AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
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16 November 2018

TO: ALL PRIVATE HEALTH INSURERS

ROADMAP FOR APRA'S REVIEW OF THE PRIVATE HEALTH INSURANCE CAPITAL FRAMEWORK

This letter updates stakeholders on APRA's planned approach to reviewing the capital framework applicable to private health insurers, and outlines the next steps.

Background

APRA's role as the prudential regulator of private health insurance is to implement measures designed to keep the industry on a sustainable footing. APRA has been reviewing the prudential framework for private health insurers to build insurer resilience across three key dimensions - risk, governance and capital.[1] Phase 1 risk management and phase 2 governance are now substantively completed. This letter details APRA's planned approach to phase 3 capital.

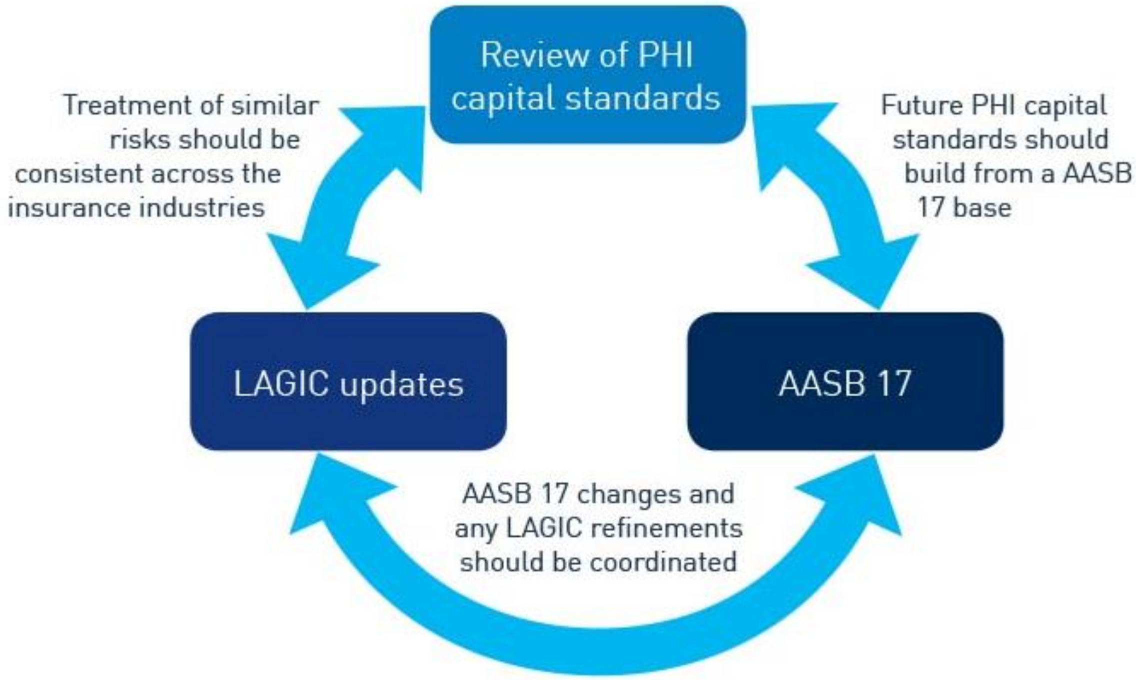
Capital requirements are a core component of the prudential framework for insurers. Holding sufficient capital builds resilience in insurers so that they can survive periods of stress, without jeopardising the protection of their policyholders. The objective of APRA's review is to ensure that the capital standards applicable to private health insurers provide for an appropriate level of financial resilience for the protection of policyholders.

Accounting standards for insurance contracts are also changing, with the forthcoming introduction of *AASB 17 Insurance Contracts* (AASB 17). AASB 17 is effective for annual reporting periods beginning on or after 1 January 2021. However, the International Accounting Standards Board voted on 14 November 2018 to propose a one-year deferral of the effective date of IFRS 17 *Insurance Contracts* (IFRS 17), the international equivalent of AASB 17, to 1 January 2022. This proposed deferral is subject to public consultation in 2019.[2]

In the life and general insurance industries, APRA is currently considering how to integrate AASB 17 into the capital framework (commonly referred to as the Life and General Insurance Capital, or LAGIC, framework), and to make any necessary updates and refinements to the LAGIC framework in light of experience since its commencement in 2013. There are important interactions between implementation of AASB 17, the review of private health insurance capital standards and updates and refinements to the LAGIC framework that need to be taken into account, as illustrated in the diagram below:

[1] https://www.apra.gov.au/private-health-insurance-prudential-policy-outlook.

[2] https://www.ifrs.org/news-and-events/2018/11/iasb-to-propose-one-year-deferral-of-insurance-contracts-standard.



Objectives of the review

APRA has stated that it does not consider that current levels of capital held in the private health insurance industry are too high or should be reduced. The starting point for the review is consistent with that position. APRA's primary goal in undertaking the review is to ensure that the capital standards for private health insurers provide for an appropriate level of financial resilience. To that end, APRA will seek to ensure that the level of capital required is aligned with the risks in the insurer's operations, so that policyholders are protected.

While APRA will not approach the review with the objective of increasing or reducing overall industry capital levels, there are factors that may lead to increased minimum capital requirements as alignment of capital requirements to risk is enhanced. These are discussed further below.

An increase in minimum capital requirements would not mean that actual capital levels would need to increase for all insurers. APRA expects that many insurers have sufficient total capital to absorb an increase in minimum requirements. The quantum of impact can be expected to differ from insurer to insurer depending on current capital levels, structures and business models.

APRA has decided to consult on proposals to adopt the LAGIC framework as the starting point for the capital framework for private health insurers. The LAGIC framework reflects APRA's overall approach to capital and is consistent with international best practice. Consistency of capital frameworks across the insurance sectors would allow for a common language for capital, support discussions about capital between APRA and insurers, and within groups that contain multiple APRA-regulated insurers.

There are important differences between the risk profiles and business models of private health insurers as compared to other insurers. These differences need to be recognised and reflected in the ultimate design of the capital framework. APRA will give careful consideration to the need for industry specific adjustments to the LAGIC framework in relation to private health insurance and will consult with insurers and other stakeholders.

Overall structure

Adopting the LAGIC framework as the starting point for the review means that APRA will consult on:

- translating the current “total assets vs Capital Adequacy Requirement” presentation of the capital position into a “capital base vs capital requirement” presentation;

- continuing to use Australian accounting standards as the base for the capital framework, with prudential adjustments as necessary to convert the accounting balance sheet to an appropriately prudent capital position. In light of the forthcoming implementation of AASB 17, APRA intends to consult on building the new capital framework for private health insurers from a AASB 17 base;

- introducing adjustments, modelled on the adjustments in the LAGIC framework, designed to ensure a prudent treatment of items on the accounting balance sheet such as deferred tax assets, goodwill and other intangibles, and deferred acquisition costs. These adjustments reflect APRA’s view that it is not prudent to include in the capital base certain assets - the value of which depends on future profits, or which would otherwise be unlikely to hold their value in a severely stressed scenario;

- the appropriate probability of sufficiency to target in the capital framework, noting that the LAGIC framework targets a 99.5% probability of sufficiency over a 12 month period on a gone concern basis, and the current private health insurance capital framework is targeted at a 98% probability of sufficiency over a 12 month period on a going concern basis. APRA intends at this stage to consult on aligning the private health insurance framework with the LAGIC probability of sufficiency;

- considering the capital position of the whole regulated private health insurer in the capital framework. The LAGIC framework considers risks that arise across the entire regulated institution; the current framework for private health insurers considers only the health benefits fund of the insurer;

- a more standardised approach to setting capital requirements that relies less on insurer discretion. The current private health insurance capital framework allows for very significant levels of discretion in the calculation of key components of the Capital Adequacy Requirement. The LAGIC framework generally allows for less discretion over items such as asset risks, asset concentration risks and insurance risks. While some discretion can be appropriate for parts of the calculation that are highly insurer-specific, APRA’s initial view is that a more standardised approach is desirable to help narrow the differences between insurers that have similar business models and risk profiles. This is particularly the case for asset risks (such as the impact of interest rates, inflation, exchange rates, equity market movements and credit spreads) that are likely to be similar across insurers; and

- rules, based on the LAGIC framework, that specify which capital instruments can be included in the capital base, to ensure that they are able to absorb losses and protect policyholders. This approach is consistent with the approach taken to authorised deposit taking institutions under the Basel framework and with relevant Insurance Core Principles issued by the International Association of Insurance Supervisors, and considers two broad tiers of capital, each with differing requirements and limits according to their quality.

Scope of the review

APRA intends that the review will cover both *Prudential Standard HPS 100 Solvency* (HPS 100) and *Prudential Standard HPS 110 Capital Adequacy* (HPS 110).

In relation to HPS 100, the review will consider the ongoing need for a quantitative liquidity standard for private health insurers.

For HPS 110, the review will cover all aspects of the calculation of required capital and the capital base, including the issues noted above. It will also cover reporting to APRA as it relates to capital adequacy and solvency, disclosure requirements relating to capital adequacy and solvency, and requirements around capital management policy (in LAGIC terminology, the Internal Capital Adequacy Assessment Process, or ICAAP).[3] Attachment A includes a simplified schematic of the components of the LAGIC framework; Attachment B includes a diagrammatic representation of how the ICAAP requirements operate in principle.

Process for the review

The process for the review will be consistent with APRA's general approach to policy development, and will include extensive consultation. Attachment C contains indicative timeframes for the key steps of the review.

The timeframes in Attachment C reflect two rounds of consultation and one quantitative impact study. If significant issues arise during consultation that would benefit from further exploration, APRA will consider whether an additional round of consultation is appropriate.

The timeframes also have some dependency on implementation of AASB 17. Once a final position is reached on the deferral of IFRS 17, APRA will assess whether amendments to the milestones for the review are necessary.

Transitional arrangements

APRA's intention is to put in place appropriate transitional arrangements to allow for an orderly implementation of the new capital framework. These arrangements are likely to include a combination of an industry-wide transition and insurer-specific additional transitional arrangements on a case-by-case basis where necessary.

Insurers are entitled to operate according to the current standards until any replacement standards come into effect. To assist insurers in understanding how capital management decisions made while the review is underway may impact APRA's decisions on applications for transition, the following factors will be considered by APRA:

- an insurer that takes actions to reduce its capital levels or weaken the composition of its capital can expect APRA to be less likely to agree to additional transitional arrangements should the insurer ultimately need to raise additional capital or strengthen its composition of capital;
- an insurer that issues a capital instrument not aligned to the LAGIC requirements can expect APRA to be less likely to agree to transitional arrangements for that instrument; and

[3] In the PHI context, the capital management policy encompasses a capital management plan, pricing philosophy and investment rules.

- an insurer that attempts in good faith to issue a capital instrument that aligns to both the current requirements of HPS 110 and the LAGIC requirements can expect APRA to be more likely to agree to additional transitional arrangements for that instrument. If that instrument ultimately ends up aligning to the requirements of the new capital framework, it would be eligible on an ongoing basis with no need for transition.

APRA's general approach to transition of capital instruments that do not meet the requirements of the new standards is to allow for transition through to the next available call date. APRA does not generally 'grandfather' instruments.

Next steps

In preparation for the review, APRA encourages private health insurers to familiarise themselves with the LAGIC framework. The prudential standards and guidance are available on APRA's website.[4]

APRA intends to hold workshops and other informal consultation opportunities for insurers and other interested stakeholders later this year and early next year. Insurers can expect to hear further from APRA on details for these events in due course.

The next formal step in the process will be the release of a discussion paper that outlines the proposed framework for private health insurer capital at a principles level, including industry-specific adjustments where assessed as appropriate and necessary. This is currently planned for release in the second quarter of the 2019 calendar year.

While APRA intends at this stage to incorporate consideration of aligning the prudential framework to AASB 17 as part of the review, this may be reconsidered once the final position on the deferral of IFRS 17 is known.

Please feel free to contact Peter Kohlhagen (peter.kohlhagen@apra.gov.au or 02 9210 3363) or your responsible supervisor if you wish to discuss any of the matters raised in this letter.

Yours sincerely,

Geoff Summerhayes
Executive Board Member

[4] See here under capital for life insurers: https://www.apra.gov.au/life-insurance-standards-and-guidance and equivalently for general insurers under capital here: https://www.apra.gov.au/general-insurance-standards-and-guidance

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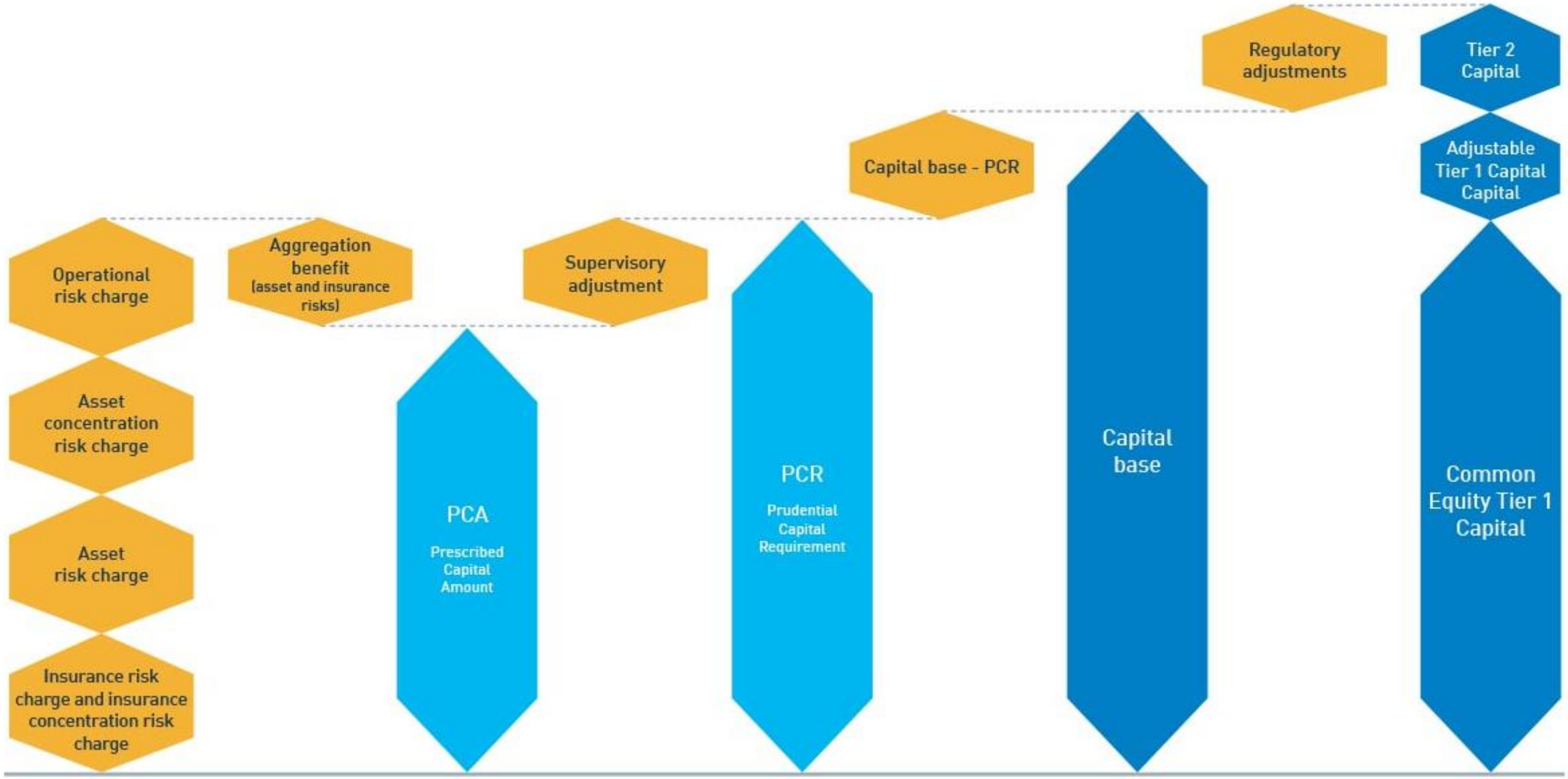
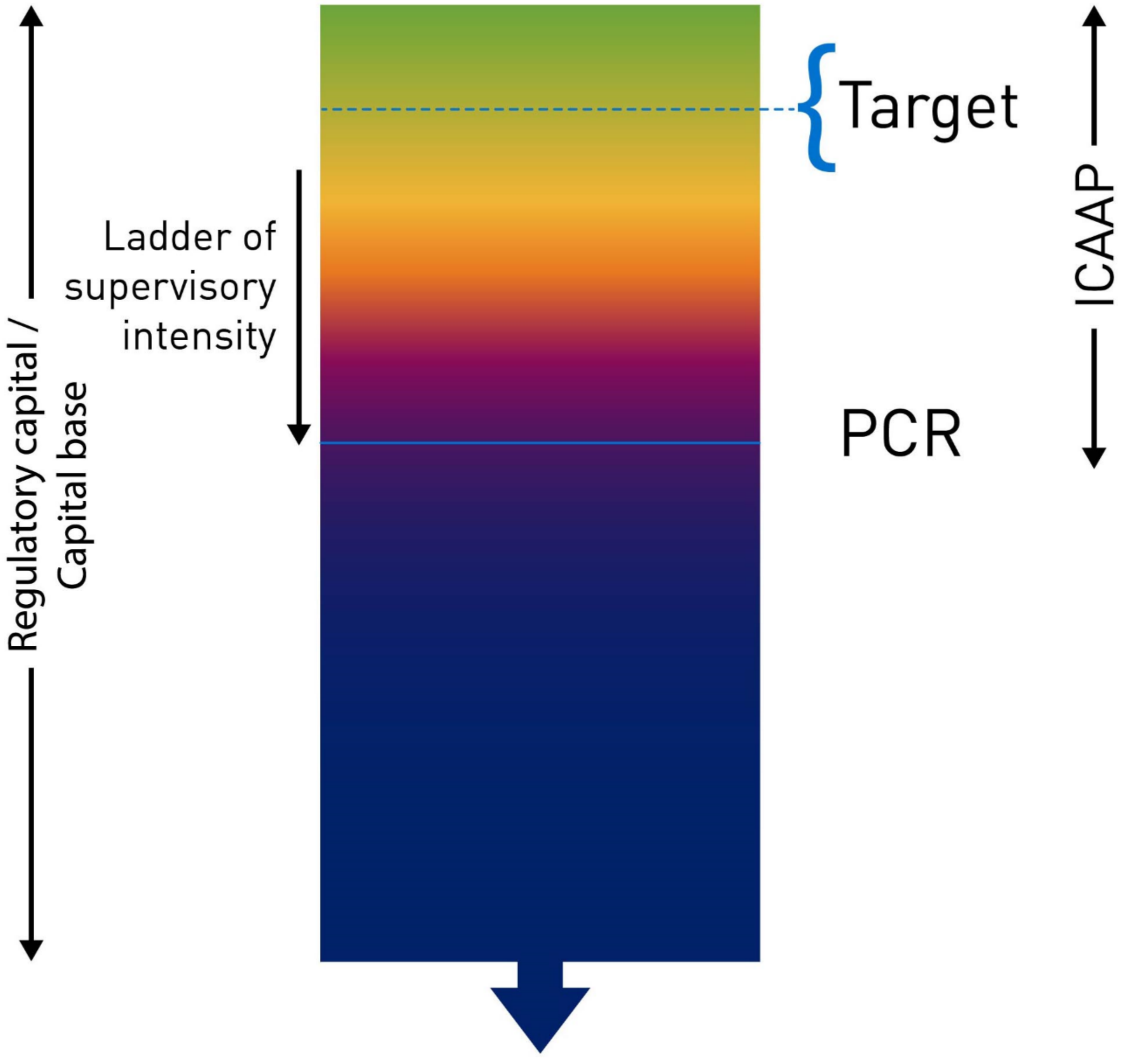
Attachment A – simplified structure of the LAGIC framework



Attachment B – operation of the ICAAP requirements



Attachment C – indicative outline of the PHI capital review