Mrs Helen Rowell
General Manager, Policy Development
Australian Prudential Regulation Authority
400 George Street
Sydney NSW 2000
Email: InsuranceCapital@apra.gov.au

12 August 2010

Dear Mrs Rowell

REVIEW OF CAPITAL STANDARDS FOR GENERAL INSURERS AND LIFE INSURERS

The Insurance Council of Australia[1] (Insurance Council) welcomes the opportunity to comment on APRA's Discussion Paper for its review of capital standards for general insurers and life insurers. The Insurance Council and its members appreciate the open and consultative approach taken by APRA since it commenced this project

The Insurance Council strongly endorses APRA's goal of making its capital requirements more risk sensitive. It is also supportive of APRA's intention to improve the alignment of its capital standards across the industries it regulates, although the Insurance Council would urge APRA to recognise the different characteristics and needs of each industry.

As discussed at our meeting on Level III supervision on 18 June and the APRA briefing on Basel II and III on 23 July, Insurance Council members consider that the characteristics of general insurance differ from those of other financial services sectors, particularly banking. General insurers have lower financial vulnerability, with their financial position deteriorating at a much slower pace if they are in trouble. This enables the regulatory framework to facilitate the early detection of financial problems and the application of progressive corrective action by management and supervisors.

Even were a general insurer to fail, an orderly wind-up is much easier since they aim to match expected future claims by policyholders with sufficient assets, which facilitates the transfer or run-off of their portfolios. Given these differences, it appears unnecessary from the point of view of policyholder security to apply to general insurance capital requirements developed for the banking sector.

[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. December 2009 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross premium revenue of $32.9 billion per annum and has total assets of $94.2 billion. The industry employs approx 60,000 people and on average pays out about $95 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

We understand that APRA will consider the definitions of Tier One and Tier Two capital and how much of the latter can be recognised for the purposes of the Prescribed Capital Amount when it consults next year on adopting in Australia the outcome of the discussions on Basel III. The Insurance Council looks forward to a comprehensive debate on this issue.

Given that APRA proposes a common framework for required and eligible capital across general and life insurers that is broadly consistent with the requirements currently applied to general insurance, the Insurance Council and its members support the broad thrust of the Discussion Paper's proposals. However, as has been raised with you by the Insurance Council and members, industry cannot provide a final, definitive view on all aspects of APRA's proposals until it has had a chance to go through the detail of all the Technical Papers relevant to general insurance and carefully consider the outcome of the Quantitative Impact Study (QIS). The following comments are provided on this basis.

GENERAL COMMENTS

Commencement date

The Discussion Paper simply refers to the revised capital standards taking effect in 2012. Clarification is needed whether the start date will be 1 January or presumably 1 July 2012. It is an important issue as insurers will start soon to set pricing for that year and need to be aware of any capital implications. Related to this question is the issue of whether there would be a transition period before full compliance is expected.

Probability of sufficiency

The Discussion Paper on page 9 refers to 99.5 % probability of sufficiency for general insurers over a one-year period. A similar requirement is set for life insurance on page 43. However, on page 36 a return period of 1 in 250 years for an MER event is to be assumed. Given that there are no apparent policy reasons for the different ratio, the Insurance Council suggests that 1 in 200 should be risk of failure that general insurers are required to meet.

The Insurance Council questions whether, with the conservatism inherent in the Discussion Paper's proposals, the sufficiency ratio proposed is really 1 in 200. The general direction of APRA's proposals appears to be towards increased capital requirements. The Insurance Council therefore values public statements made by APRA that its intention is not to raise the total level of capital held by general insurers and, if the QIS results indicate that this would be the outcome of the revised capital regime, that APRA would be willing to adjust its proposals to maintain overall capital levels.

The Insurance Council would appreciate clarification of the reference on page 9 to "an insurer needs to have sufficient capital to absorb unexpected shocks that may arise over the one year period and continue to be able to meet its obligations to policyholders at the end of the period. This could be taken as requiring that provision be made for run-off.

Level II implications

The Insurance Council seriously questions whether it is practical to put Level II implications aside and complete analysis of the impact of the LAGIC proposals on the basis of Level I alone. APRA may find that the outcome reached would have unwelcome, unnecessary or impractical implications at Level II and change will be required.

INSURANCE COUNCIL OF AUSTRALIA

Possible implications for dividends

The Insurance Council requests clarification of the statement on page 13: "there should not be opportunities for reducing capital without a corresponding reduction in risk". The current implication is that restrictions will be imposed on paying dividends out of current earnings.

SPECIFIC COMMENTS
Please see Attachment.

LENDERS MORTGAGE INSURANCE (LMI)
The Insurance Council questions the justification for increasing the insurance risk capital factors for mortgage insurance to the highest category. As explained in the Discussion Paper and a response to a question at the APRA/Industry briefing on 30 June, APRA's rationale for reclassifying various classes of business is the conclusion that the relevant classes (travel and mortgage) had higher risk margins than the other classes in their 'old' grouping. This led APRA to believe their classification should be reconsidered as they must have higher uncertainty.

The Insurance Council's concern is that there is a distortion here for LMI because of diversification benefits. As LMI providers are required to be mono-line insurers, there is no diversification available ***between classes of insurance (***although LMI clearly provides diversification benefits within the confines of residential mortgage credit risk across the economy), which may be the key driver of higher observed risk margins.

We understand APRA has concerns about inconsistencies in the use of diversification benefits across the industry and that, through the QIS APRA, plans to collect information on the levels of diversification being assumed. The Insurance Council urges that APRA reconsider its proposal to reclassify LMI to a higher risk category in light of the 'raw' risk margins for all other classes revealed by the QIS results.

If you have any questions or comments in relation to this submission, please contact John Anning, Insurance Council's General Manager Policy, Regulation Directorate on tel:(02) 9253 5121 or janning@insurancecouncil.com.au .

Yours sincerely

Robert Whelan
Executive Director & CEO

APRA PROPOSAL	INSURANCE COUNCIL COMMENT
Capital base	
• For insurers with investments in other APRA-regulated entities, the value of this investment would be reduced by the regulatory capital requirements of the subsidiary, associate or joint venture for the purposes of inclusion in the insurer's capital base. • There may be changes to the requirements for Tier 2 capital.	
Prescribed capital amount	
• The existing Minimum Capital Requirement (MCR) would be replaced by the Prudential Capital Requirement (PCR). The part of the PCR that is calculated by insurers and must be publicly disclosed will be called the prescribed capital amount.	
Supervisory adjustment	
• APRA could increase an insurer's total required capital if it believed the prescribed capital amount did not adequately account for all of an insurer's risks. This adjustment would not be permitted to be publicly disclosed.	• The Insurance Council understands APRA's probable motivation of not wanting to create concern amongst policyholders and shareholders about an insurer's soundness. However, it is questionable how practical it would be to prohibit disclosure of the supervisory adjustment. Analysts may ask anyway why an insurer is holding capital beyond what is necessary or of a higher standard than usually required. • Non disclosure may be inconsistent with a listed insurer's continuous disclosure obligations.
Prudential capital requirement (PCR)	
• The PCR would be the total of the prescribed capital amount and any supervisory adjustment.	

INSURANCE COUNCIL OF AUSTRALIA

• An insurer would be required to have a capital base that exceeds the PCR at all times.	
Components of the prescribed capital amount	
• The prescribed capital amount would comprise separate charges for insurance risk, insurance concentration risk, asset risk, asset concentration risk and operational risk.	
Insurance liabilities	
• APRA's requirements for the valuation of insurance liabilities are described in GPS 310. The insurance liabilities comprise outstanding claims liabilities and premiums liabilities.	
• The current methodology for risk margins would be retained. APRA proposes to: ➢ clarify that risk margins must be held on both reinsurance and nonreinsurance recoveries; and ➢ consider constraining the level of diversification available.	**Risk margins on reinsurance and non-reinsurance recoveries** • The proposal makes no sense from an actuarial viewpoint (page 37). **Insurance liability diversification** • The limits APRA is considering to place on the overall level of diversification benefit assumed in the insurance risk margins run counter to risk based supervision (page 38). The Insurance Council notes that APRA was proposing to make no allowance for diversification at level III.
Insurance risk capital charge	
• The insurance risk capital charge is described in GPS 115. It would continue to be calculated by applying APRA-specified factors to the outstanding claims provisions and premiums liability provisions.	• The current review provides the opportunity for a serious reconsideration of the relationship between the outstanding claims risk factor and the premiums liability risk capital factor rather than just continuing to use 1.5 (page 32).
• Minor changes would be made to the outstanding claims liability and	• As indicated in the covering letter to this submission, the Insurance Council, on behalf of its members that provide LMI, will comment in detail on the reclassification

premiums liability risk capital factors. The classes affected are travel, mortgage insurance and 'other'.	of mortgage insurance once both the Technical Papers relevant to general insurance are available.
• Changes are proposed to the insurance risk capital charge groupings for inwards reinsurance business. The separate charges for facultative versus treaty business will be removed, and the groupings by class will be aligned with groupings for the direct classes.	• This is generally considered to be a sensible and workable approach.
Insurance concentration risk capital charge	
• The insurance concentration risk capital charge is described in GPS 116. It is the Maximum Event Retention (MER) plus the cost of one reinstatement of the relevant reinsurance cover.	• The Insurance Council suggests that inward reinstatement for reinsurers should be netted off their total MER and also that the issue with whole of portfolio needs to be re-addressed as the exposure to losses from multiple events requires insurers to purchase sideways covers rather than additional vertical protection. • The Insurance Council notes that use of models to calculate MER needs to be carefully considered, particularly as, for instance, the RMS model does not cover losses of the type which have caused the most significant Australian catastrophe claims in the last twenty years i.e. only cyclone and earthquake are specifically modeled by RMS.
• The insurance concentration risk charge requirements in GPS 116 will be clarified in a technical paper still to be released.	• Comments delayed pending release of the Technical Paper.
Asset risk capital charge	
• The investment risk capital charge (which would be renamed the asset risk capital charge) is described in GPS 114.	• In theory, there is some merit to the proposal but there is a strong feeling amongst members that it is too complex for the benefits it would bring. A more detailed analysis will be done once both Technical Papers relevant to general insurance has been released and discussion has been possible with APRA. • The requirement for the appointed actuary to be involved in this calculation at Level 1 may well prove unworkable in practice at Level 2 if this approach to asset charges is carried through to Level 2 requirements at a later date.

INSURANCE COUNCIL OF AUSTRALIA

	• Reinsurance does not appear to sit easily with investment counter party risks under this new overarching Asset Risk charge. • Life and general insurance require different considerations in making decision about matching duration.
• APRA proposes to improve the risk sensitivity of the asset risk capital charge by requiring the insurer to apply a series of stress tests to the balance sheet.	
• The stress tests would include changes to a range of factors affecting the assets and, in some cases, the liabilities.	• In setting out the other stress tests that may be relevant (page 29) mention is made of "equity and property assets". There needs to be a definition of "property" which clarifies whether it covers investments as well as owned assets?
Asset concentration risk capital charge	
• The investment concentration risk capital charge (which would be renamed the asset concentration risk capital charge) is described in GPS 114.	• The Insurance Council's members need to evaluate these changes in light of the outcome of the QIS. • Clarification is needed on who is the counterparty where a reinsurer has provided a Letter of Credit (LOC). It is generally thought that the reinsurer remained the counterparty, but consideration of the extra exposure to ADIs from LOCs that they provide needs to be included in the standard to ensure it is appropriately treated. • Depending on outcome of matter above, if ADI providing the LOC becomes the counterparty, a key issue becomes the concentration of who provides the LOCs. Given the small number of issuing banks, insurers may run through the concentration limits quickly and then face 100% counterparty charge.
• The asset concentration thresholds would be strengthened.	
• Special treatment would be allowable for exposures to:	
➢ highly rated governments;	
➢ reinsurance recoveries;	
➢ APRA-authorised entities; and	
➢ related parties.	

Operational risk capital charge	
• There would be an explicit charge for operational risk.	**Operational risk** • The Insurance Council questions whether the scale of insurer's operation is an appropriate basis to calculate the operational risk capital charge? • The Insurance Council questions how an insurer could proactively plan to meet a subjective charge such as proposed? • The Insurance Council suggests that if APRA want to encourage good risk management, providing a symmetrical approach that allowed better managed companies to reduce the charge would be appropriate.
• Operational risk profile and management would be a consideration in determining any supervisory adjustment.	

Aggregation benefit	
• The aggregation of the insurance risk capital charge and the asset risk capital charge would include explicit allowance for diversification between risks.	• The Insurance Council will comment on this issue in light of the outcome of the QIS.
• The operational risk capital charge, asset concentration risk capital charge and insurance concentration risk capital charge would be added unadjusted to the other charges.	
ICAAP	
• Insurers would be required to develop and maintain an internal capital adequacy assessment process (ICAAP).	• How will the ICAAP relate to the Financial Condition Report (FCR). It has been suggested that the FCR would comment on the ICAAP.
• The five main features of an ICAAP would be:	
➢ board and management oversight;	
➢ sound capital assessment;	
➢ comprehensive assessment of risks;	
➢ monitoring and reporting; and	
➢ internal control review.	