



Health Benefits Organizations — Solvency Standard 2005

THE PRIVATE HEALTH INSURANCE ADMINISTRATION COUNCIL:

- (a) revokes the *Health Benefits Organizations — Solvency Standard 2003* made under subsection 73BCB (1) of the *National Health Act 1953*; and
- (b) makes this Standard under subsection 73BCB (1) of that Act.

Dated 6 July 2005

G. GINNANE
Chief Executive Officer
Private Health Insurance Administration Council

Contents

	1	Name of Standard	2
	2	Commencement	2
	3	Establishment of Standard	2
Schedule 1		Solvency Standard	3
Part 1		Introduction	3
Part 2		Principles & Calculation Methods	6

1 Name of Standard

This Standard is the *Health Benefits Organizations - Solvency Standard 2005*.

2 Commencement

This Standard commences on 1 July 2005.

3 Establishment of Standard

The Standard set out in Schedule 1 is established for the purposes of Division 3A of Part VI of the *National Health Act 1953*.

Schedule 1 Solvency Standard

Part 1 Introduction

1.1.1 This Standard

- (1) This Solvency Standard is established under the *National Health Act 1953 (the Act)*, and is an integral component of the prudential reporting and management regime for registered health benefits organizations under the Act.
- (2) The Act specifies a two tier capital requirement for the health benefits fund of an Organization with each tier considering the capital requirements in a different set of circumstances.
- (3) The first tier is intended to ensure the basic solvency of the health benefits fund. The second tier is intended to secure the financial soundness of the health benefits fund in a going concern sense. It is expected that in most circumstances this second tier will provide an additional buffer of capital above the minimum solvency requirement.
- (4) This Solvency Standard looks at the first tier capital requirement, referred to as the Solvency Requirement. The Capital Adequacy Standard looks at the second tier capital requirement, referred to as the Capital Adequacy Requirement.
- (5) The amount by which the Solvency Requirement exceeds the Reported Liabilities is the Solvency Reserve.
- (6) The stated purpose of the Solvency Standard under section 73BCC of the Act is:

‘to ensure, as far as practicable, that at any time the financial position of the health benefits fund conducted by a registered organization is such that the organization will be able, out of the assets of the fund, to meet all liabilities referable to the health insurance business of the organization as those liabilities become due.’.
- (7) Therefore, the purpose of the Solvency Standard is to prescribe the minimum capital requirement of a health benefits fund to ensure that under a range of adverse circumstances, the Organization would be expected to be in a position to meet its existing obligations to the members and other creditors of the fund. In this context the solvency requirement is essentially based on a run-off view of a Fund (and probably also an Organization) where the requirement is for the Fund to demonstrate that it should be able to reliably meet the accrued liabilities and obligations of the Fund in the circumstance of the wind up of the Fund.

- (8) The Solvency Requirement will be disclosed in the financial statements of the Organization and will be used as an indicator of the financial position of the Organization.
- (9) To facilitate comparability across the industry, this Standard adopts a primarily prescriptive approach to the determination of the Solvency Requirement.
- (10) It is noted that there is a difference between meeting the solvency requirement under this Standard and being solvent in terms of the *Corporations Act 2001*. It would be expected that a health benefits fund meeting the Solvency Requirement of this Standard would be in a position, following a range of adverse circumstances, to avoid insolvency as defined under the *Corporations Act 2001*.

1.1.2 How to use & interpret this Standard

- (1) The Solvency Standard is a legislative instrument in accordance with section 73BCB of the Act.
- (2) The Solvency Standard is comprised of the specifications in this Standard and those in the *Health Benefits Organizations — Interpretation Standard 2005* (the **Interpretation Standard**) referred to in this Standard. The Interpretation Standard forms a direct part of this Standard as if the text of the Interpretation Standard was reproduced explicitly in the text of this Standard.
- (3) In this Standard and the Interpretation Standard, the following conventions apply:
 - (a) **the legislative requirements prescribed in this Standard are shown in bold type;**
 - (b) commentary is shown in normal print directly following the legislative sections to which it relates;
 - (c) some sections of the Standard are also preceded by an overview — shown in normal print — intended as a plain English introduction to the principles which are developed in greater detail in the relevant section.
- (4) The commentary and overview can be used as an aid to interpretation, and to the intent of this Standard. In addition, circulars and other advice released periodically by PHIAC will provide further background and an insight to its considerations in the development of the Standard.
- (5) Terminology used in this Standard, to the extent it is not specifically defined, takes the same meaning as that in the *National Health Act 1953*. In other cases, the words and phrases set out in the Interpretation Standard have the specific meaning assigned in this Standard.

1.1.3 Application of the Solvency Standard

- (1) This Solvency Standard is made for the purposes of section 73BCB of the *National Health Act 1953*.
- (2) **It applies:**
 - (a) **in respect of all health insurance business of a registered health benefits organization; and**
 - (b) **on and from 1 July 2005.**
- (3) **Transitional arrangements apply for health benefit organizations registered on the day the *Health Benefits Organizations — Solvency Standard 2000* commenced (see Division 2.3).**

Commentary The Standard has been through a due process of exposure and consultation established and managed by PHIAC, and has been the subject of consultation with the Australian Government Actuary. The Standard is a disallowable instrument and will accordingly have been through the Parliamentary processes, and not disallowed.

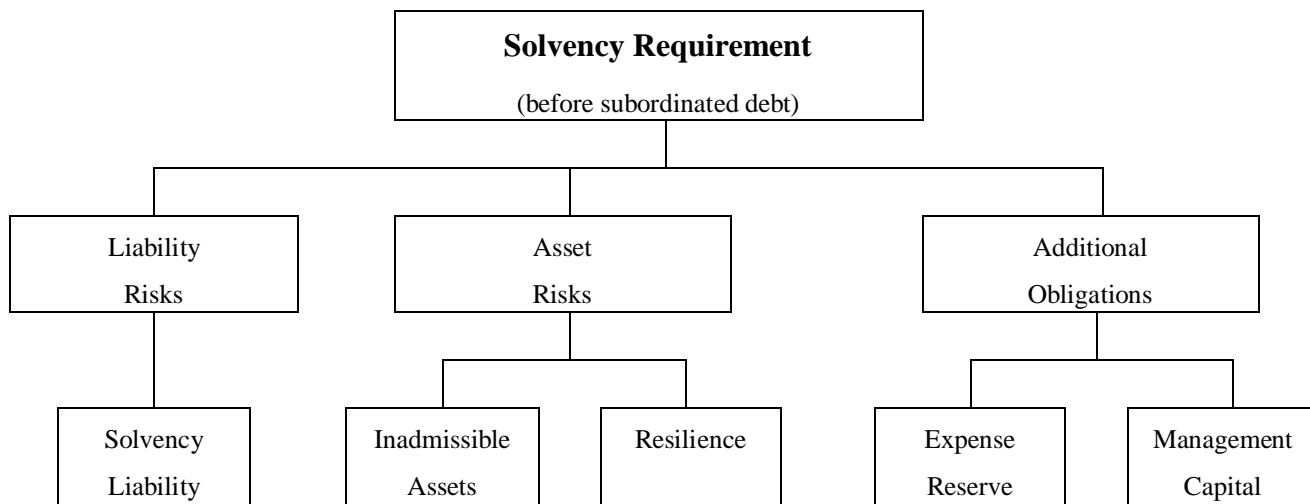
Part 2 Principles & Calculation Methods

Division 2.1 The Solvency Standard

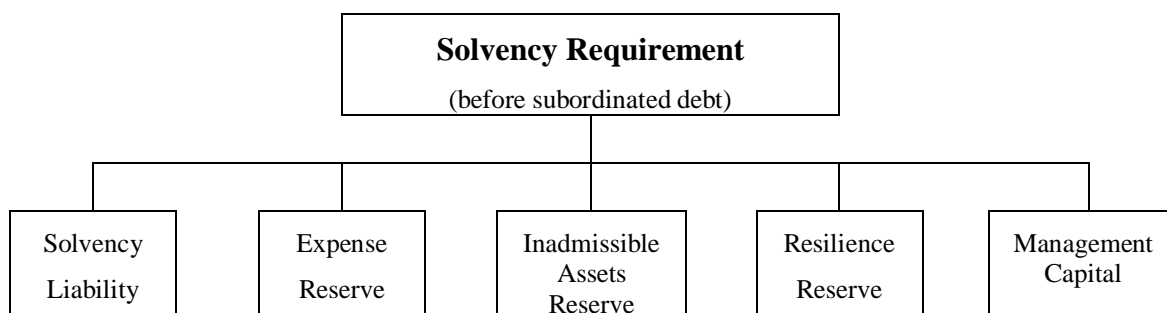
2.1.1 Overview

- (1) The liabilities of a Fund reported in the financial statements of an Organization and determined in accordance with relevant accounting standards generally reflect a best estimate of the Fund's obligations at a particular date with additional risk margins to allow for the inherent uncertainty in the central estimate of the outstanding claims and the central estimate of future expected cash flows relating to the unearned premium liability (contributions in advance).
- (2) The assets of a Fund are similarly generally disclosed in the financial statements on a fair value basis.
- (3) The financial position of a Fund may, therefore, be assessed by a comparison of the value of its assets and liabilities so reported.
- (4) However, the prudent regulation of the private health insurance industry requires that the level of security offered to health fund members exceeds that implied by a best estimate basis of calculation. The Solvency Standard requires that the Fund has available capital to provide for the security of the Fund's member entitlements under a range of adverse conditions.
- (5) This Solvency Requirement is determined by considering the various risks which could impact the security of the Fund's member entitlements, and require the provision of a prudent level of reserves against such risks.
- (6) These risks, and an assessment of the prudent provision, are considered in the context of a Fund closed to new members, and hence operating in a run-off situation.
- (7) It is not the intention of this Standard to provide absolute security to Fund members. To attempt to do so would be prohibitive to the viability of the industry and hence not in the best interest of fund members overall. Rather, the prescribed reserves provide for a range of adverse but reasonably possible conditions.
- (8) In assessing the solvency requirement of a Fund consideration is given to:
 - (a) the risks which may affect the value of its liabilities; and
 - (b) the risks which may affect the value of its assets supporting those liabilities; and
 - (c) the additional obligations that may be anticipated to arise in the event of a closure of the Fund not otherwise reflected in the current balance sheet provisions of the Fund.
- (9) The level of provision against these risks is set relative to the overall objectives of the Solvency Standard.

- (10) Based on the above considerations, the structure of the Solvency Requirement, before the use of any alternative sources of capital such as subordinated debt, is as follows:



- (11) For practical calculation purposes, the structure of the Solvency Requirement is expressed as follows:



2.1.2 Solvency Liability

The Solvency Requirement must make provision for the risks pertaining to elements in respect of which an assumption is required in valuing the accrued liabilities of the Fund.

2.1.3 Expense Reserve

The Solvency Requirement must provide for a reserve against the risk of the expenses of the Fund eroding the asset value of the Fund under conditions of the Fund being closed to new members and in run-off and where future contribution income into the Fund has discontinued.

2.1.4 Inadmissible Assets Reserve

The Solvency Requirement must provide a reserve — the Inadmissible Assets Reserve — in respect of:

- (a) an asset which has a value that is dependent upon the continuation of the business; and
- (b) holdings in an associated entity which is an institution itself subject to legislated minimum capital requirements; and
- (c) the risks arising from asset concentration.

2.1.5 Resilience Reserve

The Organization must assess the resilience of the Fund and provide for an appropriate reserve — the Resilience Reserve. In this context, resilience is assessed as the ability of the Fund to sustain shocks to the economic environment in which it operates and which are likely to result in an adverse movement in the value of its assets relative to the value of its liabilities.

2.1.6 Management Capital Requirement

The Solvency Standard specifies requirements that are essentially proportional to the risks and size of a Fund. However, many management risks are not simply proportional to the size of a Fund and consideration needs to be given to the dimensions of the overall Organization and its risk profile outside the Fund.

2.1.7 Subordinated Debt Allowance

It is intended that the solvency requirements of a Fund may be met via a combination of shareholder/member capital and retained earnings in the Fund, and other suitable means such as the use of Subordinated Debt. As any debt liability of a Fund is disclosed as part of the underlying reported liabilities of the Fund, the approach in this Standard is to allow the Solvency Requirement to be reduced by the amount of Approved Subordinated Debt that may be counted for solvency purposes.

Division 2.2 Solvency Requirement

2.2.1 At any time, the value of the assets of the Fund must be of an amount considered sufficient to meet the obligations of the Fund at that date, to members and creditors referable to the Fund, under a range of adverse conditions. This amount is referred to as the Solvency Requirement.

2.2.2 ***Health Benefits Fund Solvency Requirement ('HBFSR')***

- (1) The HBFSR is an intermediate calculation and is determined as:
 - (a) Solvency Liability; plus
 - (b) Expense Reserve; plus
 - (c) Inadmissible Assets Reserve; plus
 - (d) Resilience Reserve; plus
 - (e) Management Capital Amount.
- (2) The performance of each subsequent step in the calculation process described in subsection (1) must not reduce the progressive result from its amount at the completion of the previous step.

2.2.3 The Solvency Requirement is then determined as:

- (a) HBFSR; less
- (b) Approved Subordinated Debt.

2.2.4 The Solvency Excess Assets measure for the Fund is determined as:

- (a) Total Fund Assets; less
- (b) Solvency Requirement.

2.2.5 The Solvency Reserve measure for the Fund is determined as:

- (a) Solvency Requirement; less
- (b) Reported Liabilities.

2.2.6 In determining the Solvency Requirement, allowance must be made for any guarantees or obligations stated or implied to Fund members arising from legislation, the Fund's membership rules, and current or past promotional material of the Organization.

2.2.7 The Solvency Requirement must provide for the value of the liabilities of the Fund in respect of current and prospective obligations to members and other creditors of the Fund, resulting from the adoption of a basis more conservative than best estimate.

2.2.8 The Solvency Requirement, in considering scenarios of adverse experience, must provide for risks associated with both the valuation of the liabilities and the valuation of the assets.

2.2.9 As the prescribed solvency test considers the obligations of the Fund in the state of the Fund closed and in run-off, an allowance for unfunded run-off costs must also be included in the Solvency Requirement.

2.2.10 Each component of the calculations specified in this section is to be calculated in accordance with the Interpretation Standard.

Commentary The methodologies for determining the Solvency Requirement for a Fund incorporate prescribed minimum parameters. While the diversity of the private health insurance industry is recognised, given the statutory nature of the Solvency Requirement and the desire for understanding and comparability of what will be a reported measure, it has been determined that any significant flexibility in this Standard would not be appropriate.

Division 2.3 Transitional Provisions

2.3.1 The transitional provisions set out in this Division only apply to health benefit organizations registered on the day on which the *Health Benefits Organizations — Solvency Standard 2000* commenced (that is, 1 January 2001).

2.3.2 All health benefit organizations so registered will be required to meet this Standard on and from 1 January 2006, concluding the transitional solvency requirements that:

- (a) have applied during calendar years 2001 to 2005 under previous Standards made under subsection 73BCB (1) of the Act; and
- (b) are reiterated by section 2.3.3.

2.3.3 Until 1 January 2006, the Health Benefits Fund Solvency Requirement (*HBFSR*) is defined as the lesser of:

- (a) $A + (X\% \times (B - A))$; and
- (b) B;

where:

A = the Reported Liabilities of the Fund, plus:

- (a) the greater of 2 months breakeven contributions or \$1 million; plus
- (b) the value of any prescribed assets; plus
- (c) the value of other assets not available for solvency purposes.

B = The HBFSR determined in accordance with this Standard.

**X = 17% in calendar year 2001;
 33% in calendar year 2002;
 50% in calendar year 2003;**

**67% in calendar year 2004;
83% in calendar year 2005.**

2.3.4 The determination of:

- (a) 2 months breakeven contributions; and**
 - (b) the value of any prescribed assets; and**
 - (c) the value of other assets not available for solvency purposes;**
- is to be made in accordance with the minimum reserving requirements for registered organizations existing prior to 1 January 2001.**

Commentary

1. Where a Fund, to which the transitional arrangements apply, can meet the Solvency Requirement determined in accordance with Division 2.2 of this Standard at a date prior to 1 January 2006, then it would be appropriate for the Fund to calculate and report the Solvency Requirement determined in accordance with the requirements of Division 2.2 of this Standard.

2. During the transitional period, any Organization which is unable to meet the Solvency Requirement as described in Division 2.2 of this Standard, but is able to meet the Transitional Requirements described in Division 2.3 of this Standard, will be considered as having met the Solvency Requirement described in section 73BCD, for the purpose of Part VIA, Division 3 or Part VIA, Division 4 of the *National Health Act 1953*.

Division 2.4 Materiality

2.4.1 Overview

- (1) In many cases in practice, the calculation processes outlined in this Standard and the Interpretation Standard will be able to be simplified by the Organization as it becomes apparent that certain components in the required calculations dominate for certain Funds in certain circumstances. It is not the intention of this Standard to require expensive calculations to be undertaken which have a negligible impact on the overall Solvency Requirement determined.
- (2) However, equally, items that have a material impact on the results should not be understated.
- (3) Particular values or components are considered material to the overall result of a calculation when their misstatement or omission would cause the Solvency Requirement result to be misleading.
- (4) Materiality tests assess the significance of the particular value/component by relating it to the amount of the overall result to which it contributes.
- (5) The Interpretation Standard specifies the appropriate materiality standard to be adopted in respect of each of the major components of the values determined under this Standard.

2.4.2 The Solvency Requirement result determined under this Standard will meet the materiality requirements of this Standard if the component calculations satisfy the materiality standard set out in the Interpretation Standard.

Division 2.5 Statement Relating to the Determination

2.5.1 Report by Organization

- (1) In respect of any determination of the Solvency Requirement, the Organization must provide a report setting out details of the calculation processes and the assumptions used in deriving the results.
- (2) The details of the calculation methods and assumptions should include details of:
 - (a) the determination of the Outstanding Claims Liability;
 - (b) the determination of the Unexpired Risk Reserve;
 - (c) the determination of the Reinsurance Liability;
 - (d) the determination of the Reinsurance Outstanding Claims Liability;
 - (e) the determination of the Solvency Liability;
 - (f) the determination of the Expense Reserve;
 - (g) the determination of the Inadmissible Assets Reserve;
 - (h) the determination of the Resilience Reserve;
 - (i) the determination of any management capital requirement;
 - (j) the determination of any allowance with respect to subordinated debt as permitted.
- (3) The report should also comment on the policies and procedures in place to monitor continuous application of this Standard.