

# GUIDELINES

## MATTERS TO BE INCLUDED IN A FUNDING PLAN

### Background

1. A body corporate, being either:
  - (a) a Medical Defence Organisation (MDO) within the meaning of the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003* (the Act); or
  - (b) a body corporate prescribed in the *Medical Indemnity (Prudential Supervision and Product Standards) Regulations 2003* (the Regulations); or
  - (c) a body corporate related to a body corporate mentioned in (a) or (b);may apply to APRA, under subsection 13(1) of the Act, for a determination under subsection 13(3) of the Act that the minimum capital requirements<sup>1</sup> do not apply to the body corporate during 1 July 2003 to 30 June 2008 (the transition period).
2. APRA can only make a determination under subsection 13(3) of the Act where, at the time of application by the body corporate, the body corporate:
  - (a) is not a general insurer under the *Insurance Act 1973* (Insurance Act), or is a general insurer and is prescribed by the Regulations; and
  - (b) does not, or would not during the transition period, comply with the minimum capital requirements; and
  - (c) lodges a funding plan that:
    - (i) is in the form prescribed by the Regulations;
    - (ii) is certified by an independent auditor and independent actuary; and
    - (iii) complies with guidelines issued by APRA.
3. APRA can not make any determinations on or after 1 July 2005.

### Purpose

4. These guidelines set out the matters to be included in a funding plan lodged for the purposes of subsection 13(3) of the Act.

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<sup>1</sup> Minimum capital requirements are those prescribed by *Prudential Standard GPS 110 Capital Adequacy for General Insurers* made under section 32 of the *Insurance Act 1973*.

## **Authority**

5. These guidelines are made under paragraph 13(9)(a) of the Act.

## **Funding Plan**

6. A funding plan is required when a body corporate does not at the time of application, or would not during the transition period, meet the minimum capital requirements. Accordingly, a funding plan should establish methods and measurable targets to achieve compliance with the minimum capital requirements during the transition period. A funding plan must demonstrate that the body corporate will be able to meet the minimum capital requirements, and any additional capital requirement imposed by APRA, by no later than the end of the transition period.
7. A funding plan should therefore reflect planned developments in the body corporate's operating environment, forecast results and specify measures to be undertaken where targets are not met.
8. A funding plan is not a substitute for a business plan. A business plan is an important management and control tool that enables a company to communicate its strategic direction and objectives, identify opportunities in the market place, forecast results and establish benchmarks. A sound business plan also needs to consider the impact of differing assumptions or scenarios on the body corporate's financial position. A business plan is required by *Prudential Standard GPS 220 Risk Management for General Insurers*.

## **Elements of a funding plan**

### ***Capital position***

9. A funding plan must detail the capital position of the body corporate at the time of application or at the nearest time for which accounts have been prepared. The capital position must be calculated in accordance with the Prudential Standards made under the Insurance Act.<sup>2</sup>

### ***Methods of capital growth***

10. A funding plan must detail what method, or methods, will be used to increase the capital of the body corporate during the transition period. These methods may, for example, include the methods detailed in paragraphs 11-17.

### **Organic growth of capital**

11. This method of capital growth would be achieved through the normal business operations of the body corporate. Profitability, through underwriting, expense control and investments, enables a body corporate to accumulate retained earnings and therefore strengthen its capital position.

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<sup>2</sup> Refer *Prudential Standard GPS 110 Capital Adequacy for General Insurers* and *Prudential Standard GPS 210 Liability Valuation for General Insurers*.

12. This method must be supported by appropriate financial projections with measurable and achievable targets.

#### Raise additional capital

13. Depending on the corporate structure of the body corporate, this method may involve transactions such as a capital injection from a parent entity or entities, or capital raising through the issue of shares or other capital instruments.
14. Where a capital injection is the method to be utilised, evidence will be required to illustrate that contractual arrangements have been put in place with the funding entity and that the funding entity has the available funds, or the ability to raise funds, to fulfil these contractual obligations.
15. This method must be supported by appropriate financial projections with measurable and achievable targets.

#### Restructure business

16. A body corporate may be able to restructure its business strategies, business mix, asset portfolio and reinsurance arrangements to generate a lower minimum capital requirement. A lower minimum capital requirement may enable a body corporate to meet the minimum capital requirements immediately, or may require the body corporate to increase its capital base by a smaller amount than would have been required if no restructure occurred.
17. This method must be supported by appropriate financial projections with measurable and achievable targets. It must also be supported by details on how and when the current business will be restructured.

#### ***Measurable targets***

18. A funding plan must set measurable and identifiable targets supported by appropriate financial projections to illustrate how these targets are to be achieved. Targets must be set on a quarterly basis and a funding plan must require the body corporate to report to APRA on the compliance or otherwise with those targets.<sup>3</sup>
19. At the absolute minimum, a funding plan must set targets for the minimum capital to be achieved at the end of each quarter. Other targets may be set for matters such as premium revenue, investment revenue, reinsurance expenses and other operating expenses.
20. Targets that relate to minimum capital must be set at levels that:
  - (a) take into account, and are reflective of, the underlying risk profile of the body corporate; and
  - (b) will enable the body corporate to meet insurance and other liabilities as they fall due; and

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<sup>3</sup> For reporting requirements see paragraphs 30-35.

(c) will not adversely affect policyholders.

21. The maximum available transition period is five years, however APRA will not accept a funding plan that aims to increase capital resources within the final year of the transition period only. A funding plan must demonstrate a commitment to steady, if not immediate, capital growth over the transition period to support the business risks and ensure that compliance with minimum capital requirements will occur by the end of the transition period.

***Measures to address non-compliance with targets***

22. A funding plan must specify what types of measures will be taken by the body corporate should there be a failure to meet specified targets. This will ensure that the body corporate has considered the possibility that targets will not be met and has developed appropriate strategies to address non-compliance.
23. At a minimum, the funding plan must provide for reporting to the Board, at least in line with reporting to APRA,<sup>4</sup> of a failure to meet the specified targets. A body corporate should have in place appropriate management information systems and controls to support the monitoring and required reporting functions of the funding plan. These systems and controls should be reflected in the body corporate's Risk Management Strategy as required in accordance with *Prudential Standard GPS 220 Risk Management for General Insurers*.
24. Specific measures to address the non-compliance may include:
- (a) using an alternative method to increase capital to the targeted level;
  - (b) revising projections and targets;
  - (c) altering reinsurance arrangements; and
  - (d) ceasing to undertake new business until targets have been met.
25. In addition to identifying such measures, the funding plan should also identify the systems and procedures in place to support carrying out the specified measures.

***Financial projections***

26. A funding plan must use financial projections to support targets. Financial projections should be undertaken on a best estimates basis, and the funding plan should identify the key risks that may impact on the achievement of the targets by the body corporate. A funding plan should therefore:
- (a) be based on projections prepared using assumptions that are consistent with the assumptions underlying the liability values calculated in accordance with *Prudential Standard GPS 210 Liability Valuation for General Insurers*;

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<sup>4</sup> See paragraphs 30-35.

- (b) use projections that are based on assumptions that are reasonable and appropriate having regard to the actual experience and data of the body corporate;
- (c) use projections that are based on quarterly periods; and
- (d) incorporate, to the extent possible, projections that indicate the sensitivity of projections to the key risks identified.

### ***No reduction in capital***

27. A funding plan must not permit a reduction in capital, unless prior APRA approval is obtained. A reduction in capital includes, but is not limited to:

- (a) repatriation to a parent entity;
- (b) share buybacks;
- (c) the redemption, repurchase or early repayment of any eligible capital instruments issued by the body corporate or a special purpose vehicle;
- (d) trading in own shares; and
- (e) interest and dividend payments.

28. APRA will only consider granting approval for a reduction in capital where a body corporate can demonstrate to APRA that such a reduction will not adversely affect policyholder interests. APRA's approval may be subject to conditions.

29. In no circumstances will APRA allow a capital reduction where a body corporate is not meeting targets specified in its funding plan.

### ***Reporting***

30. A funding plan must include a specified commitment by the body corporate to report to APRA, in writing, whether the target or targets set out in the funding plan have been met. Where specified targets have not been met, the report must identify these and must also identify the measure or measures that have been, or will be, used to address the non-compliance and achieve the targets.

31. Reporting must be on both a quarterly and annual basis.

### **Quarterly reporting**

32. A report must be submitted to APRA within 20 business days after the end of each 3 month reporting period (based on the financial year of the body corporate). This report must be signed by the Principal Executive Officer<sup>5</sup> or the Chief Financial Officer (whatever his or her official title may be) of the body corporate.

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<sup>5</sup> 'Principal Executive Officer' means the principal executive officer of the body corporate for the time being, by whatever name called, and whether or not he or she is a member of the governing board of the body corporate.

33. A report in accordance with paragraph 32 must be based on analysis of available key financial data, for example asset movements, investment revenue and operating expenses. It is not expected that this report include a comprehensive assessment or review of all assumptions and elements of the funding plan, only those that can reasonably be assessed on a quarterly basis.

#### Annual reporting

34. A report must be submitted to APRA on an annual basis as follows:

- (a) for a body corporate that is a disclosing entity to which paragraph 319(3)(a) of the *Corporations Act 2001* applies – within 3 months after the end of the financial year of the body corporate; and
- (b) for a body corporate to which paragraph 319(3)(b) of the *Corporations Act 2001* applies (that is, a body corporate that is not a disclosing entity) – within 4 months after the end of the reporting period.

35. The report in accordance with paragraph 34 must be signed by the Principal Executive Officer or the Chief Financial Officer (whatever his or her official title may be) of the body corporate and must be based on a detailed review and analysis of all of the key elements of the funding plan. In preparing this report, the body corporate must take into account the advice of its auditor and actuary. Any departure from the auditor's or actuary's advice must be disclosed.

#### ***Revisions to the funding plan***

36. A body corporate should review the adequacy of its funding plan on an annual basis. However, a funding plan may only be revised when a body corporate:
- (a) fails to meet a target, or targets, specified in the funding plan;
  - (b) receives advice from its independent auditor or independent actuary that the information contained in the funding plan should be revised; and
  - (c) seeks APRA's prior approval on the grounds that there are circumstances that warrant a revision to the funding plan.
37. A revised funding plan must not reduce the target levels of minimum capital set out in the original funding plan without APRA's prior approval.
38. Where a body corporate revises its funding plan it must lodge a revised funding plan with APRA within 14 days after the funding plan has been revised and approved by the Board of the body corporate. The revised funding plan must comply with all of the requirements in these guidelines and must also be certified by an independent auditor and independent actuary in the same manner as the original funding plan.<sup>6</sup>

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<sup>6</sup> Refer to paragraph 39.

### ***Certification***

39. A funding plan must be certified by an independent auditor and independent actuary.<sup>7</sup> Reports provided by the auditor and actuary to the body corporate certifying the funding plan must be lodged by the body corporate with APRA together with the funding plan.<sup>8</sup>

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<sup>7</sup> This requirement is imposed by subparagraph 13(3)(d)(ii) of the Act.

<sup>8</sup> The matters to be certified by the independent auditor and independent actuary are specified in guidelines made by APRA for the purposes of subparagraph 13(3)(d)(ii) of the Act: *Guidelines – Certification of Funding Plans by Auditors and Actuaries*. The requirements relating to the qualifications and independence of the auditor and actuary are specified in guidelines made by APRA for the purposes of subparagraph 13(3)(d)(ii) of the Act: *Guidelines – Qualifications and Independence of Auditors and Actuaries*.