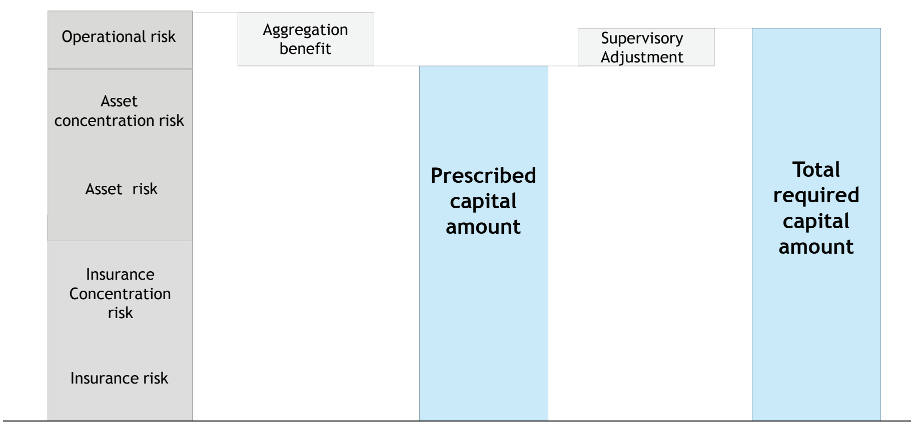
Concurrent Session: General Insurance

Insurance Capital Review Seminar

30 June 2010

Hosted by

Components of required capital



Asset risk capital charge

- Current factor based approach (investment risk charge)
- Current charge makes no allowance for:
  - duration mismatch between assets and liabilities
  - inflation and currency mismatch risks
  - increasing credit risk as term of assets increase
  - diversification benefits of holding a mixture of assets from different asset classes.
- Existing investment risk charge GPS 114 will be replaced by the 'asset risk capital charge'.

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Asset risk capital charge

- The new charge will be more risk sensitive than the old one
- The asset risk capital charge is based on series of stress tests to the balance sheet
- Some similarities to the existing life insurance approach
- The same charge will apply to both life and general insurers

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Asset risk modules

- Real interest rates
- Expected CPI inflation
- Currency
- Volatility
- Equity
- Property
- Credit spreads
- Default

Interest and inflation stresses

	Maturity (years) 1	2, 3	4, 5	6, 7	8+
Real interest					
up	80%	70%	65%	60%	55%
down	-70%	-60%	-55%	-50%	-45%
Inflation					
up	95%	75%	65%	60%	55%
down	-85%	-65%	-55%	-50%	-45%

Other stresses

- Foreign currencies rise or fall by 25% against the AUD
- Equities – dividend yield increases by 2.5%
- Property – rental yield increases by 2.75%
- Credit spreads increase by 0.6% (AAA) or 1.5% (A rating)
- Default – same as GPS 114 for reinsurance recoveries, other recoveries, unpaid premiums, unclosed business.

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Aggregation of asset risk charges

- Stresses in all 8 modules are most unlikely to occur simultaneously
- A correlation matrix will be used
- Reduces the capital charge by up to 50% compared with simple addition
- Higher correlations between currency, equity, volatility
- Lower correlations between currency, interest rates, inflation.

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Other asset risk issues

- Materiality – simplify calculations

- Inflation risk – already captured to an extent in the insurance risk margins
  - need to ensure no double-counting

Asset concentration risk capital charge

- Charge for large exposures to individual assets or to a single counterparty or group of related counterparties
- 100% risk charge for the portion of any large exposures which exceed prescribed thresholds
- Current limit of 50% of capital base for rating grade 4 and for property, 25% of capital base for rating grade 5
- Lack of limits on exposures to grade 1, 2 or 3 counterparties is considered inappropriate.

Asset concentration risk capital charge

Proposals

- Maintain 100% capital charge for excess of assets over limits
- Base limit of 25% of capital base
- No limit for govt exposures with grade 1 or 2
- 50% of capital base for exposures to APRA regulated parties
- 100% of capital base for exposures to related entities which are also APRA regulated
- Dollar minimum thresholds for exposures to strong counterparties (eg. Banks)
- No change to limits for reinsurance exposures.

Insurance risk capital charge

No change in overall approach, some changes to factors

Direct Business

- Travel 9%→11% for OSC (13.5%→16.5% for PL)
- Mortgage 11%→15% for OSC (16.5%→22.5% for PL)
- Actuary to choose charge most appropriate for ‘other classes’

Reinsurance business

- Align class groupings to match direct
- Remove distinction between facultative & treaty
- Collapse number of risk charge groups from 12 to 6

Insurance concentration risk capital charge

- Assuming limit of cover exceeds PML, current capital charge = MER plus cost of one reinstatement
- Aim to maintain adequate capital to withstand one large event
- BUT:
  - Ambiguity around definition of a large event
  - Does not address capital impact of unexpectedly large retained losses
  - More clarity needed for non property insurers
- Proposals not yet finalised - Technical paper expected in July / August

Insurance concentration risk capital charge

- **Likely content of proposals - Definition of a large event:**
  - retain PML concept and requirement for one reinstatement of cover
  - clarify PML based on single region/ single peril
  - same limit of cover for two insurers similarly exposed to a location specific peril, regardless of other exposures
  - remove reference to discretionary requirement for whole of portfolio approach

Insurance concentration risk capital charge

- **Likely content of proposals - Allowing for multiple events:**
  - Unexpected levels of retained losses from multiple events can impact capital adequacy if retentions are high.
  - APRA considering addressing this risk through either:
    - a) supervisory process (capital management plans, reinsurance strategy, stress testing) <u>OR</u>
    - b) a modification of the rules based formula to deal with the impact of net retained losses from more than one event
  - Some preference for (b) but details yet to be finalised

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Insurance concentration risk capital charge

- **Concept for modification to rules based formula:**
  - Retain PML, MER, one reinstatement requirement
  - Capital charge based on a proportion of losses arising from multiple events within one treaty year, with the proportion reducing as the likelihood of events become more remote.
  - Eg: $a \times MER_1 + b \times MER_2 + c \times MER_3 + d \times MER_4$ + cost of one reinstatement, where a,b,c,d <1
  - Would take account of cover which limits retained losses
  - Detail needs to be worked through

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Insurance concentration risk capital charge

- **Likely content of proposals - Non property classes:**
  - property insurers need to consider risks from non property classes
  - outline expectations for identification of maximum event
  - clarify methodology for netting reinsurance assets for insurers with stop loss cover
  - For classes such as trade credit, LMI - allow deduction of a portion of premium liability provision

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Operational risk

Proposed Charge

ORCC = 3% x max {GP + |Δ|, (PL+OSCL) + |Δ|}

where:

- GP = Total annual earned premiums (gross of reinsurance)
- PL = Gross Premium Liability (central estimate)
- OSCL= Gross outstanding claims liability (central estimate)
- |Δ| = Absolute value of the annual change in the relevant quantity (from year t-1 to t) for changes which exceed ±10%.

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Other items

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- Risk margins
  - maintain 75% PoS approach
  - require risk margins on recovery assets
- Diversification
  - collect information on diversification benefit in risk margins
  - may limit overall level allowed
- Discount rates
  - maintain requirement to use yields from Commonwealth Government Bonds
- Capital base
  - no double counting of regulatory capital
  - may limit quantum of Tier 2 capital allowed

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Questions?

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