



Prudential Standard HPS 115

Capital Adequacy: Insurance Risk Charge

Objective 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.

Authority

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

Application

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 and the Future Exposure 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 Charge as defined in paragraphs 15 and 16; and
 - (d) the Other Insurance Liabilities Charge as defined in paragraphs 17 and 18.
9. The Insurance Liability Risk Charge applies to the private health insurer’s **health insurance business** as well as its **health-related insurance business**.

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 liabilities¹ excluding claims settled but not yet paid by the **Outstanding Claims Risk Size Margin** defined in paragraph 13.
12. The outstanding claims of both health insurance business and health-related insurance business are subject to the same risk margin, as outlined in paragraph 13.
13. The Outstanding Claims Risk Size Margin of a fund, is calculated as:

$$\text{Min [1.03 x (Hospital Treatment **Single Equivalent Units** (SEUs)) ^ -0.16, 0.34]}$$

Premiums Liability Risk Charge

14. The risk charge for Premiums Liability Risk 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:

$$\text{Premium Liability Risk Charge} = \text{PLRC}_{\text{HIB}} + \text{PLRC}_{\text{HRIB}}$$

Where:

- (a) PLRC_{HIB} is the Premiums Liability Risk Charge of the health insurance business and is calculated as:
 - (i) $\text{PL}_{\text{HIB}} \times \text{HIB Stress \%}$
 - (ii) PL_{HIB} is the health insurance business premiums liabilities determined in accordance with HPS 340.
 - (iii) HIB Stress % is as defined in subparagraph (c)
- (b) $\text{PLRC}_{\text{HRIB}}$ is the Premiums Liability Risk Charge of the health-related insurance business and is calculated as:
 - (i) $\text{PL}_{\text{HRIB}} \times \text{HRIB Stress \%}$
 - (ii) PL_{HRIB} is the health insurance business premiums liabilities determined in accordance with HPS 340.
 - (iii) HRIB Stress % is as defined in subparagraph (d).
- (c) $\text{HIB Stress \%} = \text{size stress} + \text{additional uncertainty stress}$

Where:

- (i) $\text{Size stress} = 23.1\% - 1.2\% \times \log(\text{Hospital treatment (HT) SEUs at the reporting date})$.

¹ as determined in accordance with HPS 340

- (ii) additional uncertainty stress = $33\% \times \{\min [\max(\text{growth}_t, \text{growth}_{t-1}, \text{growth}_{t-2}, 2.5\%) - 2.5\%], 15.0\%\}$.
 - (iii) growth_t = HT SEU increase over last 12 months divided by HT SEUs at the reporting date.
 - (iv) growth_{t-1} = HT SEU increase over prior 12 months (12-24 months) divided by HT SEUs at the reporting date.
 - (v) growth_{t-2} = HT SEU increase over prior 12 months (24-36 months) divided by HT SEUs at the reporting date.
 - (vi) 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 % = $37.9\% - 1.2\% \times \log(\text{health-related insurance business accrued premium for the 12 months ending on the reporting date, in dollars})$

Risk Equalisation Charge

15. The Risk Equalisation Charge relates to the risk that risk equalisation transfers are less favourable than the valuation of the risk equalisation liability or receivable determined in accordance with HPS 340.
16. The risk equalisation charge is calculated as:

$4\% \times \text{unbilled calculated deficit}$

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 Charge

17. The Other Insurance Liabilities 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 Charge is calculated as:

Other insurance liabilities at 99.5th %; less

Other insurance liabilities.

Where:

- (a) Other insurance liabilities at 99.5th % is the other insurance liabilities valued at a 99.5 per cent level of sufficiency over a 12 month period. 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 of claims will exceed the stressed 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 health insurance business and health related insurance business may be materially worse than expected. The FER quantifies the amount of capital needed should a set of standardised industry stresses occur. The FER is calculated as:

$$FER = FER_{HIB} + FER_{HRIB}$$

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 Future Exposure Risk Charge, for each of HIB and HRIB, is calculated as 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 and not central estimate assumptions. There is no allowance for investment income or other parts of the business.

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 policy holders under 65 years of age lapse immediately. This means all insured persons within the 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 costs which are considered variable for the lapsing membership over a one-year time horizon.

Prescribed Benefit Stress – health insurance business

25. Prescribed Benefit Stress for HIB is an additional increase to 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 Future Exposure Risk Charge, 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 products.
30. The allowances for management actions must be appropriate, justifiable and equitable in each of the scenarios. 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 9 months of the reporting date. The 9 month period must be extended if required to allow for the time it would take the insurer to identify the event, assess the extent of the change, consider the insurer's risk appetite for severe management action, and implement the actions.
 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, the estimate of accrued premiums cannot be greater than the stressed benefits and management expenses. That is, any insurance profits forecast after management action cannot offset prior losses.

Tax benefits

34. 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*.

Adjustments and exclusions

35. 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.

Transition

36. On application by a private health insurer, APRA may grant transitional relief from the obligation for the private health insurer to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than 30 June 2025.