INFORMATION PAPER

Review of the Private Health Insurance Capital Framework

December 2021

Disclaimer Text

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Proposed PHI capital framework

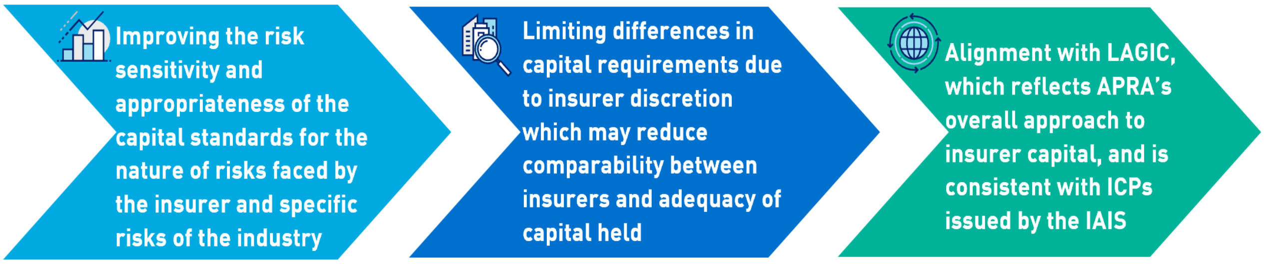
Overview

APRA is reviewing the capital framework for private health insurers (insurers) to ensure that the prudential standards provide for an appropriate level of financial resilience and hence adequate protection for policy holders. This Information Paper outlines the objectives of the framework and its key features, and is intended to help boards, senior management, investors and other market participants understand the new regulatory standards that will apply.

Objectives

APRA is seeking to ensure that private health insurance capital standards provide for an appropriate level of financial resilience for the protection of policy holders. The review seeks to address APRA's concerns that the current PHI capital framework does not appropriately reflect the risks faced by insurers or adequately allow for consideration of adverse events that could affect their performance.

This is being achieved through:



This response package follows a discussion paper released in 2019; *Private Health Insurance Capital Standards Review*, which described the proposed structure of the revised private health insurance (PHI) capital framework.

While the revised framework will enhance risk sensitivity, consistency across the industry, and improve alignment with other insurance sectors, there is not expected to be any need for insurers to raise capital to meet increased minimum capital requirements as a result of APRA's proposed reforms.

Seeking alignment, reducing burden

The proposals reflect APRA's intention to increase the risk sensitivity of capital requirements to the activities of insurers, and improve the alignment of capital standards across insurance industries. On this basis, APRA outlined its intention to use the existing life and general insurance capital framework (LAGIC framework) as a starting basis to guide the design of revised PHI standards. APRA has since released a partial-Quantitative Impact Study (partial-QIS) in March 2021 to ensure that proposed capital requirements are appropriate and aligned with the objectives of this review.

This review is occurring alongside the integration of changes to APRA's insurance capital framework due to new accounting standards, AASB 17 Insurance Contracts. APRA's intent is to integrate AASB 17 into the PHI capital framework where possible and appropriate, to align the prudential and accounting requirements and reduce burden on industry from otherwise needing to manage and report on divergent frameworks.

Proposed standards

As part of this package, APRA has released draft prudential standards for consultation with industry which incorporate both changes to the capital framework (outlined in this response package) and AASB 17 driven changes.

The background to APRA's proposals on AASB 17 and LAGIC updates is outlined in the Response to Submissions Paper; *Integrating AASB 17 into the capital and reporting framework for insurers, and updates to the LAGIC framework.* APRA strongly encourages insurers to monitor and engage with APRA's consultation on proposals for the integration of AASB 17 and LAGIC updates, in addition to this consultation.

The draft standards incorporate APRA's consideration of feedback received from industry and other stakeholders during multiple rounds of engagement, and the response paper provides additional context and detail on the draft prudential requirements. APRA seeks feedback on the revised proposals set out in this response package and draft standards by 31 March 2022.

Consultation feedback and APRA response

The feedback received in response to the partial-QIS and discussion paper commented on both the design and broader impact of the proposed capital framework.

Design

Respondents to the discussion paper and partial-QIS generally supported APRA's intention to align the PHI capital framework with the structure of the LAGIC framework, while highlighting the importance of making refinements to reflect the specific characteristics of the PHI industry.

As a result, the proposed structure for the PHI framework is largely unchanged from the discussion paper at a conceptual level. However, the proposals outlined in APRA's response package have been further developed and address industry feedback where appropriate, to ensure the risks of the PHI industry and individual insurers are appropriately reflected.

The key proposals set out in the response paper are outlined on the next page.

Consistency with LAGIC where appropriate including:	Reflecting PHI-specific risks:
• LAGIC risk charges • 99.5 per cent probability of sufficiency • $5 million minimum capital requirements • More robust capital management and planning requirements including introducing an ICAAP to cover the whole insurer	• Insurance Risk Charge designed to reflect the bespoke risks of the insurer and the PHI industry including: o an adverse event component, to consider a severe industry wide adverse event that causes a reduction in membership; o prescribed factors for insurance liabilities; and o an allowance for management actions to reflect insurer responsiveness to insurance risks and better reflect actual capital used. • Retaining pricing philosophy requirements

Strengthening capital management practices is an important part of the intent of the new framework. The ICAAP, which is a core capital management process required of all APRA-regulated industries, is intended to replace the current capital management plan requirement. It would need to be approved by the Board initially and when significant changes are made. Further guidance on ICAAP requirements is available in CPG 110 – *Internal Capital Adequacy Assessment Process and Supervisory Review* and draft HPS 110 – *Capital Adequacy.*

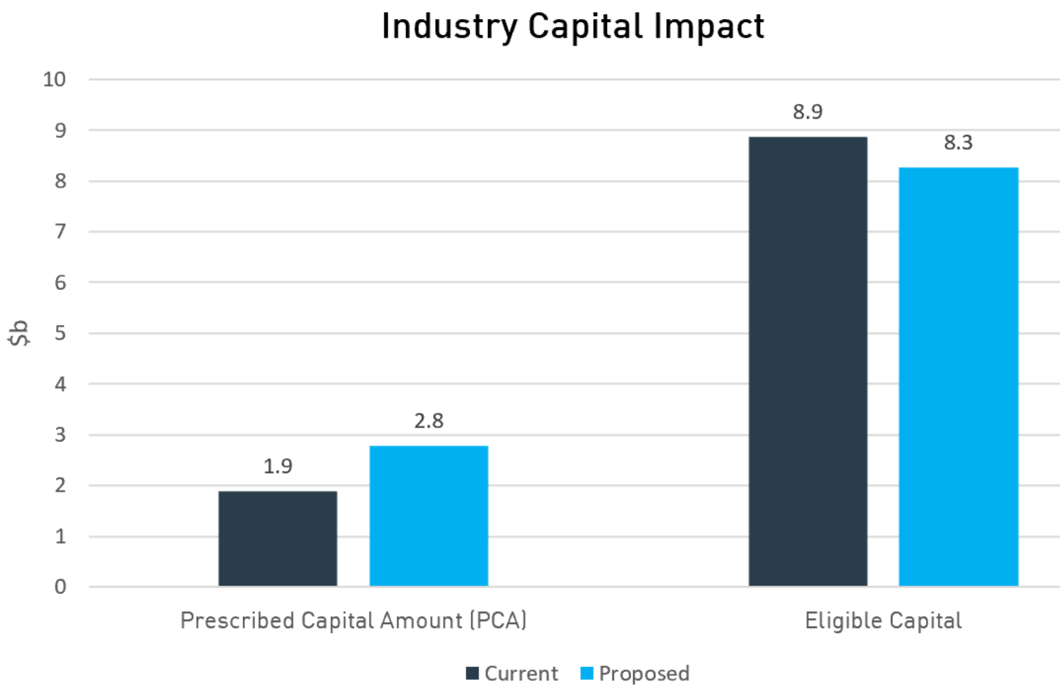
Impacts

Several respondents to both the partial-QIS and discussion paper commented on the potential impacts of APRA's proposals on capital requirements, premium levels and competition within the industry.

Capital requirements and premium levels

APRA's proposals will strengthen capital requirements for private health insurers, to support the long-term soundness of individual insurers and the industry as a whole. The review is not expected to provide a basis for increasing premiums. While APRA's proposals will result in an increase in minimum capital requirements, the industry is well-capitalised and holds well in excess of the proposed Prescribed Capital Amount (PCA). On this basis, the industry is well-positioned to absorb an increase in capital requirements without an increase in the actual capital held, or targeted.

Based on data from the partial-QIS, no insurers are expected to need to raise equity or increase premiums to meet the proposed minimum regulatory requirements. The chart below is an estimate based on information provided as part of the partial-QIS, and represents the industry aggregate impact on both the prescribed capital amount and eligible capital; the impact for individual insurers will differ. As the chart indicates, capital coverage for the industry following implementation of the proposed changes is expected to remain very strong.



Setting new targets

APRA expects that insurers will recalibrate and reset capital targets to reflect the new framework, recognising the additional strength that has been built into minimum capital requirements at a probability of sufficiency of 99.5 per cent, rather than 98 per cent. A number of respondents to the discussion paper and partial-QIS commented that target capital levels are often set based on regulatory requirements. APRA notes that it may be appropriate for insurers to target lower capital coverage ratios than in the past, given the changes in minimum capital requirements, enabling actual capital levels to remain largely the same (in dollar terms). Insurers should review their capital targets and buffers as part of their capital management planning within the ICAAP. If an insurer wishes to raise capital to maintain current high capital multiples, this would be an insurer's decision rather than a consequence of APRA's revised capital framework.

Broader impacts – balancing APRA's mandate

When developing policy proposals, APRA seeks to balance the objectives of financial safety, efficiency, competition, contestability and competitive neutrality, and in doing so promote financial system stability in Australia. More broadly, APRA has identified that this review will have a range of impacts, including:

Improved financial safety and stability	Capital requirements	Competition
Stronger prudential capital requirements to support the long-term financial soundness of insurers.	All insurers will meet minimum requirements, and should recalibrate targets to maintain a prudent level of surplus capital.	APRA has engaged with the ACCC to refine the design of the framework to minimise any competition impacts.

APRA considers the proposals in the response package will enhance prudential outcomes, improve financial safety and promote financial system stability while not unduly impacting other objectives. While some of APRA's proposals may reduce competition, the effects are expected to be comparatively minor in nature.

Increased – Financial safety, financial system stability, efficiency

APRA's proposals strengthen the prudential requirements for capital and ensure the capital standards provide for an appropriate level of protection for policy holders.

APRA's proposals are also expected to improve efficiency by determining capital requirements on a basis that better reflects the risks faced by each insurer.

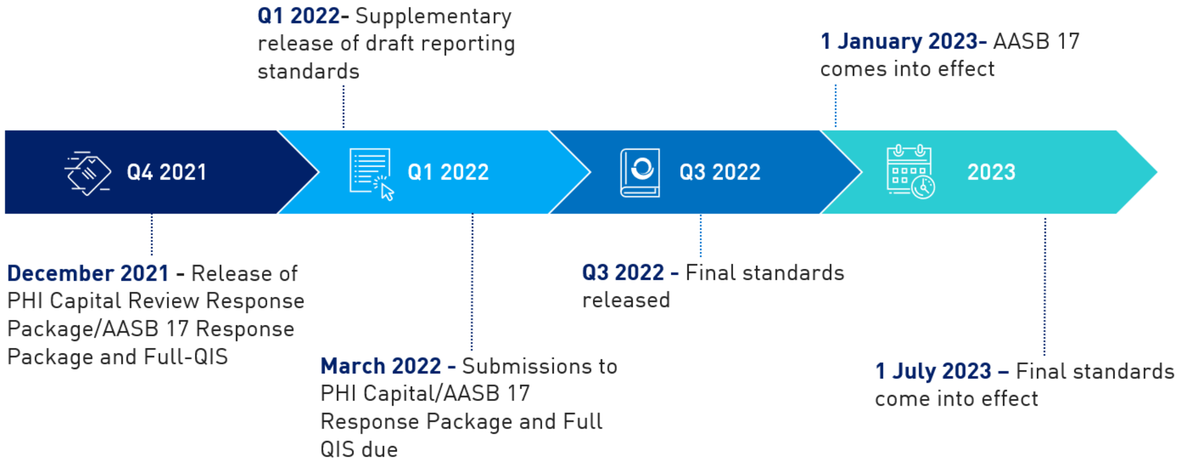
Slightly reduced – Competition and contestability

The key area where APRA received feedback on competition impacts was the inclusion and calibration of a capital component for misestimation of the insurance risk charge.

APRA has refined design aspects to ensure that any adverse competition or contestability impacts are minimised.

Next steps

A detailed timeline is set out below, highlighting next steps. APRA invites written submissions on the proposals set out in the response paper and draft standards by 31 March 2022 to the General Manager, Policy Development at insurance.policy@apra.gov.au.



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