2 October 2012

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

Via email: shaun.gath@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 the interests of over 4,000 members, including more than 2,100 actuaries. 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 proposed Capital Standards for private health insurers and thank you for the opportunity to provide comments. Our comments are set out in the attachment. If required we would be happy to discuss our views on the matter, in particular the Capital Stress Test and Operational Risk Capital Requirement.

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

David Goodsall
President

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PHIAC: Proposed Capital Standards for Private Health Insurers

Summary

In July 2012, PHIAC released for comment a Consultation Paper and Technical Annexure on Proposed Capital Standards for Private Health Insurers. The Actuaries Institute has a number of comments on the proposed changes, as outlined below.

The Institute supports the rationale for change in the Capital Standards, including the closer alignment of the Solvency Standard with its statutory objective, the explicit recognition of operational risk, inclusion of dividend expenditure and greater insurer involvement in the identification and measurement of risk.

The Institute supports PHIAC's key goals for the proposed Standards, i.e. to assess more accurately the risks faced by insurers; improve insurers' engagement with those risks; and improve the quality of information available to support PHIAC's regulation of the industry.

The proposed changes shift the Capital Standards from being prescriptive in their requirements to a principle-based approach under which private health insurers are afforded a greater deal of flexibility in quantifying risk. While this is a positive development, it brings challenges in calculating and communicating risk.

Our comments relate to practical execution of the proposed standards, in the following areas:

- Probability of sufficiency
- Capital Stress Testing
- Operational Risk
- Admissible Assets and
- Solvency Qualifying Assets

Proposed Capital Adequacy Standard

Probability of sufficiency

The proposed Capital Adequacy Standard aims to achieve approximately a 95% to 99% probability of the fund meeting its objectives over the next 12 months on an ongoing basis. As noted in PHIAC's consultation paper, this is lower than the 99.5% sufficiency targeted by other insurance regulatory regimes.

The consultation paper states "A lower level of sufficiency is justifiable because of the short-tailed nature of the Australian private health insurance business, which provides opportunities for insurers to respond to and correct adverse experience within 12 months". While we would agree that private health insurance is short tail, we note that a 95% probability of sufficiency provides the same level of sufficiency for both long and short tail business, but short tail business requires less capital than long tail business to achieve a particular level of sufficiency.

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We would argue that the fact health insurers can achieve a high level of sufficiency with relatively small amounts of capital (i.e. – at low cost) is an argument for targeting a high probability of sufficiency, not a low probability of sufficiency.

While we expect that the 18 month test will mean insurers will hold risk capital in excess of the Capital Adequacy Reserve (based on their own risk appetite), we suggest that PHIAC confirms the status of the 18 month test, so that the 18 month test will provide a satisfactory level of protection for customers from insurer failure. Arguably a 95% Capital Adequacy Reserve does not provide sufficient protection, and there is the risk that insurer failures would become more frequent, damaging confidence in the industry. However, we note that the 18 month test, especially with no allowance for management actions able to be included, should provide sufficient notice for higher premium increases to be planned. We note PHIAC's comments that the inability to allow for management action provides a level of sufficiency that is higher than 95% in practice.

In the technical annexure of the Capital Standards Review, a "99% level of sufficiency of policyholder liabilities" is achieved by using a conservative valuation basis that targets a 75% level of sufficiency, and then adding on an explicit margin from 8% to 25%, depending on the size of the insurer.

In terms of presentation, we believe that discussion of 95% to 99% probability of sufficiency on the one hand, and targeted 99% sufficiency of liabilities on the other hand has the potential for confusion. It would be more straightforward to target a consistent probability of sufficiency throughout, for example 99% sufficiency.

Capital Stress Test

The proposed Capital Stress Test performs the functions of the existing Renewal Option Amount and the Resilience Amount, stressing the insurer's net margins and investment returns. Additionally, the test stresses returns on health related business. The overall function is to estimate capital at the 95th percentile adequacy level for 3, 12 and 18 months, i.e. the extent of capital depletion over 3,12 and 18 months in a '1 in 20 year' adverse scenario.

The Institute questions the benefit of combining the two existing components (Renewal Option and Resilience) into a single capital stress test as this reduces the information visible to management and the Board. We believe that there is significant value in the amount of capital an insurer needs to support variability in claims, as being distinct from the capital impact of its investment position. This could be addressed within the current test by separately reporting stand-alone insurance and investment stresses and an allowance for diversification.

Under the proposed standards, as forecast net margin falls, the capital requirement increases rapidly – in the same way as for the current Renewal Option Amount. While this might be appropriate, it means PHIAC is optimistic to suggest as they do in the consultation paper that the new standards will "allow insurers to more confidently engage in competitive behaviour".

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The calculation of the 1 in 20 loss requires what PHIAC calls "probabilistic forecasts" and PHIAC believes "the benefits of an improved understanding of financial strength are likely to outweigh costs over time". The Institute regards it as important, in order to achieve this goal, that PHIAC recognises that the best "1 in 20 bad year" scenarios will not be developed from statistical models as these are not reliable enough for most insurers. In this industry, at least 2 of the last 20 years have included serious problems as a result of the "death spiral" that started to occur in the 1990s.

Given the degree of political risk in the industry, the Institute cautions against any expectation that application of statistical methods by themselves will lead to an accurate estimation of the "1 in 20" capital requirement. Such methods can be appropriate for setting a regulatory minimum capital calculation. However they are likely to underestimate the effect of "tail" events, and so fall short of truly representing a "1 in 20 year" sufficiency test.

In other regimes, the use of an internal model is available as an option, rather than being the standard approach. The model is agreed between the insurer and the regulator. For insurers without the desire or capacity to develop an internal model, they can use standard factors specified by the regulator. This ensures large insurers can benefit from developing sophisticated financial modelling and using it in its business, while costs are moderated for smaller insurers. This does not exempt smaller insurers from needing to understand risks, rather this is better done outside the capital requirements, for example in the Financial Condition Report.

So, while the move away from a prescriptive approach to a principles-based approach may benefit some (larger) insurers, retaining a more prescriptive approach may be reasonable for smaller insurers.

Operational Risk

Purpose of the Requirement

The proposed Operational Risk Capital Requirement ("ORCR") combines three separate issues:

- Minimum capital ($1 million)
- Operational risk, other than risks related to high levels of new business (0.5% of annual premiums), and
- Risks arising from high growth rates, which PHIAC defines as premium from new customers representing more than 6% of the total annual premium.

Comments on the proposed approach

Due to the $1 million minimum allocation, for the smallest insurers, operational risk will be a significant component relative to annual premium (up to 13% for smallest insurer but closer to 0.5% for larger insurers) and capital.

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The formula allocates specific capital to operational risk which is tied to annual premium and reflects the moves taken by Basel II and APRA to explicitly recognise an allowance for operational risk.

The current definition of gross growth will be difficult to calculate and independently assess for reasonableness by a third party as its calculation requires assumptions about changing product mix, forward rate increases and retention of existing policyholders (although we note that this is the case for the existing Renewal Option Reserve). It may be simpler to use the sales rate directly in the calculation, without any adjustment for the new customer product mix.

The proposed approach also ignores any ongoing operational issues relating to the existing product suite, for example, selective lapses. We suggest PHIAC consider including lapses in its calculation of operational risk.

0.5% of premiums is, of course, only a proxy for general operational risk, but we appreciate the capital requirements should be practical and straight-forward. However, the Institute believes there should be capacity for an insurer to use their own calculation where this is part of their capital management plan. The simple formula approach would remain available where insurers do not undertake the additional analysis, or where PHIAC considers that the internal analysis is insufficient.

PHIAC notes that the capital stress test should increase insurers' understanding of insurance and investment risks, and we suggest that the same would be true for self-assessed operational risk. Insurers will be incentivised to increase internal risk management capabilities, and therefore enhance the overall management and measurement of risk in the industry.

Admissible Assets

A look through approach is to be applied to pooled investments and subsidiaries. This is theoretically appropriate but may cause practical difficulties in some situations where obtaining timely detailed actual exposures in pooled investments is not possible.

Given the additional risks of pooled investments managed by third parties as compared to direct investments, it may be appropriate to limit the admissible proportion of a fund's assets invested in any particular pooled investment. Whilst it appears that no such limit is currently intended, it is possible that the default counterparty maximum of 7.5% is to apply. If this is the case, this should be clarified.

It appears that the value of derivatives covered by the derivatives policy is limited to 7.5% of fund assets for any one counterparty. It is assumed that given there are fund asset allocation proportion limits as well, the underlying effective exposures arising from the derivatives should be included within these limits. It is further assumed that the movement in the underlying admissible effective exposure would be picked up in the capital stress test.

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Proposed Solvency Standard

Qualifying assets

The only interest bearing assets that qualify for solvency purposes are those that are redeemable within 90 days. This could be interpreted to mean interest bearing investments with a maturity of greater than 90 days would not qualify even where securities are eligible for RBA repurchase agreements or secondary markets exist to liquidate the investments. If this is the case, such treatment would seem severe. If this is not the case, the meaning of "redeemable" as intended by PHIAC should be clarified.

Other comments: Capital Management Plan

There is the intention for the Capital Management Plan ("CMP") to have increased definition and coverage. Like the APRA ICAAP, it seeks to bring together capital targets, pricing and investment policies into one document. We would support this, as it is likely to increase management ownership of the CMP and improve linkages between capital / investments and pricing.

When it comes to Capital Targets, given the shift in Capital Adequacy Standards, it may be difficult for insurers to initially determine their target capital level as they will be unable to benchmark to peers (as a result of a lack of transparency) and will still be coming to terms with their minimum capital obligations under the new standards.

Small insurers are unlikely to have the expertise required to define their risk appetite and target capital levels in house, potentially generating additional cost to the insurer. The Institute believes that every licensed insurer should be capable of articulating appropriately its risk appetite and its capital requirements. However, given the historic range of small health insurers in Australia, and the potential costs of some techniques used in this area, we suggest that PHIAC should state its views on what is "appropriate" for smaller insurers.

There is the requirement of advice from the Appointed Actuary if the insurer fails an 18 month capital stress test. This means an additional requirement on the insurer to calculate an 18 month capital stress test, over and above the 3 and 12 month tests for the Solvency and Capital Adequacy requirements.

Some leniency may be required in the first year of the new capital standards to allow insurers to further develop their CMPs to adjust to the new measurements.

As an aside, we note the potential impact of seasonality on the 3 month and 18 month tests.

There appear to be several ways in which the three month solvency test could be performed, each meeting PHIAC's description but each giving very different capital levels. For example, the 3 month test could be:

- the first 3 months of the 12 month test (in which case accurate calendarisation of claims and the stress effects becomes critical), or

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- the “1 in 20 bad quarter” or
- the worst quarter out of the last 5 years.

In particular, if the stresses that create the bad year all occur towards the end of that year, then the first 3 months’ projection will produce little that is useful for solvency requirements. We suggest that as part of processing the results from QIS1, PHIAC discuss with companies and actuaries what other approaches had been considered.

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