



1 July 2013

Mr Shaun Gath
Chief Executive Officer
Private Health Insurance Administration Council
PO Box 4549
Kingston ACT 2604

Via email: phiac@phiac.gov.au

Dear Mr Gath

Proposed Capital Standards for Private Health Insurers

The Actuaries Institute ("Institute") is the sole professional body for actuaries in Australia. It represents over 4,100 members, including 2,200 Fellows. Our members have had significant involvement in the development of insurance and superannuation regulation, financial reporting, risk management and related practices in Australia and in Asia.

We refer to the revised Capital Standards proposal for private health insurers and thank you for the opportunity to provide comments.

We appreciate PHIAC's involvement in an Insights session at the Institute earlier this month, which provided an opportunity for our members to discuss capital standards with PHIAC management. The discussions at that meeting form the basis of this submission.

Our comments are set out in the attachment. Noting that this is the second round of consultation, we have attempted to be brief in our comments and avoid repeating our previous submission.

If required we would be happy to discuss our views further. Please contact Melinda Howes, Chief Executive Officer of the Actuaries Institute (phone 02 9239 6106 or email melinda.howes@actuaries.asn.au) to arrange this, or for any further information.

Yours sincerely

John Newman
President

Institute of Actuaries of Australia

ABN 69 000 423 656

Level 7, 4 Martin Place, Sydney NSW Australia 2000

t +61 (0) 2 9233 3466 f +61 (0) 2 9233 3446

e actuaries@actuaries.asn.au w www.actuaries.asn.au



PHIAC: Proposed Capital Standards for Private Health Insurers

Summary

In June 2013 PHIAC released a Consultation Paper on Proposed Capital Standards for Private Health Insurers. This is the second round of consultation, following proposals released by PHIAC in July 2012.

The Institute continues to support PHIAC's key goals, in particular improving insurers' measurement of and engagement with risks.

We acknowledge that PHIAC has considered feedback from the first round of consultation, and we were pleased that a number of improvements were made to the proposed capital standard. Our comments on the revised proposal relate to:

- Target capital
- Timing
- The Solvency Standard, especially admissible assets
- Notifiable circumstances

The proposal challenges insurers to improve their calculation and communication of risk. We look forward to working with insurers as they work towards this goal.

Target Capital

Insurers will need to decide what level of capital to target relative to the regulatory minimum. For an insurer in stress, the capital requirement will increase significantly as forecast profits fall.

We note that insurers will need to carefully consider:

- How capital requirements will change following adverse events.
- What adverse events will need to be considered, noting that this standard is being built and implemented at a time when the industry is overall strongly capitalised and profitable.
- How insurers will be able to respond to adverse events. The standard assumes that the rate change mechanism can address any loss making business, however there may be circumstances where this is not the case.

We suggest that these difficult issues will require a range of actuarial approaches, and the requirement to use probabilistic methods (part 3 15 (4) of the legislation) may therefore be too prescriptive. Other approaches (such as scenario analysis) should also be allowed by the legislation.

Insurers will require details of the premium increase cap assumption to set capital targets. We suggest that PHIAC develop a transparent methodology for the cap.



Timing

PHIAC has proposed that the new standard be in place from 31 March 2014. Insurers will be required to review capital management plans by this date, including:

- capital targets and triggers,
- a pricing policy which explicitly considers capital implications, and
- liquidity and other investment rules.

Updating the capital management plan will require significant effort from actuaries, management and Boards. We are concerned that imposing a tight timeframe (which encompasses year end, rate change and Christmas) may limit the opportunities to really engage and explore options with a Board.

Given the obligations placed upon the Board under the proposed new Standard there will need to be significant education of any Board, and this will take time to do well. We therefore suggest that PHIAC consider a later implementation date for the capital standard as a whole, or for capital management plans.

If PHIAC requires the standard to be in force on 31 March, it would be helpful to allow capital management plans to be prepared on a “best efforts” basis. This means that, while each insurer must comply with the standard, plans would be expected to be improved and refined over the following years. Allowing “best efforts” would be consistent with the way in which similar reforms have been introduced by APRA.

Solvency Standard

Managed Investment Schemes (MIS)/Unit Trusts

PHIAC has specified that only either listed MIS or directly held securities will be eligible assets for the proposed solvency standard, and that equivalent assets to these which are held through unlisted MIS investments will not be eligible assets at all.

Insurers may hold investments as part of funds (rather than directly) in order to reduce investment costs and increase diversification. Subject to some practical conditions, we suggest that the same investments should get the same treatment for liquidity purposes, whether they are held directly or indirectly.

While no investment is guaranteed to be liquid under all circumstances, many managed investments provide high levels of liquidity consistent with the aims of the solvency standard. Cash funds that invest only in government and bank debt would be a particularly good example of a managed investment scheme with excellent liquidity.

We understand that PHIAC is well aware of APRA’s capital standards, and has decided a different approach is appropriate for private health insurers. However we note that, while short term general insurance has some similarities to private health insurance, there is no APRA liquidity test, or penalty for investing through MIS.



The Institute proposes that PHIAC's current requirements related to the exclusion of unlisted investments are amended as follows:

Where, in the opinion of the Directors of the insurer, an unlisted MIS investment invests predominantly in Cash, Cash Equivalent, Australian Government or other listed investments and customarily provides liquidity to its investors with at most 5 business days' notice, such an investment will be an eligible investment for the proposed second Liquidity Test. It will be admitted to the extent of 100% of the cash, cash equivalent and Australian Government investments plus 50% of the fair value of the insurer's listed (other) assets. Other unlisted MIS investments will not be eligible.

The advantages of this proposal are:

1. the proposal conforms with PHIAC's stated objective for the proposed Solvency Standard, which relate to funds required over a three month period
2. the proposal reduces investment related risk compared to PHIAC's current proposal (where it increases diversification)
3. the proposal increases net investment returns compared to PHIAC's proposal (where it reduces investment management costs)

Corporate Bonds

We note that corporate bonds are not admissible, unless they are listed on an exchange. We suggest that where bonds are issued by an ADI, or a company with a credit rating of A or higher, they should be counted at least as Band 2 Qualifying Assets.

Complexity

Simplicity is identified by PHIAC as a general philosophy for the proposed standards. We suggest that the solvency requirement could be simplified by combining the three components into one.

For example, where an insurer's cash or term deposits with ADIs exceed some threshold (for example, the cash management amount), perhaps this could be sufficient to meet the solvency test without any further reporting requirements.

Notifiable Circumstance

Actuaries will be required to provide advice if insurers fail to meet an 18 month version of the stress test. We would appreciate further guidance on how this test will be performed, and the nature of actuarial advice required.