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Dear Ms Rowell

REFINEMENTS TO THE PRUDENTIAL FRAMEWORK FOR GENERAL INSURANCE GROUPS

The Insurance Council of Australia¹ (Insurance Council) appreciates the opportunity to comment on the Discussion Paper on this issue released on 16 May 2011 (the Discussion Paper). The Insurance Council endorses most of the proposed refinements. However, after discussion with members, this submission raises a number of issues that the Insurance Council submits APRA should consider further.

REFINEMENTS TO THE PRUDENTIAL STANDARDS FOR LEVEL 2 GROUPS

Definition of a Level 2 Group

No issues.

Intra-group transactions

While understanding APRA's rationale for this refinement, Insurance Council members request that APRA apply a sensible materiality threshold to avoid creating an unnecessary compliance burden. We note that APRA already has the power under sec 49 of the Insurance Act 1973 (the Insurance Act) to require an actuary of an authorised NOHC to give APRA information if it considers that the information will assist APRA in performing its functions.

Group Actuary

As previously argued to APRA during development of the current Level 2 group regulatory regime, Insurance Council members disagree with APRA's position that conflict of interests guidelines are inadequate to enable a Group Actuary to hold a position as Chief Executive or director of any company insurer within a Level 2 group.

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 2010 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of \$33.4 billion per annum and has total assets of \$101.7 billion. The industry employs approx 60,000 people and on average pays out about \$87 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).

Consequently, the Insurance Council does not endorse APRA's proposal that the Group Actuary be unable to be the Chief Executive or director of **any** entity within the Level 2 group or wider corporate group. Such a restriction will deny Group Actuaries the opportunity to broaden their knowledge and experience of the business within which they work.

Actuarial peer review

The Insurance Council does not oppose the proposed refinement but would argue that the need for peer review of the Group Actuary's work at Level 2 should be the exception rather than the rule. In order to promote transparency about when peer review at Level 2 would be required, the Insurance Council suggests that APRA deal with this issue in a Prudential Practice Guide (PPG). We note that APRA already has the power under sec 49E of the Insurance Act to require an insurer to appoint an independent actuary to investigate the insurer's liabilities.

Reinsurance arrangements and governing law requirements

There remains some confusion amongst Insurance Council's members as to APRA's intention and the practical impact of the proposed change. Although APRA refers to governing law requirements, these may not always operate in the same way, to the same timeframes, or be worded in an equivalent way to Australian requirements. As such, although the proposal appears to be reasonable, the industry would appreciate further dialogue before this area is finalised.

As an example, the Insurance Council notes that the changes which APRA proposes may affect insurers if a foreign jurisdiction requires that reinsurance treaties relate solely to business in that jurisdiction, although at the Group level reinsurance recoveries are not restricted in any practical sense. A specific instance of this would be the impending solvency regime in New Zealand. The result of this is that insurers may incur costs (in both setup and ongoing treaty price) as a result of changing reinsurance treaties to being geographically specialised rather than combining the Australian and overseas treaties into one.

APRA should consider whether a more flexible approach will result in more efficient and effective reinsurance treaty negotiations for the industry.

Share-based employee remuneration schemes

The Insurance Council has not identified any issues of concern with either component of this proposal.

Basel III reforms

The Insurance Council notes that APRA will consult with insurers on any proposed revisions to their capital base as a result of APRA's implementation of Basel III.

REFINEMENTS TO THE REPORTING FRAMEWORK FOR LEVEL 2 GROUPS

Alignment with the Level 1 reporting framework

Deferred reinsurance expense (DRE) and expected reinsurance recoveries

The Insurance Council welcomes the proposal to change the admissibility treatment of DRE. Depending on the timing of reinsurance renewal, the DRE balance tends to be cyclical. This change will not only prevent the capital bases of Level 2 insurance groups from being adversely impacted by changes in the DRE balance but will also encourage general insurers to adopt a consistent and holistic approach for their reinsurance management without being time-strained in admissible capital.

However, the Insurance Council strongly opposes two aspects of the proposed treatment:

- **Risk charging the reinsurance asset on the basis of the balance sheet.** This change will introduce a mismatch between the gross claims and the associated reinsurance recoveries, since the former is still measured at the regulatory probability of sufficiency (PoS) in GRF210.0_G *Outstanding Claims Liabilities*.

Furthermore, this change will create inconsistency in the application of capital standards across different insurers, as the PoS adopted by different insurers within their balance sheet can and does differ across the industry.

In addition, it would be inappropriate to impose a higher risk charge on insurance groups that adopt a more conservative balance sheet position at a PoS level higher than the regulatory level.

- **Risk charging DRE in lieu of the expected recovery on premium liabilities.** The Insurance Council considers that it is inappropriate to see these two concepts as interchangeable, given there are many situations where these amounts differ significantly.

For example, DRE incorporates the profit margin required by reinsurers whilst the recovery on premium liabilities does not. DRE may also include a portion relating to future business not yet written, and as such will be related to a different cohort of business than the premium liabilities. The DRE balance is also cyclical, and as such this change would create cyclicity in the capital charge which other aspects of the proposed refinements serve to reduce.

Consequently the Insurance Council suggests that no change should be made to the current requirement to risk charge the recovery on premium liabilities.

Bound but not incepted business

From the feedback received from members, the Insurance Council considers that APRA overestimates the reduction in work attributable to the Level 1 change. Members find that they have to do considerable manual manipulation of data in order to determine whether net written premium relating to bound policies that incept after period-end would have a material impact on capital adequacy.

While this manual work may be tolerable for business within Australia, for Level 2 groups with offshore operations such a level of manual intervention is disproportionate to the number of instances of material impact identified. Furthermore, there are examples of policies overseas where tacit renewal exists. There may be significant implications if APRA expects these to be included as effectively “bound”.

While the Insurance Council understands APRA’s responsibility to protect Australian policyholders, there are situations where it is impractical for APRA to project Australian regulatory practices over the top of a different regulatory environment. The Insurance Council submits that APRA should allow use of a robust estimate of bound but not incepted business at Level 2.

Inwards proportional reinsurance business

As this proposal is the mirror image for reinsurance of the proposal above, it raises the same issue about the appropriateness of applying Australian regulatory requirements in a different offshore environment. The Insurance Council submits that APRA should allow insurers to use a robust estimate of inwards reinsurance premium revenue that is not recognised for the full term of the reinsurance contract.

Other alignment

The Insurance Council requests clarification of two minor issues:

1. **Current Tax assets.** No capital charge applies to this item in the draft report form, GRF 300_0_G *Statement of Financial Position*. The Insurance Council would appreciate confirmation that this is intentional.
2. **Net incurred claims.** There is no clear definition of the concept of 'net incurred claims related to non-recurring items' and it has been suggested that it should be interpreted as 'net prior period reserve release/strengthening'. The Insurance Council requests clarification of this requirement.

Other reporting framework refinements

The Insurance Council requests that APRA reconsider its proposal concerning **assets with a counterparty grade 1 or 2**.

Currently, the maturity information is not required for several asset groups: investment income receivable, other recoveries receivable, other receivables and other assets. Given that these assets are generally settled within 12 months and a different capital charge only applies to amounts that are expected to settle after 12 months, the impact of this change in terms of the risk charge applied is unlikely to be significant.

However, the collection and consolidation of the information will be a significant task. The Insurance Council submits that the additional burden of this proposal outweighs the limited benefit in risk sensitivity and should not be implemented.

If you require further information, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at janning@insurancecouncil.com.au.

Yours sincerely



Robert Whelan
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