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To Peter

APRA DISCUSSION PAPER: PRIVATE HEALTH INSURANCE CAPITAL STANDARDS REVIEW

The Hospitals Contribution Fund of Australia Ltd (**HCF**) is pleased to make this submission to APRA in relation to the Discussion paper: Private Health Insurance Capital Standards Review and response to the consultation questionnaire.

1. SUMMARY RESPONSE

HCF is supportive of APRA's desire to align Private Health Insurance (**PHI**) capital standards with existing life and general insurance capital (**LAGIC**) standards and the discussion paper proposals put forward.

HCF recognises that at this time APRA's Prudential Capital Requirement (**PCR**) and its components have not been defined to the degree needed to enable definite quantitative impacts to be measured. HCF encourages APRA to pursue a consultative process that ensures the prudential capital requirement is commensurate with the level of risk inherent for Private Health Insurers (**Insurers**).

HCF understands that Mutual Equity Interests (**MEI**s) are not intended to be restricted only to for-profit Insurers. There is no suggestion that the amendments are intended to discriminate between mutual entities, such that the benefits would only be able to be accessed by for-profit Insurers. HCF submits that tax exempt not-for-profit Insurers should still be able to raise capital to conduct PHI business, and on terms which are no more or less favourable than for-profit Insurers.

As such, HCF requests APRA issue the MEI terms in a manner which provides sufficient flexibility for the Australian Taxation Office to determine whether it is appropriate or not for not-for-profit Insurers to issue MEIs (rather than necessitating an outcome). HCF will shortly engage with the ATO to discuss what form MEIs could take that would be consistent with the income tax exempt status of Insurers such as HCF. HCF proposes to pass the ATO's feedback to APRA so that this can inform your drafting of the MEI requirements for the PHI prudential standards. HCF submits that the question of not-for-profit status is not primarily a matter for APRA to address, but rather is a matter on which APRA, the ATO and the not-for-profit Insurers should collaborate. Additional detail is provided in section 2.5.

2. SPECIFIC CONSULTANTION QUESTIONS

2.1 Health Related Business

Regarding the scope of the capital standards, APRA is proposing to broaden the scope to the insurer, rather than the existing narrow focus on the Health Benefits Fund. What would be the implications of this proposal and practical aspects of how insurers would implement this approach?

This is expected to have a minimal impact, as the assets and liabilities of HCFs health related businesses (Dental and Eyecare Centres) are included as part of the assets and liabilities of the health benefits fund.

2.2 Probability of sufficiency

The current PHI capital standards target a 98 per cent probability of sufficiency on a going-concern basis. What are the implications of APRA's proposal that the PHI capital standards require a 99.5 per cent probability of sufficiency on a gone concern basis?

This would likely increase the insurance risk charge for Insurers, however, HCF supports this change as it ensures consistency across the insurance sectors. The impact of the insurance risk charge needs to be assessed in aggregate with all the Prescribed Capital Amount (**PCA**) components to provide an assessment of implications.

2.3 Capital base

APRA is proposing to introduce restrictions on the composition of an insurer's capital that is eligible to be included in the capital base. What are your views on the application of this proposal and challenges of transition to the proposal?

HCF supports the change as it ensures consistency across the insurance sectors and is in line with international best practice. The HCF Capital Management Plan already excludes intangible assets from the eligible capital base. This appropriately safeguards that no value is ascribed to assets that are not available to pay claims in times of stress.

2.4 Minimal proportions of capital

What are your views on APRA's proposed minimum proportions for capital, and transition considerations for the new framework?

HCF supports the change as it ensures consistency across the insurance sectors. We agree that enough minimum levels of Common Equity Tier 1 (**CET1**) and Total Tier1 capital (**T1**) are held to meet a high proportion of the PCR.

2.5 Mutual equity interests

APRA proposes to make MEIs allowable capital but proposes limits on the proportion of capital eligible for CET1. What would be the impacts of this proposal on the industry?

The proposal by APRA to make MEIs allowable capital is welcome and will introduce greater flexibility for Insurers such as HCF to issue a diverse range of capital. This provides many Insurers access to CET1 beyond retained earnings.

2.5.1 MEI limits on eligible capital

HCF is supportive of MEIs being allowable capital but is not able to comment if the above limit is appropriate or not at this point.

2.5.2 Maintaining not-for-profit and income tax exempt status for PHIs

HCF requests APRA consider an issue which arises for Insurers which are both mutual entities and not-for-profits (**NFPs**). This is a large cohort, with 63% of PHIs also being NFPs.[1]

The issue is that an NFP must not, broadly, make distributions of profits to members. This restriction is important, because Insurers which maintain an NFP status may be income tax exempt.

In that context, the prudential requirements for MEIs will be critical to determining whether an entity can both (I) access MEI capital and (ii) also be tax exempt. This is likely to be an important factor in the overall success of the MEI regime.

HCF supports APRA taking an approach that:

a) **facilitates mutual Insurers (of any kind) being able to issue MEIs; and**
b) **also best allows the NFP status of those entities to be maintained (subject to oversight by the ATO).**

To achieve this HCF considers it is important that the MEI prudential standards are not directly inconsistent with the NFP requirements. This approach should best allow the ATO to determine if an Insurer may issue MEIs whilst maintaining an income tax exemption (rather than the prudential requirements necessitating an outcome).

2.5.3 Income tax exemption for Insurers

A 'private health insurer' within the meaning of the *Private Health Insurance (Prudential Supervision) Act 2015* (Cth) is exempt from income tax in Australia provided that it is "*not carried on for the profit or gain of its individual members*" (see item 6.3 of the table in section 50-30 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**)).

The phrase "*not carried on for the profit or gain of its individual members*" is not defined in the 1997 Act.

However, there are similar NFP concepts incorporated in varying terms throughout the tax law,[2] and similar language has been considered by the Courts over time.[3]

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1 Information regarding the NFP status of each PHI is available at: https://www.privatehealth.gov.au/dynamic/insurer.

2 Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012 (Cth), Explanatory Memorandum [1.115].

3 *The Incorporated Council of Law Reporting of the State of Queensland v FC of T* 2 ATR 515; *FC of T v Word Investments Ltd* 70 ATR 225; *Nadir Pty Ltd v FC of T* 73 ATC 4074; *FC of T v Cappid Pty Ltd* 71 ATC 4121; and *Case U118* 87 ATC 710.

The varying provisions and related case law were summarised by the Federal Government as part of a proposal to implement a single statutory definition of the NFP concept (within the Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012 (**2012 Bill**). The proposed definition provided that a not-for-profit entity was an entity that:

a) **is not carried on for the profit or gain of its owners or members (including upon winding up); and**

b) **is prohibited from distributing, and does not distribute, its profits or assets to its owners or members (including upon winding up), unless the distribution is made to another not-for-profit entity with a similar purpose or is genuine compensation for services provided to, or reasonable expenses incurred on behalf of, the entity.**

This approach is also reflected in the positions adopted by regulators (particularly the ATO and the Australian Charities and Not-for-Profits Commission (**ACNC**)) which have primary responsibility for administering the various NFP provisions.[4]

In that context, it is appropriate that a significant number of mutual entities, that are Insurers, include provisions in their constitutions and governing documents that broadly restrict distributions of profits and gains to members. APRA is provided with these governing documents as part of its registration process for Insurers.

2.5.4 APS 111 concept of MEI may be inconsistent with NFP status

Certain requirements for a MEI for an Australian Deposit Taking Institution set out in Attachment K of APS 111 may be regarded by the ATO as necessarily inconsistent with NFP status. These include:

a) the references to dividends and distributions paid by the issuer from distributable items, such as retained earnings (see paragraph 1(e) of Attachment K and the modified versions of paragraph 1(f) and (g) of Attachment B of APS 111); and

b) the reference to a MEI holder's claim on the residual assets of the issuer. This is arguably inconsistent with the manner in which an NFP must manage its assets on a winding up.[5]

Any requirements in APRA's proposed PHI prudential standards that MEIs confer membership interests or be regarded as "shares" may result in similar challenges.

2.5.5 Working towards a solution

HCF understand that MEIs are not intended to be restricted only to for-profit Insurers. There is no suggestion that the amendments are intended to discriminate between mutual entities, such that the benefits would only be able to be accessed by for-profit Insurers.

Furthermore, HCF submits that a tax exempt Insurer should still be able to raise capital to conduct PHI business, and on terms which are no more or less favourable than for-profit Insurers.

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[4] See Taxation Ruling 97/22, Taxation Ruling 2011/4 and ACNC Guidance: Not-For-Profit.

[5] We note on this issue that the payment would not exceed the principal amount of the MEI. There is also some case law which might assist differentiating the final payment on the MEI from a prohibited payment on a winding up (see *C of T v Co-operative Bulk Handling Limited* (2010) 189 FCR 322, paras 36-37).

As such, HCF requests APRA issue the MEI terms in a manner which provides sufficient flexibility for the ATO to determine whether it is appropriate or not for NFPs to issue MEIs (rather than necessitating an outcome).

HCF will shortly engage with the ATO to discuss what form MEIs could take that would be consistent with the income tax exempt status of Insurers such as HCF. HCF proposes to pass the ATO's feedback to APRA so that this can inform your drafting of the MEI requirements for the PHI prudential standards. HCF submits that the question of NFP status is not primarily a matter for APRA to address, but rather is a matter on which APRA, the ATO and NFPs should collaborate.

In the interim, HCF requests that APRA consider taking one or more of the following approaches.

1. Allow the MEIs to be debt interests for tax purposes, for example because the subscription price is repayable in 10 years or there are fixed returns. We acknowledge that a solution along these lines may not be consistent with the purpose of treating MEIs as CET1 capital.

2. Allow the MEIs to be equity interests for tax purposes, but with fixed returns. This may be achieved where a fixed return on the MEI is only contingent on a sufficient profit level being achieved.

3. Adopt neutral language in the MEI requirements. For example, at this stage HCF would support an approach that adopts terms such as:

   (a) 'payment' rather than distribution or dividend;
   (b) 'MEI holder' rather than 'member'; and
   (c) 'amount' or 'revenue' rather than profit or gain.

4. Affirm in the MEI standards that payments on an MEI are consistent with an entity's NFP status on the basis that a distribution on an MEI is not regarded as a distribution of a profit or gain to a member. Alternatively, the statement may be more neutral, i.e. that the MEI requirements are not regarded as necessarily inconsistent with an entity being NFP.

2.6 Insurance risk charge

What are the advantages and disadvantages of the proposed components of the insurance risk charge? What are your views on the potential correlation between risks captured in each component and how the components could be aggregated to calculate the overall insurance risk charge?

APRA has proposed a prescribed factor approach form part of the insurance risk charge. What are the advantages and disadvantages of setting different factors for calculating the risk charge? What are your views on matters that should be addressed by risk margins and metrics to determine claims risk for remaining coverage?

2.6.1 Insurance risk charge

APRA proposes to use the broad structure of the insurance risk charge for general insurers (short tail) to inform the approach for PHI, given the predominately short tail nature of claims faced by both industries. Specific characteristics that affect insurance risk in PHI will need to be taken into account.

HCF recommends that the risk charge relating to health insurance should be consistent, if not lower than the current risk factor for short tail general insurance. HCF agrees that there should be different risk factors applied to PHI, overseas students and overseas health insurance.

2.6.2 Risk Equalisation

The discussion paper does not provide any guidance on the treatment of risk equalisation. HCF's view is that given the relatively short delay of two to three months between quarterly risk equalisation submissions, and the capital requirements that insurers would be subject to, it is unlikely that a material risk charge relating to risk equalisation will be necessary. Any risk equalisation receivable would have an asset risk charged based upon a LAGIC asset risk structure.

2.6.3 Adverse stress event

APRA has proposed a prescribed event stress form part of the insurance risk charge. What intensity is necessary to reflect a 99.5 per cent probability of sufficiency? Should alternative approaches be considered in the capital standard to address the risk of a severe adverse outcome?

Further guidance is required to be provided by APRA before HCF can provide a comment in relation to this. For example, the extent of the severity of this scenario, how it would be applied in practice, year level e.g. 1-in-200 etc.

2.7 Insurer specific adjustments

What criteria should APRA consider as part of its proposal to enable it to make an insurer specific adjustment to take account of experiences of an individual insurer?

HCF does not have a specific view on this but appreciate that APRA may deem certain risks pertaining to an insurer which are not adequately considered in the capital framework. This is consistent across the LAGIC framework.

2.8 Asset risk charge

Are the proposed asset risk stresses appropriate, and should insurers hold assets which could be affected by adverse events not captured by these stresses?

HCF supports the change as it ensures consistency across the insurance sectors, and particularly as with HCF, which has businesses in multiple insurance lines. The impact of adverse events should be considered as part of the insurance risk, not the asset risk charge.

2.9 Asset risk concentration charge

What are the expected impacts of the proposed asset concentration risk charge?

This is expected to have minimal impact as HCF is sufficiently diversified and has minimal asset concentration. HCF supports this change.

2.10 Operational risk charge

Should APRA consider a non-linear operational risk charge? What are your views on the relevance of a minimum or maximum threshold and potential metrics to determine the operational risk charge for non-insurance business?

HCF agrees that a non-linear operational risk charge should be considered, as there is not a direct correlation between the size of the business and the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

HCF is supportive of an operational risk charge aligned to the existing PHI capital standards.

As HCF's health related businesses are part of the health benefit fund, HCF recommend not applying a different operational risk charge, but is supportive of different operational risk charge, where non-insurance business is conducted outside the health business fund.

2.11 Aggregation benefit

APRA has proposed the aggregation benefit to recognise that insurance and asset risks are not perfectly correlated. What are your views on an appropriate approach for the prescribed formula, and whether a correlation factor of 0.2 can be adopted without amendment?

HCF supports recognition of an aggregate benefit component. HCF recommends that the correlation factor applied results in no change to current capital adequacy ratio and coverage ratio. HCF is not able to comment if the correlation factor of 0.2 to be adopted, until further guidance is provided in relation to all capital components.

2.12 Minimum PCR

What implications could APRA's proposed $5 million explicit minimum prescribed capital amount have for existing insurers or potential new entrants? 1
What are the expected impacts of an explicit minimum prescribed capital amount? What are the options for indexing the minimum amount?

APRA's proposal for an explicit minimum PCR of $5 million compared to current implicit minimum of $1 million has no impact for HCF. HCF agrees with a higher hurdle for new entrants into the market and a form of indexation is considered appropriate.

2.13 PHI Capital framework

Should the PHI capital framework include additional qualitative requirements to supplement those under Prudential Standard CPS 220 Risk Management?

APRA should consider that the same qualitative requirements as General Insurance are applied to PHI and that there are no additional onerous requirements to ensure alignment.

2.14 Transition Period

What are your views on the practical aspects of proposed changes to reporting requirements, including what would be an appropriate transition period to enable you to implement these changes?

HCF considers a minimum 12-month transition period is required to transition to the new reporting requirement, following release of the final standard.

However, it is noted that the final AASB 17 and APRA capital standards have yet to be released and require final details prior to setting in a final implementation timetable.

2.15 ICAAP (Internal Capital Adequacy Assessment Process)

APRA proposes to enhance capital planning for PHI by adopting the ICAAP to underpin capital management and more explicitly articulate those requirements. APRA also proposes to enhance the ICAAP by retaining requirements under the existing PHI capital standards to establish a pricing philosophy, investment rules and build on the circumstances in which the ICAAP will be reviewed.

HCF is supportive of APRA's proposal to adopt ICAAP, in the assumption it is not materially more onerous than existing requirements. As HCF is an NFP organisation, which is focused on member value and affordability, any support from APRA to minimise any additional costs is requested.

2.16 Solvency Standard

APRA proposes to remove the solvency standard and its qualitative requirements. However, considering claims characteristics of the industry, APRA proposes to retain qualitative liquidity management planning requirements.

HCF is of the view that that the PHI capital framework does not need to include additional qualitative requirements to supplement those under Prudential Standards CPS220 Risk Management. HCF reports on solvency monthly to the HCF Board, and quarterly to the Risk & Compliance Committee and will continue with this discipline.

2.17 Minimum capital impact

What is the quantitative impact of APRA's proposal for the introduction of a minimum capital requirement (MCR)?

There is no impact for HCF.

2.19 Capital base impact

What is the indicative quantitative impact on an insurer's current capital base of applying each of the regulatory adjustments specified in GPS 112 to determine an insurer's regulatory capital base?

HCF capital base would reduce by $184.8m, consisting of intangible assets and deferred acquisition costs. In practice this is no change for HCF as it excludes intangible assets for purposes of its internal capital adequacy calculations.

2.20 Capital adequacy impact

What is the quantitative impact of on an insurer's capital adequacy requirement of calculating HPS 110 on the basis of a 99.5 per cent probability of sufficiency?

Moving to 99.5% probability of sufficiency is estimated increase the insurance risk charge by 23% to 29%.

HCF welcomes the opportunity to discuss its submission further should you require additional information. Further, HCF would like to continue engagement with APRA throughout the broader consultation and capital standard finalisation process.

Yours sincerely

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CHIEF FINANCIAL OFFICER