuals	Total change in costs
Total, by sector	1.8	Nil	Nil	1.8

Annual regulatory costs, averaged over 10 years				
($m)				

Assessment of net benefit

As outlined in APRA's 2019 discussion paper, and 2021 response paper, there are a range of net benefits in APRA's approach to revising the PHI capital framework with reference to the existing LAGIC framework (Option 3):

- The existing capital framework for life and general insurers reflects APRA's overall approach to capital. By starting with this approach, APRA aims to improve the resilience of the PHI industry to financial stresses and promote a prudentially sound industry over the long term. This will also directly address APRA's concerns that the current PHI capital framework is less robust than the capital requirements that apply in other insurance sectors.

- Adopting the LAGIC framework will strengthen prudential outcomes for PHI policy holders, and provide for a consistent level of protection for policy holders across APRA-regulated insurance industries.

- Consistency of capital frameworks across the insurance sectors allows for a common language for capital and supports discussions about capital between APRA and insurers, and within groups that contain multiple APRA-regulated insurers across different insurance sectors.

- Introducing an aligned approach and principles to incorporate the new accounting standard AASB 17 will make regulatory requirements more comparable and clearer, enabling capital requirements to be more easily understood by external stakeholders.

- Aligning APRA's requirements with AASB 17, where appropriate, will also reduce regulatory burden on insurers by removing the need for dual reporting for accounting and capital purposes.

Conclusion: comparison of policy options

When developing policy, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, while promoting financial system stability in Australia. APRA considers that, on balance, Option 3 will enhance prudential outcomes and improve financial system safety and stability in Australia.

While Option 3 has a marginally higher compliance cost, the prudential benefits associated with addressing prudential concerns arising from the deficiencies in the current PHI capital framework are materially higher.

	Option 1	Option 2	Option 3
Regulatory costs	No change	Low to moderate	Moderate
Increases the risk	Does not meet this	Partly meets this	Meets this criterion

	Option 1	Option 2	Option 3
sensitivity of standards	criterion	criterion	
Limits inappropriate insurer discretion	Does not meet this criterion	Partly meets this criterion	Meets this criterion
Alignment with LAGIC and international best practice	Does not meet this criterion	Does not meet this criterion	Meets this criterion
Comparability	Does not meet this criterion	Does not meet this criterion	Meets this criterion
Alignment with AASB 17 where appropriate	Does not meet this criterion	Meets this criterion	Meets this criterion
Overall	Net cost	Moderate net benefit	Material net benefit

Implementation and review

As delegated legislation, prudential standards impose enforceable obligations on APRA-regulated institutions. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a prudential standard, including a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated institution's authority to carry on its business or increasing regulatory capital requirements.

Under APRA's policy development process, reviews of new measures are typically scheduled following implementation. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards, and remain relevant and effective in facilitating sound risk management practices. To ensure the PHI capital reforms are achieving their intended objectives, APRA will review the capital framework at the earliest of three years after implementation. APRA will act within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.