VIEWS FROM THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

HELEN ROWELL

Executive General Manager, Supervisory Support Division
Australian Prudential Regulation Authority

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Slide 1 – Intro

Good morning everyone. It is a pleasure to be here to speak to you today.

Some of the speakers this morning have made comments about the events of the last few years. The spectacular thunderstorm in Sydney on Sunday evening was a reminder for me of the storms last summer, when I was in Brisbane for a very wet Christmas. I used to love thunderstorms, but the weather events of the last few years have really changed that. On Sunday evening, rather than enjoying the lightning show and the sound of the thunder and heavy rain, my first thoughts were about whether or not it was hailing somewhere in Sydney and the number and amount of insured claims that may result. That is clearly one of the downsides of close association with the insurance industry over a number of years combined with the paranoid outlook of a prudential regulator. I can only imagine what it must be like for those of you that work for insurers!

The industry has demonstrated its resilience over the last few years, in the face of a spate of catastrophe events and the pressures created by ongoing economic and market uncertainty. Nevertheless, APRA remains on 'heightened alert' status and continues to remind all of the industries that we regulate of the need to be wary of complacency.

Fortunately, we have experienced a more benign summer (so far) in 2011/12 than we had in 2010/11 and there has been more positive news for global financial markets to absorb in recent months. Global and domestic equity markets have firmed and market volatility has returned to average levels or below. These are positive developments for the capital position of the insurance industry, although interest rates and investment returns remain low. Market sentiment is also fragile and is likely to remain so, certainly until European governments can demonstrate tangible progress in dealing with their sovereign debt crisis.

Looking through these market uncertainties, as a prudential regulator must do, the current operating environment presents challenges for the Australian financial sector, including the insurance industry. Insurers need to consider how to sustain profitability and a sound financial position through the tough and uncertain market and industry environment that lies ahead.

It is against this backdrop that I will outline for you this morning just some of the issues on APRA's agenda for the insurance industry over 2012 and beyond.

Slide 2 – Agenda

I will start with some brief comments on APRA's perspective of the current environment and its implications for the industry, and hence the areas on which APRA is currently placing particular focus. I will also touch on where we are up to in our review of insurance capital, and in particular some of the issues that have been raised in feedback received to date on the consultation package released in December.

APRA has been emphasising in a number of forums the need for insurers to adopt a holistic approach to risk and capital management. In that context I will make some observations about risk appetite, stress testing and the ICAAP requirements under LAGIC. I'll also comment on reinsurance management and the use of catastrophe models, based on our assessment of industry practices in dealing with the events that have impacted insurers over the last few years.

Finally, I will conclude with some brief comments on international developments and a few other issues that are currently on APRA's agenda that are of relevance to general insurers, namely remuneration and the role of boards and senior management.

Slide 3 – Current environment & industry risks (chart)

As this graph shows, the general insurance industry remains well capitalized. At 31 December 2011 the industry held close to 1.8 times the minimum capital requirements set by APRA and surplus capital of close to $12bn. Capital coverage of the industry did reduce a little over 2011 but still remains very strong.

The industry has also maintained its profitability over the last four years, notwithstanding the pressures it has faced on underwriting results and from lower investment returns.

However as I noted earlier, pressures remain and it will be challenging for insurers to sustain their profitability and maintain a sound financial position over the coming years. This continuing uncertain environment heightens the need for sound risk and capital management by insurers so that they are well positioned to respond to developments as they unfold.

Slide 4 – Current environment & industry risks (cont)

APRA will, as always, maintain its proactive and risk-based approach to supervision, seeking to ensure that it is on top of the material factors that will impact the strength and performance of the industry.

There are, however, some areas on which APRA will be placing particular focus over the coming year or so. Some of these areas were also on APRA's radar in 2010 and 2011, while others are coming back into sharper focus for 2012.

Reinsurance is not surprisingly an area that we have been monitoring closely for the last few years given its importance to the financial strength of the industry.

Reinsurance counterparty risk

In early 2011, APRA undertook a data collection to assess whether the failure or material downgrade of a major reinsurer was a material risk for the industry. Pleasingly, the information provided showed that the industry is well diversified in terms of reinsurance counterparties from a geographical standpoint and across APRA and non-APRA-authorised reinsurers. In excess of 90% of the reinsurers utilised are also rated APRA grade 3 (S&P A rated) or higher. APRA is considering whether to make this data collection permanent so that it can more readily monitor reinsurer counterparty exposure going forward.

Placement risk

The catastrophe events in Australia and New Zealand in 2010 and 2011 have lead to some reinsurers reducing or restructuring the cover they are willing to provide in the region or requiring significant price increases for some types of cover. Consequently, some insurers may retain greater catastrophe risk on their balance sheet, in turn increasing the volatility of their capital position and also their capital requirements.

For insurers with material property exposures, APRA has been undertaking targeted reviews of their reinsurance strategy and its alignment with their risk and capital management strategy. APRA has also been looking at changes made to reinsurance arrangements and capital triggers, the robustness of stress-testing for catastrophe events and the approach to use of catastrophe models. These reviews are intended to provide APRA with a better overall view of the impact on industry from the recent catastrophe events and the changes occurring in the reinsurance market. It is also highlighting areas of good practice and where there is room for improvement.

Catastrophe modelling

One such area is in relation to catastrophe models, where poor governance practices in the use of these models can have a significant impact on an insurer. I will come back to this issue a little later.

APRA will continue its targeted reinsurance reviews throughout 2012 and provide feedback to individual insurers and the industry on the outcomes of these reviews.

Pricing processes

Sound pricing practices and processes are fundamentally important for insurers, as inadequate pricing resulting from poor pricing processes potentially exposes them to the risk of significant losses. Review of insurer pricing processes and controls forms a core part of APRA's supervision activities, however we see heightened risk in this area at present for a number of reasons. These include: increased competition within the industry (including from aggregators), likely increases in reinsurance retentions and costs, and the deterioration in the profitability of some classes of business that may have been masked by the release of reserves in recent years.

APRA's review of pricing processes and controls over recent years suggests that there is room for improvement in the development of technical prices, and in the monitoring of pricing that is undertaken by insurers, for example of actual versus technical rates. This will remain an area of focus for APRA over 2011/12 and in future.

Adequacy of reserving

Reserve releases have been a feature of general insurers' results in recent years and, as noted above, have the potential to mask deterioration in profitability. This is also an area that is looked at on a regular basis by APRA, however the current challenging environment for the industry heightens the risk of reserve releases being used to boost apparent profitability.

APRA is planning to undertake an internal review of the reserving strength of a range of insurers, focusing on the underlying assumptions and methodologies used across key classes of business. APRA will look to provide specific feedback to individual insurers once the review is completed and will also consider publishing any general observations on industry practice that may emerge from the review.

Slide 5 – Insurance capital review (LAGIC)

You are all more than aware that APRA has been undertaking its review of the capital standards for general and life insurers over the last two years. In December 2011, we released a second response paper and 14 draft prudential standards for consultation. Submissions on this consultation package are due this Friday.

The remaining key milestones in the project timetable for this year are shown on this slide, and include issue of the final capital standards and consultation on the reporting requirements in the middle of the year.

APRA intends that the new capital framework will be effective from 1 January 2013, however there is provision for transition arrangements which I will touch on shortly.

Slide 6 – Insurance capital review (LAGIC)

I'm assuming that most of you are familiar with the key aspects of APRA's proposals. So let me briefly touch on a couple of the key areas that have been raised in the informal feedback that we have received to date on the December package.

Composition of capital

APRA outlined in the December response paper its proposed criteria and limits for the composition of the capital base of insurers. The proposals are intended to substantially align these requirements with the proposed requirements for authorised deposit-taking institutions (ADIs) under APRA's implementation of the Basel III capital framework. APRA's practice for many years has been to maintain consistency of capital definitions for ADIs and general insurers.

The proposed criteria for capital instruments to qualify as Common Equity Tier 1, Additional Tier 1 and Tier 2 capital are the same as proposed for ADIs. The proposed limits are expressed as a percentage of required, rather than total, capital. This is consistent with the proposed limits for ADIs which are expressed as minimum percentages of risk-weighted assets rather than as a proportion of capital base. The proposed limits for general insurers have also been set to broadly align with the proposed minimum requirements for ADIs, so that the proportion of minimum required capital represented by the different components of capital is similar.

APRA had previously signalled its intention to align this aspect of the capital framework for ADIs and insurers. The response paper in December was, however, the first time that APRA had provided details of its proposed criteria and limits for the capital base for insurers. APRA therefore welcomes comments on these proposals.

We are aware that some insurers are concerned that the limits are unduly constraining, will require changes to the mix of capital instruments issued and will increase the cost of capital for the industry. Some insurers have also raised questions in relation to the treatment of current capital instruments that do not meet the revised criteria to qualify as regulatory capital. APRA is happy to discuss any such concerns, and appropriate transitional arrangements, with individual insurers.

APRA will be releasing a draft of GPS 112, the measurement of capital standard, in late March for its first round of consultation. This draft will necessarily be based on the proposals in the December response paper as we will not be able to fully reflect comments made in the submissions that we expect to receive later this week. The comments in submissions on the response paper will be fully considered before the final standards are issued later in the year.

Insurance Concentration Risk Charge

APRA has received considerable feedback on the insurance concentration risk charge, or ICRC. In particular on the impact of the horizontal requirement, the component of the ICRC that is intended to address a series of material catastrophe events over a year.

The key concerns raised include that it is overly conservative, that reinsurance to offset the requirement is more expensive and less readily available and that there are implementation issues related to the timing of reinsurance renewals. In APRA's view, the events of the last few years serve to demonstrate the need for the risk of multiple events to be addressed in the capital framework. We do not share the view that the horizontal requirement is unduly conservative. The other issues appear to be ones that can be dealt with through appropriate transition arrangements. APRA encourages insurers to outline in their submissions details of their concerns in relation to the ICRC and in particular any transition issues that may need to be addressed.

Transition arrangements

Which brings me to the topic of transition.

There have been requests for APRA to consider deferral of the implementation date for the LAGIC proposals. APRA's view is that there is no need for a general deferral of the implementation date from 1 January 2013. The vast majority of the underlying policy proposals have not substantively changed since the release of the March 2011 response paper. Any remaining areas of concern are limited to one or two areas (such as the capital base proposals and the horizontal requirement that I have just touched on). Further, in most cases these concerns or issues will be able to be addressed through appropriate transition arrangements.

APRA has indicated that it plans to work with insurers throughout 2012 to determine the transition arrangements that may be required on a case by case basis. APRA is also considering, however, whether a short delay in the implementation of the horizontal requirement component of the ICRC is warranted. APRA will make a decision on this as quickly as possible, once it has had an opportunity to consider the information provided in the submissions that are due this Friday.

Slide 7 – Risk appetite, stress testing and ICAAP

One of the other areas that APRA has received a number of questions about is the implementation of the ICAAP requirements and I will come back to this in a moment. I'd first like to provide some context around risk appetite and stress testing and how these link to the ICAAP requirements under LAGIC.

As I mentioned earlier, APRA has been emphasising in a number of forums the need for insurers to adopt a holistic approach to risk and capital management. The starting point for this is the insurer's risk appetite.

APRA expects there to be a clear link between an insurer's risk appetite and its risk and capital management framework, including the target capital levels determined as part of the insurer's ICAAP. APRA expects that target capital levels will be set in accordance with the insurer's risk appetite and not solely by reference to APRA's minimum capital requirements.

The Board is primarily responsible for an insurer's risk management framework and risk management strategy. Integral to this is responsibility for setting the company's risk appetite, which should provide a clear statement of the degree of risk the insurer is willing and able to take in pursuing its objectives. Without a clear and considered risk appetite statement, risk management throughout an insurer's business will be carried out on uncertain foundations, with unclear expectations.

APRA has recently reviewed a number of insurers' risk appetite statements and spoken to CEOs and boards about the engagement of the board in the process for setting the insurer's risk appetite. Some of the issues that have emerged from APRA's review include that there is:

- no clear statement of risk appetite, or a lack of understanding of the concept;
- a questionable level of engagement by the board in setting the risk appetite;
- a wide range of quality of the risk appetite statement, from poor to quite good;
- a lack of analysis using stress testing or scenario analysis to set the risk appetite; and
- a disconnect between the risk appetite statement and its translation into operational, and hence risk and capital, management.

In response, APRA is increasing its focus on risk appetite. APRA is continuing the development of an internal checklist for what supervisors should look for in an insurer's approach to risk appetite. APRA is also continuing to provide feedback to industry through a range of forums and intends to issue industry guidance on this topic in due course.

Stress testing

As I have noted, APRA expects stress and scenario testing to be used both in setting the insurer's risk appetite and in developing target capital levels. It should form part of the insurer's ongoing capital management, and therefore be an integral part of an insurer's ICAAP. It should also play a key role in determining an insurer's reinsurance strategy.

Rigorous, forward-looking stress testing supports capital and reinsurance management by identifying severe events, including a series of compounding events or changes in market conditions that could adversely impact the insurer.

APRA reviews the approach taken by insurers to stress and scenario testing as part of its regular supervision activities. APRA has also previously undertaken surveys of industry practice in this area. As with risk appetite statements, there is a range of practice from poor to quite good. Some of the areas for improvement include the nature of the stresses and scenarios considered, in particular their severity, and the adequacy of the reporting to the board. APRA intends to develop cross-industry guidance on stress testing in due course. In the meantime, requirements and guidance on stress testing are being included as part of the ICAAP requirements under LAGIC.

ICAAP

As I have noted, some insurers have asked questions about the ICAAP requirements, and in particular what is expected to be included in ICAAPs and what has to be reported to APRA and when.

APRA already expects insurers to have in place a process for assessing overall capital adequacy and setting capital targets, and a strategy for maintaining capital levels. The proposed ICAAP requirements therefore build on APRA's current capital management requirements and guidance for insurers, and the existing requirements for capital management plans will be subsumed into the ICAAP requirements.

Further details of APRA's expectations in relation to ICAAP were set out in the December response paper and draft standards. APRA will also issue for consultation later in 2012 guidance on ICAAPs.

The December package distinguished two documents that need to be produced: the ICAAP summary statement & the ICAAP report.

The ICAAP summary statement is intended to be a roadmap, briefly describing and summarising the capital assessment and management processes of the insurer. This document is expected to be developed and available to APRA from 1 January 2013. As the ICAAP builds on existing capital management requirements and practices, APRA's view is that insurers should be able to meet this timeframe.

The ICAAP report is an annual report that will summarise the outcomes of applying the ICAAP over the last year and give an overview of expected capital management actions and issues for the coming period. It should include details of actual capital levels and capital management actions during the previous period, and projected capital levels and planned capital management actions. It should also summarise any changes to capital targets or other aspects of the ICAAP. The first ICAAP report will be due four months after the first balance date after 1 January 2013, so at the end of October 2013 for June balancers and in April 2014 for December balancers.

APRA expects that the ICAAP will be developed by the insurer's senior management with input from relevant areas and experts. However, the ICAAP is fundamentally the responsibility of the Board: the Board should be actively engaged in the development of the insurer's ICAAP and its implementation, and must ultimately approve the ICAAP.

APRA expects that the first round of preparing ICAAP summary statements and reports will be an education process for both insurers and Boards. APRA is not expecting that the first ICAAPs will be perfect. APRA will work with insurers over the next few years, reviewing and providing feedback on their ICAAPs, and finalising its PPG on ICAAPs to provide broader industry guidance on its expectations.

Slide 8 – Reinsurance and use of catastrophe models

Let me come back to the topic of reinsurance management and the use of catastrophe models.

As many in the industry have noted, the series of catastrophe events over 2010/2011 had, and will continue to have, a significant impact on the general insurance industry. While the resilience of the industry is indeed a credit to management and boards, the events highlighted several issues that warrant close attention from both industry and APRA.

APRA's review of the response to these events (which I have commented on earlier) identified a few areas where industry practice could improve.

For example, industry needs to better articulate in their Reinsurance Arrangement Statements (RAS) what their reinsurance arrangements are and how they operate, including worked examples. The schematics in the RAS need to accurately reflect the words (and vice versa).

I've also noted the need for stress testing by insurers as part of establishing their reinsurance arrangements. In particular, APRA has suggested that insurers should consider the potential impact of a series of events similar to those of 2010/2011, the erosion of lower layers and back up covers, and further reinstatements being unavailable.

Reinsurance catastrophe modelling

There is also a need for insurers to have strong governance and risk management practices around the use of catastrophe models. Catastrophe modelling can be a great resource when structuring reinsurance programmes; however, when not used appropriately it can be dangerous.

Models can give misleading answers for a number of reasons:

- fundamental inadequacy of the model;
- over reliance on mathematical theory and/or poor reflection of the real world; and
- inappropriate inputs that produce nonsense outputs.

It is therefore important that insurers do not accept the model output blindly and use this as the basis for the purchase of catastrophe cover. Insurers should also not rely on a single model. Otherwise they may purchase inadequate levels of reinsurance and be exposed to significant claims costs in the event of a natural catastrophe.

Model uncertainty is not necessarily a defect of the models; rather, it is an unavoidable aspect of any model. The challenge for insurers is to adequately understand and address that uncertainty. Insurers should understand the limitations of any models that are used and embed an awareness of model uncertainty into their overall risk management framework. That will enable them to make model-related decisions with a conscious eye towards the possibility of model error.

APRA will continue to assess this issue in more depth, with a view to releasing a guide to good practice in model assessment in due course. We also intend to encourage boards and senior management to develop a good understanding of the limitations of models and the importance of appropriate use of models.

Slide 9 – Other current APRA issues

Let me turn now to one or two other issues cross-industry issues of relevance to insurers

International developments

Systemic importance assessments (G-SIIs)

There is a lot of work underway internationally on the identification of global systemically important institutions and appropriate regulatory and supervision measures for such institutions. To date a lot of the commentary and focus in this area has been on banks, but work is also underway in relation to insurers.

APRA is actively involved in the analysis being undertaken by the International Association of Insurance Supervisors (IAIS) on what might constitute a global systemically important insurer (or 'G-SII' for short). The IAIS is also developing policy measures for systemically important insurers whose failure would have significant cross-border repercussions. In fact, Ian Laughlin is attending IAIS meetings in Basel this week and this is one of the topics on the agenda.

This has proved to be quite a challenging issue. The IAIS is currently considering various possible methodologies and scenarios for the determination of G-SIIs, with a view to publishing final G-SII methodologies and appropriate policy measures in November 2012. This will be input to the FSBs activities in this area but will also form the basis of future IAIS developments.

As is the case in banking, it is likely that this work will flow in due course to consideration of the identification of domestic SIIs and appropriate policy measures for them. APRA will continue to actively participate in the work of the IAIS in this area and consider its implications for Australia as it develops.

Recovery & resolution plans

Another topic receiving international attention is recovery and resolution planning – sometimes referred to as living wills.

Recovery plans are measures that would enable a financial institution to survive a destabilising event (e.g. strategies for raising additional capital or disposing of core business). Resolution plans are measures that would enable a cost-effective resolution to be implemented by the authorities where recovery is not possible (e.g. simplifying complex group structures to facilitate resolution).

They are clearly related, as both deal with distress events that threaten the viability of a financial institution and seek to achieve a resolution that minimises adverse systemic impact, at the lowest risk to taxpayers.

The concept of a living will is not entirely new. Regulators have for many years required financial institutions to have recovery plans of one sort or another; however, recovery plans have generally taken the form of limited, and often quite generalised, supervisory requirements.

APRA has begun its own work in this area. Our initial priority is recovery planning in the ADI industry. In the latter part of 2010/11, APRA established a pilot program on recovery planning for a number of the larger ADIs, requiring them to prepare a comprehensive recovery plan that sets out the specific actions they would take to restore themselves to a sound financial condition in the face of a major depletion of capital and associated liquidity pressures.

Finalised plans for these ADIs will be required by mid-2012 and APRA intends to extend its recovery planning program to a wider set of ADIs in 2012/13. Recovery planning is also likely to be extended to the larger general insurers and life insurers in due course, modified to suit the nature of their business. It will also take into account the ICAAP requirements, as there is some overlap.

APRA will also be undertaking an assessment of institution-specific resolution planning, but only after it is satisfied that substantial progress has been made on recovery planning.

The living will concept is being adopted by supervisory agencies in a number of countries (including the US and Canada) and is increasingly becoming a core element of prudential supervision. While international developments in this area will influence APRA, our requirements will be tailored to the peculiarities of our markets and will reflect our standards.

Remuneration

As you may recall, in April 2010 APRA introduced new requirements in relation to remuneration. The requirements aim to ensure that regulated institutions' remuneration arrangements promote prudent risk-taking in the management of their business, and that there is effective governance of remuneration matters.

Since then, APRA's supervision teams have monitored progress on implementation as part of their normal ongoing activities. APRA recently met with the Board Remuneration Committees of a group of institutions to discuss the manner in which they provide oversight of remuneration arrangements for senior executives and how policy is translated into practice.

From its discussions, APRA identified a number of issues warranting further consideration and has requested that all ADIs, general insurers and life insurers consider whether improvements could be made to current remuneration policies and practices. Some of the issues to consider that were noted in the recent letter that was sent to most ADIs and insurers include:

- Is the Remuneration Committee well-established with clear governance arrangements?
- Are there strong linkages between remuneration and risk management oversight by the Board or its committees?
- Is the primacy of the Board in setting remuneration arrangements for relevant staff well understood and recognised in practice?
- Do KPIs adequately reflect potential risk-taking by an individual as opposed to the wider management team?
- Is the Remuneration Committee satisfied that appropriate weight is being given to risk-related KPIs?
- Is the quality of risk management explicitly taken into account in the KPIs?

We expect to see industry remuneration practices evolve over time in response to these considerations and will continue to engage with boards and senior management on these issues.

Slide 10 – APRA's expectations of boards

Finally, let me conclude with some comments on the role of boards and senior management.

Feedback from boards is that we are expecting too much of them – that they're being over-burdened with regulatory requirements and we're confusing the role of the board with that of senior management.

The Insurance Act imposes primary responsibility for protecting the interests of policyholders on the directors and senior management of general insurers. Given the critical role of the board in protecting policyholders' interests, APRA places obligations on all insurance company boards through its prudential standards.

APRA's prudential standards empower boards because they give a frame of reference for good practice. Boards rely heavily on management in many ways, apart from the obvious one of running the business. Management has an obligation to recognise the difficult role the board has and to make it as easy as possible for the board to meet its responsibilities. Management can have a great influence on the board's priorities and on the way it performs its role, and ultimately on how well it meets its regulatory obligations.

There is therefore much that management can and should do to support boards, including:

- help the Board think ahead, including to meet regulatory requirements;
- provide clear and targeted information so that the main essence of an issue can more be readily determined;

- provide tools to complement documents to explain issues, for example sensitivity tables or graphs in capital management considerations.

Boards meet relatively infrequently and many directors do not work in the insurance industry. Therefore, to enable boards to make balanced, informed decisions, senior management should provide directors with access to important and relevant material in a manner that is able to be readily digested and understood.

This approach, in turn, helps APRA and we get a virtuous circle like that shown on the chart.

Stronger support of boards by management will give APRA more confidence that boards are meeting their regulatory obligations and lead to lower intensity of supervision by APRA.

Slide 11 – Closing and Questions

So, I have covered a lot of ground this morning and hopefully given you a good perspective of APRA's 2012 agenda and priorities for the general insurance industry.

The industry has much to give itself a pat on the back for given its sound performance over what has been a very challenging few years. As I said at the outset, however, there is no room for complacency as the current challenging environment looks like it will continue for the foreseeable future.

APRA and the industry have a shared interest in ensuring its ongoing financial strength. We look forward to continuing to work with you to you achieve that objective through sound risk and capital management!

I'd be happy to take questions.