Health Insurance (prudential standard) determination No. 5 of 2023

Prudential Standard HPS 115 Capital Adequacy: Insurance Risk Charge

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 115 Capital Adequacy: Insurance Risk Charge*, 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 115 Capital Adequacy: Insurance Risk Charge, comprises the document commencing on the following page.

Prudential Standard HPS 115

Capital Adequacy: Insurance Risk Charge

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires a private health insurer to maintain adequate capital against the insurance risks associated with its insurance activities.

The ultimate responsibility for the prudent management of capital of a private health insurer rests with its Board of directors. The Board must ensure that the private health insurer maintains an adequate level and quality of capital commensurate with the scale, nature and complexity of its business and risk profile, such that it is able to meet its obligations under a wide range of circumstances.

The Insurance Risk Charge is the minimum amount of capital required to be held against insurance risks.

This Prudential Standard sets out the method for calculating the Insurance Risk Charge. This charge is one of the components of the prescribed capital amount for private health insurers.

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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**, 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.

Insurance Risk Charge

6. This Prudential Standard sets out the method for calculating the Insurance Risk Charge.

7. The Insurance Risk Charge for each fund is the sum of the Insurance Liability Risk Charge, the Future Exposure Risk Charge and the Deferred Claims Liability Risk Charge.

Insurance Liability Risk Charge

8. The Insurance Liability Risk Charge is the sum of:

   (a) the Outstanding Claims Risk Charge as defined in paragraphs 10 to 13;

   (b) the Premiums Liability Risk Charge as defined in paragraphs 14;

   (c) the Risk Equalisation Risk Charge as defined in paragraphs 15 and 16; and

   (d) the Other Insurance Liabilities Risk Charge as defined in paragraphs 17 and 18.

9. The Insurance Liability Risk Charge applies to the private health insurer's **health insurance business** (HIB) as well as its **health-related insurance business** (HRIB).

Outstanding Claims Risk Charge

10. The Outstanding Claims Risk Charge relates to the risk that the value of the outstanding claims liabilities will be greater than the value determined in accordance with *Prudential Standard HPS 340 Insurance Liability Valuation* (HPS 340).

11. The risk charge is calculated by multiplying the outstanding claims liabilities[1] excluding claims settled but not yet paid by the **Outstanding claims risk size margin** defined in paragraph 13.

12. The outstanding claims of both HIB and HRIB are subject to the risk margin defined in paragraph 13.

13. The Outstanding claims risk size margin of a fund is calculated as:

    Min [1.03 x (Hospital Treatment **Single equivalent units** (SEUs)) ^ -0.16, 0.34]

Premiums Liability Risk Charge

14. The Premiums Liability Risk Charge relates to the risk that the value of the premiums liabilities will be greater than the value determined in accordance with HPS 340. The Premiums Liability Risk Charge is calculated as:

    $PLRC_{HIB} + PLRC_{HRIB}$

    Where:

    (a) $PLRC_{HIB}$ is the Premiums Liability Risk Charge of the health insurance business and is calculated as:

        PL_{HIB} x HIB Stress %

        Where:

        (i) PL_{HIB} is the health insurance business premiums liabilities determined in accordance with HPS 340.

        (ii) HIB Stress % is defined in paragraph 14 (c)

    (b) $PLRC_{HRIB}$ is the Premiums Liability Risk Charge of the health-related insurance business and is calculated as:

        PLHRIB x HRIB Stress %

        Where:

        (i) PL_{HRIB} is the health-related insurance business premiums liabilities determined in accordance with HPS 340.

[1] as determined in accordance with HPS 340

(ii) HRIB Stress % is as defined in paragraph 14 (d).

(c) HIB Stress % = size stress + additional uncertainty stress

Where:

(i) Size stress = 22.1% - 1.2% x log (Hospital treatment (HT) SEUs at the reporting date).

(ii) additional uncertainty stress = 33% x {min [max(growtht, growtht-1, growtht-2, 2.5%) - 2.5%, 15.0%]}.

Where:

$growth_t$ = HT SEU increase over last 12 months divided by HT SEUs at the reporting date.

$growth_{t-1}$ = HT SEU increase over prior 12 months (12-24 months) divided by HT SEUs at the reporting date.

$growth_{t-2}$ = HT SEU increase over prior 12 months (24-36 months) divided by HT SEUs at the reporting date.

Where a merger has occurred since t-2, growth is to be calculated on the total HT SEU's for the merged private health insurers, such that only organic growth is captured.

(d) **HRIB Stress % = 37.9% - 1.2% x log (dollar value of health-related insurance business accrued premium for the 12 months ending on the reporting date)**

Risk Equalisation Risk Charge

15. The Risk Equalisation Risk Charge relates to the risk that the value of risk equalisation transfers are less favourable than the value determined in accordance with HPS 340.

16. The risk equalisation risk charge is calculated as:

$4\% \times$ unbilled calculated deficit

Where:

Unbilled calculated deficit means total amount that would have been payable by the insurer should each SEU been entitled to the average amount as defined in rule 11(1)(e) of the *Private Health Insurance (Risk Equalisation Policy) Rules 2015* or its replacement, and under the following conditions:

(a) over the period up to the **reporting date**;

(b) where the risk equalisation levy has accrued but has not yet been paid; and

(c) where an invoice, notice or receipt from APRA has not yet been received by the private health insurer, for that period.

Other Insurance Liabilities Risk Charge

17. The Other Insurance Liabilities Risk Charge relates to the risk that the value of other insurance liabilities will be greater than the value determined in accordance with HPS 340.

18. The Other Insurance Liabilities Risk Charge is calculated as:

Other insurance liabilities at 99.5 per cent; less

Other insurance liabilities.

Where:

(a) Other insurance liabilities at 99.5 per cent is other insurance liabilities as defined by HPS 340 valued at a 99.5 per cent level of sufficiency. This means that, in the assessment of the private health insurer, there is no more than a 0.5 per cent probability that the actual cost will exceed this estimate.

(b) Other insurance liabilities is the value of other insurance liabilities determined in accordance with HPS 340.

Future Exposure Risk Charge

19. The Future Exposure Risk Charge (FER) relates to the risk that financial performance of the HIB and HRIB may be materially worse than expected and may require capital to meet policyholder obligations. The FER is calculated as:

$FER_{HIB} + FER_{HRIB}$

Where:

(a) FER_{HIB} is the charge for the health insurance business, related to the Adverse Event Stress combined with the Prescribed Benefit Stress.

(b) FER_{HRIB} is the charge for health-related insurance business, related to the Prescribed Benefit Stress only.

(c) Both components have a minimum value of zero, so any forecast profits after the stresses cannot be used to offset the charge of any other component.

20. The FER, for each of HIB and HRIB, is calculated by stressing:

(a) Benefits incurred; plus

(b) Management expenses; less

(c) Accrued premium.

This is to be calculated for the 12 months from the reporting date using stressed assumptions as described in paragraphs 22 to 27. This is to be calculated net of any reinsurance arrangements. There is no allowance for investment income or other parts of the business other than discounting as described in paragraphs 34 and 35.

21. The stressed assumptions may be adjusted for Management Actions as defined in paragraphs 28 to 33.

Future Exposure Risk Charge – Health Insurance Business

22. The Future Exposure Risk Charge for Health Insurance Business (FER_{HIB}) is calculated as the losses occurring over the 12-months from the reporting date due to the combined Adverse Event Stress and the Prescribed Benefit Stress.

Adverse Event Stress

23. The Adverse Event Stress quantifies the impact of an industry lapse scenario. This stress is focused on the lapse of younger **policy holders** resulting in an adverse event on the insurer.

24. The Adverse Event Stress is based on the following parameters:

    (a) 25% of all policies where the policyholder is aged under 65 years of age lapse immediately. Where the lapsing policies provide insurance for multiple people, all insured persons within these policies also lapse immediately;

    (b) the accrued premium and claims incurred of those who lapse are the average for their age cohort. This is to be applied equally across all states, scales, products and across hospital and general treatment. This does not focus on any particular cohort other than age;

    (c) the calculated deficit per SEU is to be increased by 20%. This reflects the impact on risk equalisation from fewer younger policy holders. The calculated deficit is the average *amount payable for each SEU* as defined in sub-rule 11(1)(d) of the Private Health Insurance (Risk Equalisation Policy) Rules 2015 or its replacement; and

    (d) management expenses are to be reduced only by variable costs which would be lower immediately following the stress. These must reflect the management expenses of the insurer over the 12-month period without specific management action as defined in paragraphs 28 to 33.

Prescribed Benefit Stress – Health Insurance Business

25. Prescribed Benefit Stress for HIB is an additional increase in the benefits incurred and management expenses, as calculated in the Adverse Event Stress, by the HIB Stress % as defined in paragraph 14(c).

Future Exposure Risk Charge – Health-related Insurance Business

26. The Future Exposure Risk Charge for Health-Related Insurance Business (FER_{HRIB}) is calculated as the losses occurring over the 12 months from the reporting date due to the Prescribed Benefits Stress.

27. Prescribed Benefit Stress for HRIB is an increase in forecast benefits incurred and management expenses by the HRIB Stress % as defined in paragraph 14(d).

Management actions

28. When determining the impact of losses from the FER, a private health insurer may make allowance for the actions that it would expect to take in response to the stresses, subject to the restrictions described in paragraphs 29 to 33.

29. Management actions may include, but are not limited to:

    (a) changing coverage;

    (b) changing management expenses;

    (c) closing products; and

    (d) migrating polices.

30. The allowances for management actions must be appropriate and justifiable. Any contractual guarantees must be taken into account in determining the management actions that would be applied.

31. Management actions cannot be assumed to occur within nine months of the reporting date. The nine month period must be extended if it is not sufficient time to allow the insurer to identify the event, assess the extent of the change, align to the insurer's risk appetite, implement the actions and for the actions to take effect.

32. Where a private health insurer proposes to change products, the timeframes must include informing an adult insured under each policy about proposed changes a '*reasonable time before the change takes effect'* as outlined in 93-20 (2) of the **PHI Act.**

33. Following the implementation of any management action, any estimated insurance profits on HIB or HRIB cannot be used to reduce the FER. That is, any insurance profits forecast after management action cannot offset prior losses.

Discounting of the Future Exposure Risk Charge

34. The determination of the FER of the fund under this standard may allow for the discounting of future cash flows in accordance with paragraph 35.

35. The rates to be used in discounting cash flows relating to the FER are derived from yields of Commonwealth Government Securities (CGS), as at the calculation date, for the relevant duration.

Deferred Claims Liability Risk Charge

36. The Deferred Claims Liability Risk Charge relates to the risk that the value of the deferred claims liability will be greater than the value determined in accordance with HPS 340.

37. The Deferred Claims Liability Risk Charge is calculated as:

Deferred claims liability at 99.5 per cent; less

Deferred claims liability; less

DCL aggregation benefit.

Where:

(a) Deferred claims liability at 99.5 per cent is the deferred claims liability valued at a 99.5 per cent level of sufficiency. This means that, in the assessment of the private health insurer, there is no more than a 0.5 per cent probability that the actual cost will exceed this estimate.

(b) Deferred claims liability is the value of deferred claims liability determined in accordance with HPS 340.

(c) DCL aggregation benefit is:

$$\text{DCL aggregation benefit} = (\mathrm{D} + \mathrm{O}) - \sqrt{\mathrm{D}^2 + \mathrm{O}^2 + 2 \times \text{correlation} \times \mathrm{D} \times \mathrm{O}}$$

Where:

(i) 'D' is the difference between the Deferred claims liability at 99.5 per cent and the Deferred claims liability. It is calculated as:

Deferred claims liability at a 99.5 per cent as defined in paragraph 37(a); less

Deferred claims liability determined in accordance with HPS 340 as defined in paragraph 37(b).

(ii) 'O' is the sum of all other components within the Insurance Risk Charge (i.e. the Insurance Liability Risk Charge and FER).

(iii) 'correlation' is 20 per cent.

Tax benefits

38. Each component of the Insurance Risk Charge must not incorporate any tax benefits. Tax benefits may reduce the **prescribed capital amount** as prescribed in *Prudential Standard HPS 110 Capital Adequacy* (HPS 110).

Adjustments and exclusions

39. 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.