STUDY OF THE PRUDENTIAL SUPERVISORY REQUIREMENTS FOR GENERAL INSURERS IN AUSTRALIA

September 1999

Australian Prudential Regulation Authority
PREAMBLE

The Australian Prudential Regulation Authority (APRA) is seeking a dialogue with the general insurance industry and Institute of Actuaries in Australia (IAA) on the scope for modernising prudential standards for general insurers, and would like to start this process by inviting comments by 17 December 1999 on issues raised in this discussion paper. Following receipt of initial comments, there will be further consultation in early 2000.

General (non-life) insurers play an important role in society by providing a vehicle for risk transfer. Persons and organisations are exposed to the risk of financial loss. For an individual, there can be great uncertainty about the occurrence and potential size of a loss in any given period.

In consideration for a payment appropriate to the risk involved, general insurers indemnify, or assume the liability to compensate for, loss or damage arising from specified contingencies such as fire, theft, injury, death and negligence. Insurance works because the pooling of a large number of uncorrelated risks reduces the relative uncertainty of the size of the overall pool losses.

General insurance policyholders are at a severe disadvantage in seeking to assess the exposures of their insurer and (hence) its future capacity to pay their claims. For example, if a house cleaner incurs a serious injury which does not manifest for some years after the event which caused it, the home owner (if negligent) could be financially ruined if their insurer has failed in the interim. It is because of such potential catastrophic consequences that all countries closely regulate their general insurance industries.

The prudential supervision of general insurers transferred to APRA upon its formation on 1 July 1998 consistent with Recommendation 40 of the Financial System (Wallis) Inquiry (FSI). In contrast to other financial institutions prudentially supervised by APRA, general insurers have been supervised in largely the same manner since the inception of the Insurance Act in 1973. In recognition of this, the APRA Board commissioned an assessment of the prudential supervisory requirements for general insurers in 1998 with a view to eventually making recommendations to the Government on ways of modernising and improving the general insurance regime.
An input to the study has been the Institute of Actuaries in Australia (IAA) working group recommendations on establishing consistency and reliability in outstanding claims provisioning; and on the development of a practical minimum solvency standard which is more responsive to the variations in risk facing general insurers with different business portfolios. These two working groups were formed by the IAA several years ago at the instigation of the then Insurance and Superannuation Commission (ISC) and presented to APRA in early 1999.

This paper canvasses a number of ideas which may be appropriately applied to the supervision of general insurers. APRA will take into account submissions made on this discussion paper - and in subsequent rounds of the consultation process - before recommending improvements to the general insurance regime to the Government in due course. However, it should be noted that responsibility for the legislative framework, including the Insurance Act, rests not with APRA, but with the Government.

Comments and any questions about this discussion paper should be submitted in writing by 17 December 1999 to:

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# TABLE OF CONTENTS

**CHAPTER 1 - THE NEED FOR, SCOPE AND OBJECTIVES OF THE STUDY**

- 1.1 Scope of the study

- 1.2 Objective

- 1.3 The protection of general insurance policyholders

- 1.4 A more responsive supervisory regime

- 1.5 Increasing the transparency of the general insurance market

- 1.6 Consistency with international best practice

- 1.7 Competition Principles

- 1.8 APRA’s long term structure

- 1.9 Risks faced by general insurance companies

**CHAPTER 2 - ENTRY STANDARDS: REQUIREMENTS FOR AUTHORISATION**

- 2.1 Current requirements for authorisation

- 2.2 Weaknesses of the current requirements for authorisation

- 2.3 Other conditions on authorisation

- 2.4 Removal of redundant provisions

- 2.5 Comparison of proposals against the objectives of the study

**CHAPTER 3 - ASSET RISKS**

- 3.1 Current requirements dealing with asset risks

- 3.2 Weaknesses of the current requirements dealing with asset risks

- 3.2.1 Credit risk

- 3.2.2 Valuation risk

- 3.2.3 Concentration risk

- 3.3 Transparency in the minimum statutory solvency requirement

- 3.4 Comparison of proposals against the objectives of the study
<table>
<thead>
<tr>
<th>CHAPTER 4 – LIABILITY RISKS</th>
<th>31</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 Current requirements dealing with liability risks</td>
<td>32</td>
</tr>
<tr>
<td>4.1.1 Valuation risk</td>
<td>32</td>
</tr>
<tr>
<td>4.1.2 Insurance risk</td>
<td>32</td>
</tr>
<tr>
<td>4.1.3 Concentration risk</td>
<td>33</td>
</tr>
<tr>
<td>4.2 Weaknesses in the current requirements dealing with liability risks</td>
<td>33</td>
</tr>
<tr>
<td>4.2.1 Valuation risk</td>
<td>33</td>
</tr>
<tr>
<td>4.2.2 Insurance risk</td>
<td>35</td>
</tr>
<tr>
<td>4.2.3 Concentration risk</td>
<td>35</td>
</tr>
<tr>
<td>4.3 Future developments - alternative risk transfer</td>
<td>35</td>
</tr>
<tr>
<td>4.4 Comparison of proposals against the objectives of the study</td>
<td>35</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CHAPTER 5 – ALM RISKS</th>
<th>37</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Current requirements dealing with ALM risks</td>
<td>38</td>
</tr>
<tr>
<td>5.2 Weaknesses in the current requirements dealing with ALM risks</td>
<td>38</td>
</tr>
<tr>
<td>5.2.1 Market risk</td>
<td>38</td>
</tr>
<tr>
<td>5.2.2 Liquidity risk</td>
<td>39</td>
</tr>
<tr>
<td>5.3 Comparison of proposals against the objectives of the study</td>
<td>40</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CHAPTER 6 – OPERATIONAL RISKS</th>
<th>41</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1 Current requirements dealing with operational risk</td>
<td>42</td>
</tr>
<tr>
<td>6.2 Weaknesses in the current requirements dealing with operational risk</td>
<td>43</td>
</tr>
<tr>
<td>6.3 Comparison of proposals against the objectives of the study</td>
<td>46</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CHAPTER 7 – DISCLOSURE</th>
<th>47</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1 Current disclosure requirements</td>
<td>47</td>
</tr>
<tr>
<td>7.2 Weaknesses in the current disclosure requirements</td>
<td>49</td>
</tr>
<tr>
<td>7.3 Comparison of proposals against the objectives of the study</td>
<td>51</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CHAPTER 8 – DEREGULATION OF SELECTED MARKET SEGMENTS</th>
<th>53</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.1 Reinsurance</td>
<td>53</td>
</tr>
<tr>
<td>8.2 Captive insurers</td>
<td>54</td>
</tr>
</tbody>
</table>
8.3 Insurers underwritten by a State or Territory Government .................................................. 54
8.4 Mortgage insurers ............................................................................................................. 55
8.5 Comparison of proposals against the objectives of the study ........................................ 55
CHAPTER 1 - THE NEED FOR, SCOPE AND OBJECTIVES OF THE STUDY

Prior to the introduction of the Insurance Act 1973\(^1\) (the Insurance Act), there were virtually no supervisory requirements for companies wishing to conduct general (non-life) insurance business in the Australian market place. All that was necessary to gain access to the market was the lodgment of a $200,000 deposit with the Commonwealth Treasurer. Some 484 insurers were registered by way of such deposits to operate in the Australian general insurance market prior to the introduction of the Insurance Act in 1973.

During the three-year period to May 1973, 16 Australian general insurers collapsed, causing major financial loss to policyholders and a widespread loss of confidence in the industry. The development of the Insurance Act was in response to these failures and to limit the possibility (or minimise the extent) of future policyholder losses through company failures.

The prudential supervision of general insurers transferred from the Insurance and Superannuation Commission (ISC) to the Australian Prudential Regulation Authority (APRA) at 1 July 1998 consistent with the Financial System (Wallis) Inquiry (FSI) view that Australia should have a single prudential regulator to supervise deposit-takers, life and general insurers, and superannuation schemes for safety and soundness.

APRA will continue to embrace a supervisory approach that:

- ensures that managements and Boards of supervised institutions are primarily responsible for financial soundness;

- is forward-looking;

- is primarily risk-based;

- is consultative;

- is consistent; and

- is in line with international best practice.

\(^1\) A copy of the Insurance Act 1973 can be found on the APRA web site at www.apra.gov.au
During the 26 years since the Insurance Act was introduced, the insurance industry has rationalised - there are now some 160 general insurers authorised under the Insurance Act - and stabilised. There have been 19 general insurance failures since 1973, none of which resulted in major policyholder losses. Those failures which have occurred can be attributed to a range of factors, including: fraud; rapid premium growth; underwriting and operating losses; cash flow and capitalisation problems; poor management and underwriting practices; competition in particular market sectors; and poor asset spread. While the failure rate in itself is not all that high, some of the underlying factors in these cases could be addressed by making the supervisory regime more responsive to the individual risk profiles of general insurers and by a greater emphasis on disclosure and transparency than occurs as a result of accounting standards alone.

However, it should be noted that prudential regulation does not seek to provide a guarantee. The regulator should not ensure that all financial promises are absolutely certain to be kept. Risk is an essential component of the financial system and, in an efficient system, is priced to reward those who bear it. Further, it is the responsibility of the management and board of a financial institution to ensure that their business delivers on the promises made; it is not appropriate for government to underwrite them (except where government has explicitly decided to do so on social policy grounds).

Prudential regulation, as its name suggests, is about promoting prudent behaviour by insurance companies and other financial institutions - with the objective of reducing the likelihood of institutional insolvency and consequential losses to policyholders, investors or depositors depending on the financial institution involved. Prudential regulation is concerned fundamentally with the quality of a financial institution's systems for identifying, measuring and managing the various risks in its business and with the adequacy of its capital as a buffer against unexpected losses.

The purpose of this paper is to assess the prudential supervisory requirements for general insurers authorised to write insurance business in Australia. The paper canvasses a number of ideas that may assist in modernising the general insurance regime to take account of market developments and international regulatory trends. The study will assist in ensuring that the regime is in line with APRA's prudential objectives, current supervisory techniques and promotes greater market efficiency.

1.1 Scope of the study

The assessment of the prudential supervisory requirements for general insurers will extend to all areas of prudential supervision other than those which have been recently
Chapter 1 – The need for, scope and objectives of the study

reviewed or which are subject to current legislative reform. In particular, the prudential supervisory requirements for Lloyd’s will not be assessed. Part VII of the Insurance Act was comprehensively amended by the Insurance Laws Amendment Act 1998 to take into account Lloyd’s reconstruction and renewal plan and to improve the protection available to Lloyd’s underwriters’ Australian policyholders.

Further, APRA intends proposing to Government that its enforcement powers contained in Part V of the Insurance Act be subject to separate consideration as part of a parallel initiative to harmonise enforcement provisions across APRA. Accordingly, these provisions will not form part of this study.

1.2 Objective

The objective of the study is not to impose excessive entry barriers or compliance costs on the industry - which would be contrary to APRA’s mandate - but rather to highlight areas of the prudential supervisory requirements for general insurers, which may benefit from amendment to:

- make it clear that the objective of the supervisory regime is to protect general insurance policyholders;

- promote policyholder protection by improving the responsiveness of the general insurance supervisory regime to the risk profile of individual insurance companies;

- enhance the transparency of the general insurance industry through increasing the relevance, consistency and accessibility of disclosures to the market;

- ensure the supervisory requirements are in line with the International Association of Insurance Supervisors (IAIS) Insurance Supervisory Principles and current international best practice;

- reduce restrictions on competition and direct costs on industry where these costs and restrictions cannot be justified on cost/benefit grounds;

- reflect APRA’s supervisory objective to regulate like risks in a like manner across financial institutions, where appropriate and practicable; and

- ensure that the supervisory regime responds appropriately to risks that may affect the ability of a general insurer to meet its policyholder liabilities.
1.3 The protection of general insurance policyholders

Prudential supervision of general insurers should protect the interests of policyholders and promote confidence in the general insurance industry.

The more prescriptive and restrictive regulation becomes, the more inherently costly it is. A good regulatory system requires the regulator to strike a balance between the efficiency costs of regulatory intrusion and the benefits such intrusion offers to the security of the financial market. Regulation should, therefore, remove neither the incentives for parties to investigate before entering into financial arrangements nor the gains that would normally accrue to those who are devote greater resources to gathering and assessing information.

The ultimate responsibility for the prudent operation of general insurers should rest with the board and management of the insurer. The general insurance supervisory framework should not be so prescriptive and restrictive as to entirely remove the risks associated with general insurance business.

1.4 A more responsive supervisory regime

An effective supervisory regime should ensure that insurers engaged in higher risk business are subject to more stringent requirements, for example, through increased capital requirements. Similarly, where an insurer is at risk of failure, an increasing number of supervisory tools should be available to the regulator, for example, more regular reporting, restrictions on distributions to shareholders, or a trigger for formal powers of inspection.

A supervisory regime, which better responds to the individual risk profile of a general insurance company, makes greater efficiency of capital allocation across the industry and wider economy possible. The current supervisory regime a priori may not differentiate optimally on a risk basis between companies. As a result, excessive capital requirements may be imposed on companies with low risk profiles or, in the case of companies with relatively high risk profiles, current statutory capital requirements may be insufficient to provide an acceptably low likelihood of institutional failure for consumers.

Prudential supervision should seek to respond to risky behaviour by imposing greater capital, reporting and other supervisory requirements on relatively higher risk insurers.
The prudential supervisory requirements for general insurers should promote more efficient capital allocation by better responding to the individual risk profiles of general insurers.

1.5 Increasing the transparency of the general insurance market

Insurance regulation is justified on the basis of the protection of policyholders in the face of market failure in the form of information asymmetries. The structure, size and complexity of the general insurance industry make it impossible for the consumer to adequately assess the (absolute and relative) institutional risk of a product provider. This is either because the information required to undertake the assessment is not available or because the cost of gathering and assessing that information is greater than the benefit to an individual consumer. As a result, most consumers of insurance products tend to discriminate purely on advertising, price and service at the start of the term of the contract, with little consideration given to creditworthiness in the event of a claim.

The presence of market failure in the form of information asymmetries means that market forces alone do not provide sufficient incentives to insurers to ensure that risk is appropriately managed in accordance with the reasonable expectations of relatively uninformed policyholders and third party claimants.

Insurance regulation should seek to optimise transparency of the insurance market to reduce information asymmetries. This should lead to improved market efficiency by promoting more informed consumer choice. The disclosure of the absolute and relative risk of a financial institution helps consumers – possibly through brokers and advisers - to make better-informed choices about the financial arrangements they enter into.

Disclosure requirements also expose providers of financial services to public scrutiny and competitive pressure from the professional market. Disclosure helps to promote good management of a company thereby reducing the need for, and cost of, regulation.

The prudential supervisory framework should encourage public disclosure of key indicators of a general insurer’s risk profile to mitigate information asymmetries. The study should identify means of enhancing the transparency of the general insurance industry through increasing the relevance, consistency and accessibility of disclosure to the market.

However, while disclosure can play an important role, it cannot completely replace the need for prudential regulation. As noted above, even if all information were available in
the market place (a practical impossibility), the cost of gathering and assessing that information would be proportionally greater for individual consumers than the supervisor, and may outweigh the benefits to the individual.

One measure used in prudential supervision to reduce the effects of market failure on consumers is to prescribe basic market entry requirements. In that way the regulator provides consumers with a minimum level of assurance about the risk management, corporate governance and internal controls of insurers operating in the market.

The prudential supervisory framework should provide a minimum assurance to consumers of the capacity of insurers operating in the Australian market. This should be provided through a set of minimum standards that an insurer must meet in order to gain and maintain an authority to operate.

1.6 Consistency with international best practice

APRA is a member of the IAIS. The IAIS by-laws require supervisors to cooperate to ensure improved supervision of the insurance industry on a domestic as well as an international level. The IAIS promotes improved regulation in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders worldwide.

In September 1997, the IAIS adopted a high level set of Insurance Supervisory Principles identifying subject areas that should be addressed in legislation or regulation in each of the member regulators’ relevant jurisdictions. The IAIS Insurance Supervisory Principles have identified:

- licensing and changes in control;

- corporate governance and internal controls;

- prudential rules on assets, liabilities, capital adequacy and solvency, off balance sheet items and reinsurance;

- monitoring and on-site inspections;

- sanctions; and

- coordination between supervisors,
Chapter 1 - The need for, scope and objectives of the study

as issues which each jurisdiction's insurance regulation should address.  

Australia is an active member and supports the initiatives of the IAIS. Australia undertook its first self-assessment of its supervisory framework for insurers authorised to write insurance business in Australia against the IAIS Insurance Supervisory Principles in February 1998. It was found that Australia's supervisory regime for insurers is largely in compliance with the IAIS Insurance Supervisory Principles. Areas where Australia's supervisory framework for general insurers may only partially comply with the IAIS Insurance Supervisory Principles can be summarised as:

- APRA is limited in its ability to set requirements for corporate governance and internal controls;
- APRA has limited powers under its legislation to set standards with respect to assets or liabilities;
- the current solvency requirements only partially reflect the size, complexity and business risk of individual companies; and
- APRA has limited power to direct a general insurer to stop practices that are unsafe or unsound, or to take action to remedy an unsafe or unsound business practice.

The prudential supervisory requirements for general insurers should have regard to IAIS Insurance Supervisory Principles and international best practice.

1.7 Competition Principles

As a general principle, legislation should not restrict competition unless it can be demonstrated that the benefits of the restriction to the community outweigh the costs. Further, it must be shown that the objectives of the legislation can only be achieved by restricting competition.

While the FSI clearly mandated the need for the prudential regulation of the general insurance industry and entry requirements on market participants, any assessment of the prudential supervisory requirements for general insurers should take into account Competition Principles at a more micro level. At this level there may be scope for deregulation of some types of insurance activities.

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2 A copy of the IAIS Insurance Supervisory Principles can be found on the IAIS web site at www.iaisweb.org
In making its final recommendations to the Government, APRA will consider the individual and overall regulatory impact of any proposals in accordance with Competition Principles.

In determining the appropriate mix and level of minimum standards and incentive and disciplines, the prudential supervisory regime should not impose undue restrictions on competition or impose unnecessary costs on industry where this burden cannot be justified on a cost/benefit basis.

The FSI recommended that regulation of entry, ownership and corporate structure should be kept to the minimum essential for meeting prudential objectives. Entry, ownership and corporate structure should be regulated to ensure that:

- owners (or potential owners) are “fit and proper” to conduct licensed activities and will comply with prudential regulation;
- the safety and stability of a financial institution is not prejudiced by its ownership structure;
- regulated financial entities have the capacity to undertake the financial activities for which they are licensed; and
- corporate structures are adopted which best facilitate regulatory arrangements for depositor and investor protection.

The regulation of entry, ownership and corporate structure should be kept to the minimum essential for meeting prudential objectives. These requirements should include requirements to ensure that general insurers are managed by “fit and proper” persons and have the capacity to undertake the financial activities for which they are licensed.

1.8 APRA’s long term structure

APRA is seeking to promote competitive equality and prevent contrived regulatory arbitrage by regulating like risks on a like basis across the financial sector, where appropriate and practicable. Some issues, such as standards for corporate governance, exist across all institutions supervised by APRA. In these instances, the same standards should apply. In addition, some lines of general insurance have functional similarities to term life insurance with respect to risk management. Where there are similar risks, a
similar (although not necessarily identical) supervisory approach should be adopted across APRA regulated institutions to improve competitive neutrality between financial institutions.

The prudential supervisory requirements for general insurers should be consistent with APRA’s long term approach to supervision. As far as possible, like risks should be regulated on a like basis across APRA regulated institutions.

1.9 Risks faced by general insurance companies

An insurer is exposed to risks that may affect its ability to pay policyholder claims. The risks to which general insurance companies are exposed can be classified in many ways; here, we have grouped them under the following four categories: asset risks; liability risks; asset and liability management (ALM) risks; and operational risks. The diversity and complexity of the general insurance industry means that the (absolute and relative) intensity of the various risks will vary substantially by individual institution and product provided. While an insurer faces risk on both the liability and asset sides of the balance sheet, it is the liabilities (the obligations of the insurer to pay future claims against policies issued by the company to policyholders) which tend to dominate the risk profile of a general insurer in practice.

Many of the risks faced by general insurers can be reduced through prudent management. However, even where an insurer has in place an appropriate risk management structure, the risk of institutional failure cannot be eliminated. Events may (and do) occur which are outside the expected range of events for which risk prevention measures have been taken.

The prudential supervisory regime should take into account all of the risks faced by general insurers including: asset risks; liability risks; ALM risks; and operational risks.

In addition, the prudential regulator has a duty to ensure that where a general insurer is judged to be in trouble, or likely to fall into trouble, early action is taken to minimise the losses to policyholders and to arrange orderly exits from the industry where this proves necessary.

The regulator must have powers of inspection, investigation and wind-up to ensure that where financial institutions are judged to be in trouble, or likely to fall into trouble, early action is taken by the regulator to minimise the losses to
policyholders and to arrange orderly exits from the industry where this proves necessary.

This paper assesses the objectives of the study within four categories. These are: market entry requirements; risk management; disclosure and transparency; and deregulation. Chapter 2 of this paper looks at the market entry requirements applicable to general insurers. Chapters 3 through 6 of the paper deal with asset risks, liability risks, ALM risks and operational risks respectively. Chapter 7 discusses the current disclosure requirements for general insurers and the capacity to improve the transparency of the industry to the market. Finally, Chapter 8 of the paper looks at the potential to deregulate selected segments of the general insurance industry.
CHAPTER 2 - ENTRY STANDARDS: REQUIREMENTS FOR AUTHORISATION

Market entry controls are designed to provide a minimum assurance to consumers of general insurance products of the financial soundness of the insurer with which they are dealing. Authorisation requirements typically include mechanisms to ensure that financial institutions:

- commence operations with adequate capital for the proposed volume and nature of business;
- have in place appropriate mechanisms and strategies for dealing with risk, for example, reinsurance support;
- have management with appropriate experience and integrity;
- have management and reporting systems that are appropriate and likely to be implemented; and
- have appropriate auditors and other experts appointed.

The benefits to consumers in terms of financial security of imposing licensing requirements have to be carefully balanced against the costs that may arise through the restrictions on competition that these entry hurdles impose.

2.1 Current requirements for authorisation

The Insurance Act restricts the right to carry on insurance business to authorised companies who meet certain financial conditions and to Lloyd’s underwriters. The Act does not apply to State Government insurance organisations or to insurance business carried on by bodies such as registered medical benefits or hospital benefits organisations.

Section 23 of the Insurance Act provides that APRA may grant an authority if it is satisfied that:

- where the company is incorporated in Australia and has a share capital, the paid-up capital is not less than $2 million;
in the case of any company (including those not incorporated in Australia), that its assets in Australia exceed its liabilities in Australia by not less than $2 million (the “inside Australia” test);

the company has reinsurance arrangements approved, or has been granted an exemption in respect of its reinsurance arrangements, by APRA;

the company is, and is likely to continue to be, able to meet its liabilities; and

the company is, and is likely to continue to be, able to comply with the provisions of the Insurance Act applicable to it.

An authority may be made subject to conditions.

Unlike life insurance, there is no quarantining of policyholder entitlements under the Insurance Act. As a result, there is no necessity to hold separate capital against non-insurance business activities.

To be authorised, a general insurer does not need to be incorporated in Australia, i.e. branches of foreign incorporated insurers can be authorised to operate in Australia so long as they meet the minimum entry requirements.

Companies can be exempted from certain requirements of the Insurance Act where they undertake a restricted class or classes of insurance business for the benefit of a limited group of persons in circumstances where annual premium does not exceed $1.5 million. These “section 37” companies may be (and usually are) exempted from the minimum capital entry requirements of the Insurance Act. At the present time there are four section 37 companies authorised under the Insurance Act.

Other entry requirements set out in the Insurance Act include the requirement to have an approved auditor, an address for service in Australia and an agent in Australia (in the case of branches) and a requirement for a general insurer to notify APRA of its principal banker, being a bank authorised under the Banking Act 1959 (the Banking Act).

Section 117A of the Insurance Act prohibits bankrupts and persons with convictions involving dishonesty from acting as directors or holding other key positions in insurance companies. Finally, the Financial Sector (Shareholdings) Act 1998 (FSSA) requires acquisitions of interests of 15 per cent or greater in financial institutions to receive the
prior approval of the Treasurer. The Treasurer must be satisfied that it is in the national interest for the acquisition to be approved. National interest considerations would include “fit and proper” tests on key shareholders.

2.2 Weaknesses of the current requirements for authorisation

2.2.1 Capital requirements

The $2 million threshold test for general insurers is low when compared to the $10 million shareholders’ capital requirement for life insurers; $5 million capital requirement for approved trustees of public offer superannuation funds and the $50 million minimum Tier 1 start-up capital requirement for locally incorporated banks. That being said, it should be noted that 106 of the 160 authorised general insurers in Australia are currently subject to the $2 million minimum test for on-going solvency purposes. As a result, any increase in the minimum capital requirement for general insurers would have a large impact on the number of players in the industry (although not necessarily the competitiveness of the industry given that the top 20 companies write around 90% of premium revenue across the industry).

In addition, a flat $2 million test may not be appropriate for all types of general insurance companies. Insurers may differ significantly in risk profile depending upon the type of business they propose writing.

The transfer of State regulated financial institutions to the Commonwealth has meant that the Life Insurance Act 1995 (Life Act) has been amended to incorporate the regulation of friendly societies undertaking financial business. In the Life Act amendments, the purpose of the shareholders’ capital has been clarified and extended. It is now referred to as management capital and is covered by an actuarial standard.

Whereas the current life insurance requirement for pre-existing life insurers is a flat $10 million regardless of the size or the relative risk of the institution, the “Management Capital Standard” provides the legislative flexibility to allow different shareholders’ capital requirements to be imposed on different institutions. The intention of the amendment is to extend the capital requirement to a more risk based measure, reflecting the business risks undertaken by shareholders’ funds outside of statutory funds. Currently, life companies have little business risk in the shareholders’ fund but this is not the case for friendly societies. APRA’s preference is for operating subsidiaries of life companies to be held by the shareholders’ fund, not by the statutory fund.
It may be appropriate to introduce the capacity to vary the minimum capital entry standard for different types of general insurers in line with the amendments to the life insurance capital requirements. For example, insurers intending to write long-tail or reinsurance business clearly warrant higher entry requirements to demonstrate a commitment commensurate with the higher level of risk that these entities tend to assume.

Currently, the general insurance capital requirements only recognise shareholders’ equity and reserves as a basis for determining compliance with minimum start-up capital and on-going compliance with the minimum statutory solvency requirements. However, other types of instruments, for example, debt instruments that are essentially permanent in nature and combine certain characteristics of equity and debt, may provide strength to a general insurer’s balance sheet. The prudential supervisory regimes for both life insurance companies and Authorised Deposit-taking Institutions (ADIs) recognise these types of subordinated debt instruments in determining compliance with solvency and capital adequacy requirements.

It may be appropriate for the prudential supervisory regime to give credit to hybrid (debt/equity) capital instruments in calculating compliance with the minimum start-up capital requirements and on-going solvency requirements.

2.2.2 Branches of foreign incorporated insurers

The ability for general insurers to operate in Australia as branches of foreign incorporated insurers without restriction differs to the approach adopted in the supervision of life insurers and ADIs.

Life insurers have not been able to operate as branches in Australia since the introduction of the new Life Act in 1995. The purpose of this is to provide greater protection to Australian life insurance policy owners by ensuring that all life insurers operating in Australia are subject to common reporting and capital requirements.

As part of the Government’s decision in February 1992 to permit foreign banks to establish branch operations in Australia, it decided to limit the ability of foreign branches to accept deposits in Australia. This is because of the difficulties in ensuring the same degree of protection for depositors with branches as for those with locally incorporated banks. Branches of foreign banks are required to confine their deposit-taking activities to “wholesale” markets. “Retail” deposit-taking by foreign banks is required to be undertaken through locally incorporated banking subsidiaries. Specifically, a branch of a
foreign bank is permitted to accept deposits and other funds in any amount from incorporated entities, non-residents and employees of that bank. A foreign bank branch is not permitted to accept deposits from other sources (individuals and non-corporate institutions) which are less than $250,000. It should be noted that the main reason for limiting the ability of a foreign bank branch to accept deposits in Australia is because they are not required to maintain capital in Australia.  

There are some difficulties in supervising branches of foreign incorporated general insurers. In the case of failure, APRA has experienced difficulties in freezing, in particular, the reinsurance assets of branch operations because these contracts are typically written through the home office offshore.

However, there is clearly a need to retain the ability to operate as a branch of a foreign insurer within the general insurance supervisory regime. In particular, reinsurers typically rely on the depth of their international balance sheets to provide protection commensurate to the level of risk they assume.

Further, a policy consideration in developing appropriate prudential arrangements for insurance branches is Australia’s multilateral trade commitments for financial services. These are established in the Fifth Protocol to the General Agreement on Trade in Services (GATS) (that is, the Financial Services Agreement) with successive rounds of negotiations expected to commence in November 1999.

Although the financial sector is generally subject to a “prudential carve out” - restrictive regulation may be justified on prudential grounds - specific commitments were previously made in respect to general insurance. One of these requires Australia to allow cross-border supply of general insurance and not to further restrict the form of commercial presence of general insurers operating in Australia. This commitment is subject to the limitation that non-incorporated insurers operating in Australia (ie. branches) appoint an Australian resident as the agent of the insurer.

The supervisory requirements for branches should be reviewed to ensure that effective supervision is possible.

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3 This is not the case in general insurance where branches are required to meet the “inside Australia” test.
2.2.3 Fit and proper persons

The current requirements for market entry into the general insurance sector include only limited “fit and proper” tests\(^4\) for directors, top management and other persons (regardless of title) who are in a position to exercise material influence (direct or indirect) on the conduct of the insurer. In this respect Australia’s general insurance supervisory regime only partially complies with the IAIS Insurance Supervisory Principles or the recommendations of the Joint Forum on Financial Conglomerates. That is, licensing requirements should include rules to ensure that the directors, top management and key shareholders are “fit and proper” in a broadly defined sense.

The lack of comprehensive “fit and proper” tests is not unique to general insurance supervision. No such requirements exist for life insurers or superannuation funds. In the case of ADIs, the lack of “fit and proper” tests on a bank’s directors and senior management is one of the few areas where Australia does not comply with the Basel Committee on Banking Supervision’s core principles.

As this issue is common to all financial institutions supervised by APRA, it is intended to consider the issue of “fit and proper” tests on an APRA wide basis. This will ensure consistency in approach across regulated institutions. APRA’s preferred approach to “fit and proper” tests is in line with the draft principles set out in APRA’s Policy Discussion Paper, Prudential Supervision of Conglomerates, issued in March 1999.\(^5\) A further paper on the supervision of conglomerates will be issued by APRA in the near future. That paper will propose a self-assessment approach to “fit and proper” issues.

2.3 Other conditions on authorisation

It may be appropriate to increase the factors that APRA can or must take into account upon the authorisation of general insurers in Australia. For example, if it were decided to adopt a flexible minimum capital requirement for general insurers, ongoing adherence to a business plan provided to the regulator would be critical to ensuring that the level of capital required is appropriate. Also, in some circumstances, considering the ratings provided by ratings agencies might provide an indication to APRA of a company’s ability to meet promises to consumers (for example, in the case of branches).

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\(^4\) Section 117A of the Insurance Act prohibits bankrupts and persons convicted of certain offences from being directors or principal executive officers of authorised insurers and fit and proper tests are applied to key shareholders seeking approval under the FSSA.

\(^5\) A copy of this discussion paper can be found on APRA’s web site at www.apra.gov.au
2.4 Removal of redundant provisions

A number of provisions in the current Insurance Act relating to authorisation are arguably out of date and no longer required.

For example:

- some exemptions set out in section 5 of the Insurance Act relate to bodies that are no longer in existence;

- transitional provisions dating back to the introduction of the Insurance Act in 1973 are still in force; and

- the requirement for authorised insurers to maintain a principal banker seems obsolete.

2.5 Comparison of proposals against the objectives of the study

The ability to vary the minimum capital requirements upon market entry would promote the protection of general insurance policyholders by providing greater certainty that general insurers have the capacity to undertake the activities for which they are licensed. This measure would also lead to more consistency across APRA regulated institutions by aligning, in some way, the minimum entry requirements for life insurers and general insurers. The requirement would additionally meet the objective of risk responsiveness. That is, higher capital requirements would be imposed on relatively higher risk underwriters.

Strengthening the requirements for branch offices could improve the protection available to Australian policyholders.

The proposal to introduce broadly defined “fit and proper” persons tests across APRA would increase Australia’s compliance with the IAIS Insurance Supervisory Principles and implement a recommendation of the FSI. A consistent approach across all APRA regulated institutions would be appropriate.

Finally, removing redundant provisions from the general insurance regime takes into account the Competition Principles.
CHAPTER 3 - ASSET RISKS

A general insurer receives revenue from its policyholders in the form of premiums and capital from its shareholders, and uses this revenue and capital to purchase assets and fund ongoing operations. Asset risk is the risk that the quality of an insurer’s assets will deteriorate to such an extent that the insurer will have insufficient assets to pay its policyholder liabilities. Prudential supervision of assets is primarily concerned with ensuring that the quality and availability of an insurer’s assets are adequate to provide a sufficient likelihood that the insurer will be able to pay its policyholder liabilities as and when they fall due.

The quality of an insurer’s assets depends on the credit worthiness of the counterparties to the assets, the level of concentration of those assets and the reliability of valuations assigned to those assets.

As a general principle, insurers should be able to hold whatever assets they choose on commercial grounds so long as they have the appropriate financial and managerial capabilities to effectively handle the chosen asset allocation.

3.1 Current requirements dealing with asset risks

Section 29 of the Insurance Act sets out the statutory minimum solvency requirements applying to insurers authorised to conduct business in Australia. Insurers incorporated in Australia must have total assets exceeding total liabilities by not less than $2 million, 20 per cent of premium income, or 15 per cent of outstanding claims, which ever is the greatest. In addition, all insurers, including foreign insurers which operate in Australia through branches, must have assets inside Australia exceeding liabilities in Australia by not less than $2 million, 20 per cent of premium income, or 15 per cent of outstanding claims, which ever is the greatest.

These solvency requirements are designed, albeit in a very broad brush way, to be responsive to the absolute level of risk assumed by different insurers. The $2 million absolute minimum solvency requirement is designed to provide a base level of confidence to insurance policyholders of the financial capacity of an authorised insurer.

As the authorised insurer increases its business and, accordingly, increases its exposure to risk, the solvency requirements increase through the premium income test. The premium income test becomes effective once premium income exceeds $10 million. Lastly, the outstanding claims test is activated when the outstanding claims of a general
insurer reach $13.3 million. The outstanding claims test is designed to capture the risks faced by authorised insurers in less growth orientated phases or winding down operations (where premium income is no longer commensurate with the risk) or with a portfolio dominated by long tail liabilities. In these cases, premium income may be falling relative to the level of outstanding claims. A solvency measure based on a premium income test alone would not respond adequately to the risk of such a portfolio.

The inside Australia test is designed to ensure that the minimum statutory free assets of the insurer are held within the jurisdictional reach of the prudential supervisor.

Special solvency requirements are imposed on mortgage insurers. This is because:

- there is a high correlation of claims events for this line of business associated with property cycles leading to a higher potential concentration risk on the liabilities side. Mortgage insurers are typically subject to high levels of claims in number and quantum in times of severe economic downturn; and

- the premium is collected in a lump sum at the outset of the policy and the policy would typically run for some period of years.

In addition to the more general section 29 requirements, paragraph 29(1)(d) of the Insurance Act requires a general insurer upon authorisation to have in place reinsurance arrangements approved by APRA. Section 34 requires insurers to have approved reinsurance arrangements in place on an ongoing basis. General Insurance Circular G 6/97 sets out guidelines for insurers about the types of arrangements which are likely to be approved for the purposes of paragraph 29(1)(d) and section 34 of the Act. Certain aspects of Circular G 6/97 act as additional solvency requirements that sit on top of the section 29 requirements. These guidelines require that a direct insurer:

- has net tangible assets at least 20 times its highest net risk retention;\(^7\) or

- holds net tangible assets of, at least, its solvency requirements as set out in section 29 plus its maximum event retention, \(^8\)

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\(^6\) A copy of General Insurance Circular G 6/97 can be found on the APRA web site at www.apra.gov.au

\(^7\) An insurer’s highest net risk retention is the single biggest loss the insurer may be exposed to under a single policy of insurance after netting out any reinsurance recovery.
whichever is the greatest.

The reinsurance guidelines for reinsurers require that a reinsurer authorised in Australia:

- participating in proportional or working excess of loss treaties\(^9\) has net tangible assets in Australia at least 13.33 times its highest net risk retention; or

- underwriting a major proportion of its business as catastrophe treaties,\(^10\) hold net tangible assets in Australia, of at least, its solvency requirements as set out above, plus its maximum event retention.

The reinsurance requirements have the absolute effect of increasing (above the statutory tests) the minimum amount of solvency that an insurer must maintain in order to remain in compliance with the prudential supervisory requirements for general insurers. At the same time, a general insurer can reduce the amount of its minimum statutory solvency requirement by purchasing reinsurance. Thus, part of the risk exposure is, in effect, transferred from the direct insurer to the reinsurer. The risk retained by the direct insurer is backed by the statutory minimum solvency requirement, while the risk transferred to the reinsurer is not covered by solvency requirements relating to the direct insurer. As a result, the quality of the reinsurance is of paramount importance to the regulator as the reinsurance provides protection to policyholders for that part of the risk that is not backed by the solvency requirements of the direct insurer.

In addition, the regulator imposes authorisation and solvency requirements on reinsurers authorised in Australia. Direct underwriters are not prohibited from using unauthorised foreign reinsurers, however, they would typically be restricted in the amount they can transfer to an unauthorised reinsurer. Circular G 6/97 contains a set of limitations on the amount of risk an insurer can cede to reinsurers on an aggregate and individual reinsurer

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8 An insurer’s maximum event retention is the biggest loss an insurer will be exposed to due to a concentration of policies after netting out any reinsurance recovery.

9 A contract that requires a reinsurer to pay a direct insurer a proportion of all claims, or all of an amount incurred under any claim incurred where that claim exceeds an amount agreed to in the terms of the contract, during a set period (usually a year).

10 A contract that requires a reinsurer to pay a direct insurer a proportion of, or all of, an amount incurred for claims incurred under a number of contracts where the claims are a result of a single insurable event. The contract is typically enforceable once a certain number of claims or a certain level of liability to the direct insurer is incurred.
basis. These limitations on cessions are designed, in part, to address credit risk arising from an excessive concentration of assets with a single counterparty.

The limitation on cessions to unauthorised foreign reinsurers is justified on the basis that these reinsurers may have a higher credit risk than domestically authorised reinsurers. Authorised reinsurers are required to meet the minimum statutory solvency requirements under the Insurance Act in their own right. Accordingly, the limitations on cessions are designed to restrict an authorised insurer’s exposure to unauthorised entities. The limitations on cessions also limit an insurer’s total cessions to reinsurers. This requirement is designed to ensure that general insurers maintain an interest in the business they are writing. This part of the reinsurance guidelines is seen as a tool in reducing operational risk and is discussed further in Chapter 6.

Section 30 of the Insurance Act sets out rules about assets which may be counted toward the current statutory minimum solvency requirement under section 29. Assets excluded under section 29 for the purposes of calculating compliance with the minimum statutory solvency requirement are:

- loans to directors of the insurer or directors of related companies (or a director’s spouse);
- unsecured loans to employees exceeding $1,000;
- assets under a fixed or floating charge;
- premiums outstanding for more than 3 months;
- future tax benefits;
- a guarantee given to the insurer except to the extent the guarantee has been approved by APRA for the purposes of meeting the solvency requirements under section 29;
- intangible assets (including goodwill); and
- assets of a related body (but not including deposits with, or a loan constituted by, deposits with an ADI) except where an asset of a related body has been approved by APRA for the purpose.
Chapter 3 - Asset Risks

Where APRA approves assets of a related body for the purpose of meeting the minimum statutory solvency requirements under section 29, the related body becomes a “supervised body corporate”. The supervised body corporate is required to maintain adequate accounting records, provide accounts to APRA annually and have those accounts audited by an approved auditor. APRA has the power to freeze the approved assets of the related body if, inter alia, the authorised insurer is about to become unable to meet its liabilities. The section 30 requirements are designed to address asset risk by removing intangible, doubtful and non-arms length assets from assets that can be counted toward compliance with the section 29 and reinsurance solvency requirements.

In addition, general insurers are required to value assets at net market value.

Form 102 requires insurers to disclose items (assets and liabilities) that exceed the greater of $1 million or 10% of the value of the total assets and liabilities of the insurer on its balance sheet. This is designed to indicate areas of concentration risk to the regulator.

3.2 Weaknesses of the current requirements dealing with asset risks

3.2.1 Credit risk

The current prudential supervisory framework takes into account the credit risk attributable to the liquid assets of a general insurer through requiring assets to be valued at net market value. Where assets have a ready market, the market price of the asset should include a component for the credit risk of the counterparty. That is, other things being equal, an asset with higher credit risk would have a lower market value. This is a cornerstone of the Australian regime and one of the features that sets it apart from other international regimes.

However, the credit risk of a general insurer’s illiquid assets may not be effectively dealt with in the current supervisory regime. Reinsurance assets are the largest class of illiquid assets for a typical general insurer making up about 15 per cent of the total assets on a general insurer’s balance sheet. Section 30 of the Insurance Act does not limit the amount of reinsurance assets that may be counted towards an insurer’s minimum statutory solvency requirement under section 29 of the Act. 11

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11 Unless the reinsurer is a related body of the authorised insurer, in which case the reinsurance assets would have to be approved by APRA for the purposes of calculating compliance with the statutory solvency requirement.
The guidelines in Circular G 6/97 allow insurers to reinsure with a single reinsurer where that reinsurer is authorised under the Insurance Act. Limitations apply to the amount of liabilities that can be reinsured with an unauthorised foreign reinsurer. The ability to hold 100 per cent of reinsured liabilities with a single authorised reinsurer is justified on the basis that reinsurance assets make up only about 15 per cent of a typical general insurer’s total assets. Where the reinsurance assets of an insurer were higher than the industry norm, the flexibility of the current reinsurance requirements would allow APRA to impose concentration limits if necessary. Where an exposure to unauthorised reinsurers is approved by APRA, these reinsurance assets are also fully counted toward the calculation of compliance with the minimum statutory solvency requirement.\(^\text{12}\)

These guidelines are broadly equivalent to those of life insurance with some important differences. Life insurers are able to reinsure up to 100 per cent of their ceded liabilities with a single reinsurer regardless of whether the reinsurer is registered under the Life Act. However, where a life insurer uses a reinsurer which is not:

- registered under the Life Act; or
- in the same country as that in which the business is written; or
- the parent or sister company of a specialist reinsurer - being a registered life company under the Life Act, the predominant business of which is reinsurance business,

the life insurer is not given credit for the reinsurance assets in calculating compliance with the solvency and capital adequacy standards.

The prudential supervisory arrangements relating to credit risk in ADI’s, assigns a risk weighting to assets held by the ADI. The capital adequacy requirement to account for the credit risk of the ADI is then 8 per cent of its risk weighted assets. A risk weighted approach is supported in the supervision of ADIs because the main assets of an ADI, loans, do not have a ready market. It may be appropriate to risk weight assets of insurers which are not directly portable (in particular, the reinsurance assets) in calculating compliance with the minimum statutory solvency requirement.

\(^{12}\) Unless the reinsurer is a related body of the authorised insurer, in which case the reinsurance assets would have to be approved by APRA for the purposes of calculating compliance with the statutory solvency requirement.
Chapter 3 – Asset Risks

The minimum statutory solvency requirement\(^{13}\) should take into account the relative riskiness and diversity of reinsurance and other assets in deciding whether, and to what extent, the asset should be allowed to count towards an insurer’s statutory solvency requirement.

Under Prudential Statement C1 relating to the supervision of ADIs, loans secured by residential property are given a 50 per cent risk weighting where the ratio of the amount outstanding to the value of the mortgaged residential property securing the loan is 80 per cent or less. Where the loan to value ratio is greater than 80 per cent, the loan receives a 100 per cent risk weighting unless it is 100 per cent mortgage insured through an acceptable lenders mortgage insurer. In which case, the loan would qualify for the reduced risk weighting of 50 per cent. An acceptable lenders mortgage insurer is a mortgage insurer with an A rating or above.

The risk weighting of reinsurance assets could be achieved through the use of the rating assigned to a reinsurer by ratings agencies. If the minimum statutory solvency risk weights reinsurance assets, the need to limit the amount of cessions to unauthorised foreign reinsurers is removed and, accordingly, the restrictions in ceding to unauthorised reinsurers could be dropped.

This is consistent with the philosophy that insurers should be able to hold whatever assets they like on commercial grounds so long as the amount of net assets or solvency level of the insurer is large enough to support the risks attributable to those assets. Reinsurance arrangements would still need to be approved by APRA to ensure the quality of the arrangements. In addition, APRA would need to consider what action would be required upon the downgrading of a reinsurer’s credit rating.

3.2.2 Valuation risk

The requirement to value assets at net market value reduces valuation risk, but it does not remove it. While changes in the valuation of an asset must be recognised as a revenue or expense in the financial year in which the change occurs, valuation risk is not removed because of the difficulty in valuing assets that do not have a ready market. Further, it does not take account of the potential time lags in revaluation at times other than the balance date.

\(^{13}\) For further discussion of the statutory solvency requirements see the paper A New Statutory Solvency Standard for General Insurers issued by APRA in conjunction with this paper.

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Certain assets of an insurer are subject to greater uncertainty in relation to the valuation placed on those assets, for example, assets in related companies, guarantees, derivatives and intangible assets such as goodwill. The section 30 asset rules are designed to remove or restrict the use of such assets in the calculation of compliance with the section 29 and reinsurance solvency requirements.

The current rules relating to assets under section 30 are broadly consistent with those applying to life insurers. The rules remove transactions with directors and employees of the company, assets subject to a charge and intangible assets such as premiums unpaid after three months, future taxation benefits and goodwill. The major difference with the life insurance regime is the treatment of related body assets. Under the general insurance supervisory regime, assets of a related body are either approved for inclusion - in which case they are fully counted toward the minimum statutory solvency requirement - or not approved and completely left out.

The rules relating to supervised body corporates are very black and white and do not take into account the relative risk of related body assets. Consideration should be given to replacing the current requirements for related body assets under section 30 with a system which risk weights the related body assets of general insurers.

In addition, where there are holdings in other types of regulated financial institutions (ADIs and life insurers) and those assets have been approved under section 30 for the purposes of the solvency requirements, the statutory capital or solvency requirements are not deducted from the value of those assets. That is, assets are counted toward more than one financial institution’s legislated capital or solvency requirement (also known as “double gearing”).

Any legislated capital or solvency requirement of a related financial institution should not be counted toward the solvency requirement of the general insurer.

There has been some suggestion that if related body assets are taken out or reduced in the calculation of compliance with the solvency requirements of section 29 and the reinsurance guidelines then related body liabilities should similarly be removed. That is, a netting of assets and liabilities between related bodies should be allowed. However, from a prudential perspective the risk lies in the realisability of related body assets, not liabilities. Therefore the netting of related body assets and liabilities is not supported.
Chapter 3 – Asset Risks

Some other section 30 rules may no longer be appropriate. For example, the ability to automatically count deposits with related ADIs, but not other holdings in related ADIs with the same level of security seems anomalous.

**Section 30 rules should meet their desired prudential purpose.**

### 3.2.3 Concentration risk

Asset concentration risk is not dealt with explicitly in the prudential supervisory requirements for general insurers except to the extent that general insurers are required to disclose items that make up more than 10 per cent or $1 million of certain assets on the balance sheet. This is a notification requirement only, the regulator has no statutory power to limit an insurer’s exposure to a particular counterparty or group of counterparties except to the extent that Circular G 6/97 places limitations on the concentration of reinsurance assets with unauthorised reinsurers.

In the prudential supervisory regime for ADIs, Prudential Statement E1 lays down the framework for the supervision of banks’ large exposures by requiring each bank:

- to report quarterly all exposures of the consolidated group to individual clients, or groups of related clients, above 10 per cent of the capital base\(^{14}\) of the consolidated group; and

- to give prior notification of its intention to enter into an exceptionally large exposure (ie greater than 30 per cent of capital) to an individual client or group of related clients. This applies to exposures to non-bank non-government clients, as well as to any subsidiaries of the bank. In such cases, a bank should be able to show that the proposed exposure would not result in the consolidated group undertaking an excessive risk.

In the case of life insurance, the Solvency and Capital Adequacy Standards require that, to the extent the asset exposure of a statutory fund is excessively concentrated in a particular asset, or with a particular obligor, a reserve is established against that part of the value of that exposure considered excessive. Excessive concentrations are outlined in section 11 of the Solvency and Capital Adequacy Standards and depend on the security of the obligor. For example, there is no requirement to reserve where the asset

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\(^{14}\) The base capital is capital as determined by the Prudential Statements applicable to ADIs. This includes some forms of subordinated debt and is not directly comparable to the net assets of an insurer.
exposures are guaranteed by the national government of the country in whose currency the liabilities of the statutory fund are denominated. Where the asset exposure is secured by bank bills, a reserve would have to be calculated in respect of that level of bank bills exceeding 25 per cent of the value of the assets of the statutory fund or $5 million, whichever is the greatest. In addition, life insurers are required to report exposures over 5 per cent of a statutory fund’s assets each quarter.

Consideration might be given to addressing concentration risk through the adoption of an approach similar to that of life insurance. In that way, general insurers would not be restricted in the way that they can invest their assets but would be required to hold sufficient assets to back the risk they assume. Quarterly reporting of large exposures should be maintained.

Concentration risk could be dealt with by requiring a reserve to be made against large concentrations of assets with a particular obligor or in a particular asset.

The use of derivatives by Australian general insurers to offset their asset risks is currently low. However, it is likely that this may increase over time, particularly if reinsurance rates rise and the depth of the Australian derivatives market increases.

The supervisory regime should provide APRA with sufficient flexibility to allow it to respond appropriately to an increasing use of derivatives.

### 3.3 Transparency in the minimum statutory solvency requirement

As discussed above, the reinsurance requirements under Circular G 6/97 fall into two main categories. Those acting as an additional solvency requirement, and those placing limitations on cessions. It is desirable that the minimum statutory solvency requirement be as transparent as possible. The current reinsurance requirements which act as additional solvency requirements are not transparent.

At the same time, it is desirable that APRA maintain flexibility in the application of limitations on cessions to provide for insurers in unusual commercial positions (such as in the event of takeover).

The requirements of Circular G 6/97 should be split so that those requirements which act as a solvency measure should be reviewed and, where appropriate, be built into the solvency requirements so that their application is obvious and transparent. Those requirements relating to cessions would remain as a guideline
to be applied by APRA as appropriate to each individual insurer’s commercial circumstances.

3.4 Comparison of proposals against the objectives of the study

The current supervisory requirements may not respond adequately to credit and concentration risk. Risk weighting some assets to take into account their relative riskiness and diversity would improve the supervisory regime’s response to credit risk. Further, requiring general insurers to set a reserve against large concentrations of assets would improve the ability of the regime to respond to concentration risk. These requirements should promote policyholder protection by making the supervisory regime more risk responsive to the risk profile of each individual insurer.

If the risk weighting of reinsurance assets were adopted, there would be fewer restrictions on foreign unauthorised reinsurers operating in Australia.

Removing the ability to count the legislated capital requirement of any related financial institutions toward the solvency requirements of a general insurer would make the supervisory regime for general insurers more consistent with other APRA regulated institutions. It would also ensure that capital is available for its intended purpose.

The transparency of the supervisory regime for general insurers would be enhanced by building those reinsurance arrangements that act as an additional solvency requirement (currently set out in guidelines) into the solvency requirements of the Insurance Act.

Finally, the proposals set out above would enhance APRA’s capacity to make standards with respect to the assets of a general insurer. Accordingly, Australia’s supervisory regime with respect to assets would comply more fully with the supervisory principles of the IAIS.
CHAPTER 4 - LIABILITY RISKS

The major liabilities of a general insurer are its actual and expected future payments to policyholders on events occurring on in-force policies. Approximately 75 per cent of an insurer's liabilities are made up of its technical provisions: the outstanding claims provision (OCP); and unearned premium provision (UPP). The largest of these, and the largest overall liability of an insurer, is the OCP.

A general insurer's OCP represents the present value of expected future payments including amounts unpaid on reported claims and claims incurred but not reported. The outstanding claims provision also includes an estimate of the cost of settling claims. Unsettled claims and claims incurred but not reported are an estimate based on past experience taking into account any changes in circumstances, such as recent catastrophic events and changes in the volume or mix of risks underwritten, that may affect the pattern of unreported claims.

The amount of a sound premium to be charged on a policy of general insurance would be determined so as to cover anticipated claims, reinsurance expenses, administrative and other costs, and a profit component (having regard to expected revenues from the investment of premiums). The UPP is designed to allow the insurer to match premium income over the period during which a policy is in force and to provide for any refund of premiums to policyholders. This is necessary because the period over which the policy attaches is not necessarily the same as the accounting reporting period. The UPP should be amortised over the period of the policy in line with the expiration of risk. The UPP should be sufficient to pay claims and expenses that may be incurred in the future on policies in force at the balance date.

Provisioning for liabilities and pricing policies necessarily requires estimation of the future payments of the insurer. The process of estimating liabilities typically involves choosing a model which best estimates the distribution of possible outcomes of an insurer's liabilities, setting the assumptions of the model and finally, deciding upon a point on the model at which to set the provision. This process contains two types of risk.

The first, valuation risk, arises because the model chosen or the assumptions used in the model for estimating the liabilities of an insurer may not accurately reflect the actual distribution of liabilities.

The second type of risk, insurance risk, is the risk, assuming that the model and assumptions of the model chosen are correct, that the provision struck, or the price set,
for liabilities will turn out to be inadequate. The longer the period over which the risk expires under a class of insurance (ie. the longer the tail) the greater is the insurance risk.

Finally, concentration risk arises as a result of an aggregation of policies leading to an increased level of risk for the general insurer. For example, where a company has a large number of policies in a single geographic location. That is, concentration risk depends on the degree of correlation of policies within the insurer's underwriting portfolio.

4.1 Current requirements dealing with liability risks

4.1.1 Valuation risk

The current statutory minimum solvency requirement under section 29 of the Insurance Act is designed to capture any residual risk that is not taken into account in valuing the assets and liabilities of an insurer. The liabilities of an insurer are explicitly taken into account in the section 29 minimum statutory solvency requirement.

The Insurance Act and Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities require general insurers to make provisions for their liabilities. Subsection 31(2) requires an authorised insurer to make a provision in its accounts in respect of liabilities. Subsection 31(3) allows APRA to direct an insurer to make such a provision or further provision of a specified amount; or of an amount determined in a specified manner. Section 48A of the Insurance Act allows APRA to require an actuarial investigation into the adequacy of an insurer's OCP.

Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities requires a general insurer to make provision for unearned premiums. Where there is a deficiency in the UPP, the insurer must write down the asset class, deferred acquisition costs (DAC). DAC can be written down to the lesser of the value of the deficiency or value of the DAC (ie. the DAC can only be written down to zero).

4.1.2 Insurance risk

In the current supervisory regime for general insurers, insurance risk is only implicitly dealt with through the application of the minimum statutory solvency requirements, and to some extent through the reinsurance requirements under Circular G6/97. Circular G6/97 requires insurers to have net tangible assets of a multiple of its highest net risk retention. An insurer's highest net risk retention is the single biggest loss the insurer may be exposed to under a single policy of insurance after netting out any reinsurance
recovery. This requirement is designed to provide a capital buffer against adverse claims experience.

4.1.3 Concentration risk

Circular G6/97 requires insurers, in addition to the solvency requirements of section 29 of the Insurance Act, to hold surplus net tangible assets in Australia at least equal to its maximum event retention in Australia. An insurer’s maximum event retention is the biggest loss an insurer will be exposed to due to a concentration of risk after netting out any reinsurance recovery.

4.2 Weaknesses in the current requirements dealing with liability risks

4.2.1 Valuation risk

Subsection 31(2) of the Insurance Act does not specify the method by which an insurer must calculate its liability provision(s). The OCP carried in the balance sheet may be thought of as comprising two components. The central estimate, being the best estimate of the currently incurred liabilities of the insurer, and a prudential margin being a buffer against adverse deviation from the central estimate. The setting of the OCP is governed by the Insurance Act and Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities. There is no “routine” regulatory requirement for actuarial involvement and no standard approach in particular, to the setting of prudential margins. As a result, the level at which the OCP is set may vary in strength between companies and depends on each individual company’s attitude to risk and the capital available for this purpose.

The statutory solvency requirements build upon the technical provisions of a general insurer. As a result, the technical provisions must be appropriate for this purpose.

This lack of consistency affects the ability of both the regulator and users of general purpose financial reports to assess the relative strength of a general insurer. In addition, for insurers for which the 15 per cent of the OCP is the relevant minimum statutory solvency measure under section 29, it produces the curious result that the more prudently an insurer sets its OCP the higher its statutory solvency requirement.

15 Except to the extent that the accounting standards require a true and fair value of the accounts.
In order to reduce the inconsistency in outstanding claims provisioning across insurers, actuarial advice in setting the OCP should be made mandatory and standards for calculating the OCP should be set out in prudential standards.\footnote{For further information on inconsistencies in the OCP see the Institute of Actuaries in Australia’s Working Group on the Consistency and Reliability of Outstanding Claims Discussion Paper. For further information on the recommended valuation standard see the paper A Statutory Liability Valuation Standard for General Insurers issued by APRA in conjunction with this paper.}

This actuarial advice could be either internal or external to the company.

In addition, the requirements for setting the UPP under Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities limits an insurer’s response to deficiencies in the UPP. An insurer can only write down the asset, DAC, to the amount of the deficiency or to zero where the value of the deficiency is greater than the DAC. Where the value of the deficiency in the UPP is greater than the value of the DAC, the insurer would have no choice other than to under provide for unearned premiums.\footnote{If an insurer were to provide for any deficiency by raising a “unexpired risk reserve” this would result in a qualification of the accounts by the external auditor.}

**The valuation of unexpired risk liabilities should be addressed in a prudential standard.**\footnote{For further information see the paper A Statutory Liability Valuation Standard for General Insurers issued by APRA in conjunction with this paper.}

The risks associated with pricing may involve a substantial element of operational risk and in many ways are a corporate governance issue for the management of a general insurance company. Under section 116 of the Life Act, life insurers are required to use actuarial advice in pricing. The life company is not permitted to issue policies unless the appointed actuary has given the company written advice about the likely consequences of the proposed arrangement. While the incidence of actuarial advice in general insurance pricing is increasing, it is not proposed to replicate this life insurance requirement in respect of all general insurers. Risk increases the longer the tail of the business. For short tail classes the benefit of reduced valuation risk may be outweighed by the cost of using actuarial advice in pricing.

**The requirements for operational risk should take into account the adequacy of pricing policies for short tail classes. There should be further consideration of the desirability of requiring actuarial involvement in the pricing of long tail classes.**
It should be noted that actuarial advice in pricing is required in some State based statutory schemes.

### 4.2.2 Insurance risk

The minimum statutory solvency requirement should address insurance risk. The requirement under Circular G6/97 for an insurer to hold net tangible assets of at least 20 times its highest net risk retention is a blunt test and, for this reason, is applied on a discretionary basis by APRA. As a result, it is not transparent and only goes part way to addressing insurance risk.

Changes to the minimum statutory solvency requirement are needed to ensure it deals with insurance risk:

- transparently; and
- in a risk responsive manner.

### 4.2.3 Concentration risk

The minimum statutory solvency requirement should address concentration risk.

### 4.3 Future developments - alternative risk transfer

The use of alternative risk transfer vehicles is not currently widespread in Australia. However, it is expected that this may increase over time.

The supervisory regime and minimum statutory solvency requirement should provide APRA with sufficient flexibility to allow it to give credit to alternative risk transfer instruments if it is determined at some time in the future that these instruments provide a sound method of transferring risk off the balance sheet.

### 4.4 Comparison of proposals against the objectives of the study

By improving the consistency with which insurers value and report their liabilities, the transparency of the general insurance industry would be enhanced.

The development of new prudential standards for the valuation of liabilities and new solvency requirements would improve the capacity of the prudential supervisory framework to specifically take into account all of the risks faced by general insurers.
These risks include valuation risk, insurance risk and concentration risk. A solvency requirement that is explicitly more risk responsive may provide the capacity to reduce the capital requirements for some general insurers.

Further, by making the supervisory regime more flexible so that it can give credit to other liability risk transfer methods, the regime would be consistent with the notion of promoting competitive neutrality between methods of transferring risk.

Finally, the proposals set out above would enhance APRA’s capacity to make standards with respect to the liabilities of a general insurer and make the solvency requirements of the general insurer more risk responsive. Accordingly, Australia’s supervisory regime with respect to liabilities and solvency would more fully comply with the supervisory principles of the IAIS.
CHAPTER 5 - ALM RISKS

ALM risks of a general insurer arise through the interaction between assets and liabilities and the management of that interaction. There are two main types of ALM risk, market risk and liquidity risk.

Market risk is the risk that movements in the value of the assets of a general insurer as a consequence of market movements are not matched by a corresponding movement in the value of the general insurer’s liabilities. Market movements are changes that occur in the economic environment external to the insurer such as changes in interest rates, inflation rates and foreign exchange rates.

The largest liability of a general insurer is its provision for outstanding claims. Under Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities, the liability for outstanding claims is measured as the present value of expected future payments. Expected future payments includes amounts in relation to unpaid reported claims, claims incurred but not reported (adjusted in light of the most recently available information for claims development and claims incurred and costs expected to be incurred in the settling of these claims). The discount rate or rates used in measuring the present value of the expected future payments is determined by reference to market determined risk adjusted rates of return. Typically the discount rate is based on the “risk free” rate being the relevant yield on Commonwealth securities of similar duration to the liabilities. Alternatively, insurers may use a series of different discount rates in line with the slope of the yield curve based on Commonwealth bond rates. At the same time, almost thirty percent of general insurance assets on an industry basis are held in fixed interest debt securities.

As a result, changes in interest rates may lead to a fall or rise in the value of the assets or liabilities of a general insurer respectively. If the change does not lead to an exactly offsetting change to an insurer’s liabilities or assets, the financial position of the insurer may deteriorate. This type of market risk is known as interest rate risk.

In addition, many insurers write some portion of their business in foreign currencies. They may also hold assets denominated in foreign currencies. In these cases the OCP and assets of the general insurer will be subject to fluctuations in the exchange rate. To the extent that assets and liabilities denominated in foreign currencies are mismatched, market risk in the form of foreign exchange risk will exist.
Liquidity risk is the risk that an insurer will be unable to liquidate its assets in sufficient time to pay its claims. Liquidity risk arises because of a maturity mismatch between assets and liabilities.

5.1 Current requirements dealing with ALM risks

ALM risks are not addressed within the current prudential supervisory framework, except to the extent that all risks are implicitly taken into account in the determined minimum statutory solvency requirement of a general insurer.

5.2 Weaknesses in the current requirements dealing with ALM risks

5.2.1 Market risk

The current requirements do not explicitly address market risk.

One way of addressing market risk in insurance companies is to ensure that assets and liabilities are appropriately matched so that interest rate or foreign exchange rate fluctuations can, to a large extent, offset each other. That is, by matching liabilities and assets that are expected to move together when interest rate or foreign exchange rate movements occur. However, as a general principle, insurers should be able to hold whatever assets they choose on commercial grounds so long as they have the appropriate financial and managerial capabilities to deal with the chosen asset allocation. It is preferable, therefore, that insurers be allowed to maintain mismatched assets and liabilities but, to the extent this occurs, the insurer should be required to hold assets against the market risk arising from the mismatch. This is consistent with the approach in the supervision of ADIs and life insurers.

Market risk for an ADI is currently defined as the risk of losses in traded interest rate and equity positions and all foreign exchange and commodity positions as a result of movements in market prices or rates. ADIs are required to have in place systems that accurately measure, and adequately monitor and control market risks. APRA requires ADIs to provide it with details of the management systems and procedures in place to control market risks. An APRA on-site market risk team reviews ADIs’ systems and controls to ensure that they are appropriate for the type of activities undertaken. ADIs must keep APRA informed of any changes to these systems. In addition, Prudential Statement C3 sets out a framework for determining the level of capital to be held by a ADI against its market risk. ADIs are permitted to adopt either a standard model or use their own internal model to measure market risk for capital adequacy purposes. The use of an internal model is conditional upon the explicit approval of APRA. Model
validation visits are undertaken by the APRA market risk team prior to granting approval to ensure that the internal models meet certain qualitative and quantitative standards.

In the supervision of life insurers, market risk addressed with by requiring life insurers to have a resilience reserve. The resilience reserve is calculated in accordance with the Solvency and Capital Adequacy Standards under the Life Act. The resilience reserve provides for the extent to which adverse movements in the investment markets will not be matched by a corresponding decline in the value of the liabilities of a life insurer. Life insurers are required to apply a standard set of adverse scenarios to determine the level of their resilience reserves. The greater the level of mismatching between movements in assets and liabilities through changes in the investment markets, the greater is the value of the resilience reserve.

In our view, the approach used in the supervision of life insurers may be appropriate for general insurers. Resilience should be taken into account in the new solvency standard.

The new solvency standard\(^\text{19}\) should take into account the extent to which the assets and liabilities of the general insurer are mismatched.

To some extent the current supervisory requirements for general insurers may drive a mismatch of foreign exchange assets and liabilities through the inside Australia solvency test. While we accept this is the case, from a prudential supervisory standpoint, it is important that the supervisor has jurisdictional reach over the assets of a general insurer.

Further work needs to be undertaken to determine whether it is necessary to maintain the inside Australia test.

5.2.2 Liquidity risk

There are currently no explicit requirements dealing with liquidity risk in general insurers. Similarly, there are no requirements under the life insurance supervisory regime relating to liquidity risk in life insurance. However, severe mismatching of assets and liabilities would be picked up under the requirements to calculate a resilience reserve in the solvency and capital adequacy standards under the Life Act.

\(^{19}\) For further discussion of the statutory solvency requirements see the paper A New Statutory Solvency Standard for General Insurers issued by APRA in conjunction with this paper.
Conversely, ADIs are typically more exposed to liquidity risk than general insurers due to the at-call nature of deposits. The requirements for liquidity management in ADIs is set out in Prudential Statement D1. Prudential Statement D1 requires ADIs to have in place plans for managing liquidity under different scenarios to ensure they can operate for a minimum time under adverse conditions. In addition, APRA may require ADIs to hold a specific amount of high quality assets. However, in practice, this requirement is rarely imposed because ADIs generally hold an adequate stock of high quality liquid assets to provide the capacity to meet obligations until underlying problems relating to liquidity are sorted out.

Consideration should be given to requiring general insurers to submit a prospective annual plan for managing liquidity.

The matching of liabilities and assets should be taken into account in determining the insurers required resilience under the new solvency requirements.

5.3 Comparison of proposals against the objectives of the study

The proposal to have a solvency requirement with some resilience component that explicitly considers risks arising because of a mismatch of assets and liabilities would improve the risk responsiveness of the current supervisory regime. This proposal together with that which would require general insurers to submit annual plans for managing liquidity would ensure that the regime specifically deals with these risks thereby improving the overall transparency of the requirements.
CHAPTER 6 - OPERATIONAL RISKS

Operational risk here is defined in a residual and very broad sense as all other risks not associated with the financial aspects of a general insurer's business. Operational risk is associated with the administration and operational aspects, both technical and human, of undertaking the business. Operational risk can be further broken down into a number of categories. These are:

- Administration risk, relating to the risk of error or failure in the administrative procedures of the business. This could include the procedures in the claims office or the relationships between the company and its agents and insurance brokers. It would also include error or failure arising as a result of a lack of skill or training of the staff of a general insurer;

- Technology risk, relating to the risks of error or failure associated with the technological aspects of the company. The Year 2000 date recognition problem is a good example of a potential technology risk to insurers;

- Moral risk, the risk that an insurer will act in response to a perceived moral obligation. For example, insurers may pay out claims in relation to events even though they are not legally required to do so;

- Political risk, relating to the risks associated with uncertainties in the external political environment, both nationally and internationally, to the extent they impact on the business. An example of political risk would be problems in repatriating profits as a result of foreign political actions;

- Fraud risk, relating to intentional acts undertaken, with the objective of personal benefit, to tamper with or manipulate the financial or operational aspects of the business;

- Compliance risk, relating to the need to comply with increasingly complex legislative requirements; and

- Legal risk, relating to the risks associated with setting the relationship and obligations between an insurer and its policyholders. Legal risk is particularly important for general insurers as inadequate policy drafting may mean the insurer has to pay out for risks not priced into the original premium.
As with all risks, managing operational risk is the responsibility of the board of directors and senior management of a general insurer. The board should provide governance, guidance and oversight to senior management. It should set the broad strategies and major policies, approve the overall organisational structure and ensure there is an adequate system of internal control. Effective risk management requires commitment from the highest levels in an organisation. By continuously demonstrating a commitment toward dealing prudently with risk, management ensures staff are aware of the company's attitude toward risk and provides those given the task of monitoring and reporting on risk the capacity to create change where necessary. Operational risk is therefore linked to requirements for fit and proper persons to hold positions of authority within a general insurance company. Fit and proper persons tests are discussed in Chapter 2.

In addition to the board and management of the company, prudential regulation traditionally relies on internal and external experts to monitor and report on the adequacy of internal controls.

6.1 Current requirements dealing with operational risk

APRA is required to approve the external auditor of a general insurance company under section 46 of the Insurance Act. An external auditor can only be approved if APRA is satisfied that the person has suitable experience that will enable that person to competently audit the accounts of an insurance business. The auditor is required to audit the yearly statutory accounts of the insurer (section 47) and lodge an audit certificate with APRA (section 48).

In addition, section 45 of the Insurance Act requires the statutory accounts to be accompanied by a certificate of “Reporting Approach and Compliance”. The certificate of “Reporting Approach and Compliance” sets out statements and opinions about the statutory accounts and the financial position of the insurer in accordance with a form approved by APRA. The certificate must be given in accordance with a resolution of the directors of the company and be signed by two directors of the company (unless there is only one director of the company, in which case it must be signed by that director). Alternatively, if the company is not incorporated in Australia (ie. it is a branch of a foreign insurer) it must be signed by either two directors of the company (unless there is only one director of the company, in which case it must be signed by that director) or the Australian agent of that insurer as appointed under section 118 of the Insurance Act.
Circular G 6/97 guidelines limit an insurer’s total cessions to reinsurers to 60 per cent of total premium income. This limit is designed to ensure that general insurers maintain an interest in the business they are writing. If an insurer were to cede 100 per cent of its policy liabilities to a reinsurer, the insurer would not be engaging in insurance business in its own right, but rather acting as an intermediary. In practice, general insurers have been allowed to cede more than 60 per cent of their policyholder liabilities to reinsurers where this has been justified on commercial grounds.

6.2 Weaknesses in the current requirements dealing with operational risk

The current requirements for both the external auditor and the certificate of “Reporting Approach and Compliance” focus almost solely on the accounts and financial position of the insurer. There are no requirements to report on other operational risk issues such as the appropriateness of internal controls, nor are there any requirements for external experts to perform a “whistle-blowing” function. The current requirements do not allow APRA to commission external auditors to review specific areas of a general insurer’s activities and no requirements exist for internal risk management committees to be put in place. Further, a general insurer is not required to use an appointed actuary.

In the supervision of ADIs, APRA receives an annual attestation from the chief executive of the ADI, which is endorsed by the board of that ADI. The attestation states that risks have been identified, systems designed to manage those risks are adequate and working effectively, and that the descriptions of these systems held by APRA are current. In addition to providing assurances about the reliability of financial information, external auditors check that the ADI is in compliance with the Prudential Statements.

A general insurer should be required to provide APRA with up-to-date descriptions of risk management systems put in place by that insurer. The certificate of “Reporting Approach and Compliance” should be upgraded to include a tightly prescribed attestation from the board that all supervisory requirements, including, but not limited to, the standards for the valuation of liabilities and solvency,17 have been fully complied with and that all material risks of the general insurer have been identified and systems are in place to manage those risks effectively.

APRA also requires external auditors to undertake a review of a particular area of an ADI’s operations. The area for review changes each year. In these reviews, auditors are required to comment on matters such as: the frequency and timeliness of the relevant information flows; processes in place to check the accuracy and integrity of that
information; and the usefulness of the relevant reports for monitoring compliance with the ADI’s risk management policies.

**APRA should have the power to require an ad hoc external audit review of a specific risk management issue of an insurer to be determined by APRA.**

Under the Life Act, each company is required to have an appointed auditor (section 85) and an appointed actuary (section 93).

**General insurers should be required to have an approved valuation actuary in addition to an approved auditor.** The approved valuation actuary would have responsibility for ensuring compliance with the prudential standards for liability valuation. Some exemptions may be made to the general requirement to have an approved valuation actuary where it is deemed to be inappropriate on cost/benefit grounds due to, for example, the small size of an insurer, the low risk class of business written or the strong solvency position of an insurer.

**The approved valuation actuary would be required to place a value on the liabilities of the general insurer for the purposes of the accounts and to report material changes in the value of liabilities to the Board.**

The auditor/actuary of a life company is required under sections 88 and 98 respectively to draw to the attention of the company, the directors of the company, or an officer of the company any matter that the auditor/actuary thinks requires action to avoid a contravention of the Life Act or to avoid prejudice to the interests of the owners of policies issued by the company. If the auditor/actuary believes the company has contravened the Life Act or prejudiced the interests of policyholders, or has failed to take appropriate action after the auditor/actuary has notified the company of such a matter, the auditor/actuary is required to report the matter to APRA.

In our view, it is appropriate for the auditor and approved valuation actuary of a general insurer to have “whistle-blowing” duties.

**The approved auditor of a general insurance company should be required to draw to the attention of the company any matter that the auditor thinks requires action to avoid a contravention of the regulatory requirements or to avoid prejudice to**

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20 For information about the recommended liability valuation and solvency standards see the paper A Statutory Liability Valuation Standard for General Insurers issued by APRA in conjunction with this paper.
the interests of the owners of policies issued by the company. If the auditor believes the company has failed to take appropriate action after the auditor has notified the company of such a matter, the auditor should be required to report the matter to APRA. The approved valuation actuary should have similar responsibilities in relation to compliance with the liability valuation and solvency standards.

In addition, life companies are required under section 90 of the Life Act to have in place an audit committee of the Board. This audit committee has the function of assisting the directors of the company to ensure that the financial statements of the company are in accordance with the legislative requirements and that the company has in place a proper system of management and financial controls. The life company is required to ensure that the audit committee has such power to obtain all information held by the company, the auditor and actuary which are necessary for it to fulfill its function. The life company directors must ensure that the auditor and appointed actuary are given opportunities to attend audit committee meetings and bring matters to the attention of the committee.

It is APRA’s view that, in accordance with sound risk management practices, general insurers should establish an audit committee of the Board. The audit committee should be charged with recommending measures to the Board which would lead to compliance with regulatory requirements and ensuring that the company has in place appropriate risk management systems. It should be noted, however, that an audit committee in no way removes responsibility for the prudent management of a general insurer from the Board.

The approved auditor of a life insurer is given qualified privilege in respect of any statement made for the purposes of the Life Act (including statements to APRA) and the answer to any question asked by the audit committee of the life company (section 89 of the Life Act). This qualified privilege is designed to ensure that the auditor provides full and frank information to APRA and the audit committee without fear of litigation.

The approved auditor of a general insurance company should be provided with privilege to ensure that the auditor provides full and frank information to APRA and the company without fear of litigation.

The 60 per cent limit on cessions is designed to ensure that the direct writer has some interest in the business it is writing and hence will price and manage its policies and claims more appropriately. However, it could be argued that this is a commercial matter
between the direct writer and the reinsurer. In addition, this requirement may be contrary to prudential objectives by, in effect, requiring some general insurers to retain more risk on their balance sheets than they would otherwise desire.

**Consideration should be give to removing the 60 per cent guideline to the limitation on cessions.**

### 6.3 Comparison of proposals against the objectives of the study

Currently, operational risk is not explicitly dealt with in the prudential supervisory requirements for general insurers. Requirements to provide a board attestation on the risks of a general insurer, “whistle-blowing” duties on approved independent experts, the establishment of audit committees and the introduction of “fit and proper” persons tests on directors, would ensure that the supervisory regime addresses operational risk.

Giving APRA the power to require ad hoc audit reviews on a specific topic would provide APRA with greater tools to deal with higher risk insurers and allow APRA to address specific risk issues as they arise.

A requirement to have an approved valuation actuary in conjunction with a standard for the purposes of liability valuation would provide greater consistency in outstanding claims provisions across general insurers. This would provide for greater comparability and enhance the transparency of the general insurance industry.

Removing the 60 per cent cession guideline would provide general insurers with greater commercial flexibility to manage their risks.
CHAPTER 7 - DISCLOSURE

Financial institutions are required to make disclosures to the regulator and the general public about the nature of their products and the performance of their business. The purpose of disclosure made to the regulator is to provide the regulator with sufficient information to ensure that the regulated entity is being managed prudently. Further, these disclosures help the regulator to identify financial institutions at risk and minimise the extent of policyholder losses in the event of failure.

The purpose of public disclosure in the context of prudential regulation is to help consumers better understand the nature of the contracts they are party to and the strength of the company they are dealing with, and allow them to make more informed choices between price and risk in the services being considered. Disclosure requirements expose providers of financial services to public scrutiny and competitive pressure from the professional market. In this way, disclosure assists in ensuring that market pressures apply against imprudent behaviour by the managers of financial institutions.

In order for public disclosure to be fully effective, it must be easily accessible to the general public and must be comparable across institutions. Disclosures made to the regulator and those made to the general public should only differ to the extent that there are clear commercial imperatives for the regulator maintaining the confidentiality of disclosed information.

7.1 Current disclosure requirements

Disclosure requirements are currently imposed on domestically incorporated general insurers via the Corporations Law and the Insurance Act. Branches of foreign incorporated companies are only required to comply with the disclosure requirements of the Insurance Act. In addition, listed companies are required to comply with the disclosure requirements of the Australian Stock Exchange (ASX).

Section 314 of the Corporations Law requires a company registered in Australia to report to the members of that company each financial year. This report is required to include the yearly financial, directors’ and auditors’ reports.\(^{21}\)

\(^{21}\) It should be noted that companies can alternatively provide members with a concise report for a financial year, however the concise report must contain a statement that the full report and auditor’s report will be sent to the member free of charge if the member so requests.
The basic contents of the annual financial report under the Corporations Law consists of the financial statements for the year (including a profit and loss statement, balance sheet, and statement of cash flows); the notes to the financial statements; and the directors’ declaration about the statements and notes. Section 296 of the Corporations Law requires the financial report of a company to comply with Australian accounting standards.

Section 44 of the Insurance Act requires authorised insurers to submit annual accounts and statements to APRA. These accounts must be audited by the general insurer’s approved auditor. The auditor’s certificate and a certificate of “Reporting Approach and Compliance” must also be lodged with APRA. The certificate of “Reporting Approach and Compliance” requires the directors of an authorised insurer to set out statements and opinions about the statutory accounts and financial position of that insurer.

Section 123 of the Insurance Act allows a person, on application to APRA and on payment of a prescribed fee, to inspect and make copies of such accounts and statements lodged with APRA under section 44 of the Insurance Act as have been specified by APRA by notice published in the Gazette. Currently, the Certificate of “Reporting Approach and Compliance”, the Underwriting and Profit & Loss Account, Statement of Assets and Liabilities and the Minimum Solvency Requirement statement have been specified by APRA for this purpose.

Other annual accounts and statements, provided to APRA under section 44, are not available for inspection under section 123 of the Insurance Act.

Section 44 of the Insurance Act also requires authorised insurers to lodge quarterly returns to APRA in respect of assets and liabilities, and premiums and claims. These quarterly returns are unaudited and are not available for inspection under section 123.

In addition, section 34A of the Insurance Act requires authorised insurers to lodge statements about reinsurance with APRA. These statements are lodged annually and are not available to the public.

APRA is able to commission an ad hoc actuarial report on the valuation of an insurer’s OCP. This report would not be made available to the public.

The ASX requires listed companies to submit an annual report that must be sent to security holders within 19 weeks (or, in the case of a trust, within 90 days) of the entity’s
Chapter 7 - Disclosure

financial year end. The listing rules require certain matters to be included in the annual reports of every listed entity over and above the requirements in the Corporations Law. In particular this report must include a statement of the main corporate governance practices that the entity has had in place during the reporting period.

7.2 Weaknesses in the current disclosure requirements

Only a small number of accounts and statements lodged by authorised general insurers under section 44 of the Insurance Act are currently available for inspection by the general public under section 123. While this is considered appropriate in the case of quarterly returns (which are unaudited) and for reinsurance forms lodged under section 34A (which may be commercially sensitive), there appears to be no reason why other accounts and statements lodged annually under section 44 should not be available to the public.

As a general principle, all information collected by APRA should be made available to the market except in those cases where APRA is satisfied that the information is sufficiently commercially sensitive to warrant non-disclosure. Annual accounts and statements collected by APRA in accordance with section 44 of the Insurance Act should be made available to the public.

In addition, it is our view that some of the statutory accounts and statements lodged with APRA could be improved to provide more relevant information to both the regulator and the general public. In particular, changes should be made to the reporting of the profit and loss account to require insurers to break profit and loss into current year and adjustments on prior years. Insurers should be required to report an insurance result, as opposed to an underwriting result, to enable the regulator to establish the profitability of the insurance business a company is writing. The underwriting result of a general insurer does not take into account return on the assets supporting the technical provisions. An insurance result would take into account the return on these investments.

Further, APRA needs to acquire information about the techniques used by general insurers to strike their technical provisions. This information is not currently available to the regulator.

Statutory forms should be upgraded to provide more relevant information to the regulator. In particular, the approved valuation actuary should be required to provide APRA with a report setting out his or her calculations in determining the
valuation of liabilities and the solvency requirement in accordance with the liability valuation and solvency standards.\textsuperscript{22}

The general public can gain access to the statement showing a general insurer’s minimum solvency requirements by application to APRA under section 123. However, it is our view that this does not provide sufficient accessibility to this information which is critical in forming a risk assessment of the insurer. The supervisory requirements for life insurance require life companies to make certain additional disclosures as notes to their annual financial statements lodged with the Australian Securities and Investments Commission (ASIC) and provided to members of the company in accordance with the Corporations Law. In our view this approach is suitable for general insurance.

General insurers should be required to disclose their statutory solvency requirement in notes to their annual financial statements provided to ASIC and members of the company in accordance with the Corporations Law. This requirement would include a component relating to the calculation of the company’s OCP.

In the supervision of life insurers, a company’s Financial Condition Report (FCR) is one of the most crucial documents to the regulator. In the FCR, the appointed actuary is required to comment independently on the financial condition of the company. The actuary is bound by professional standards in the way the FCR must be written and in terms of complying with ethical standards.

The FCR must include a general comment on the nature of the companies business and information on:

- policy guarantees;
- reinsurance arrangements;
- recent and expected experience;
- information systems of the company;

\textsuperscript{22} For information about the recommended liability valuation and solvency standards see the papers \textit{A Statutory Liability Valuation Standard for General Insurers} and \textit{A New Statutory Solvency Standard for General Insurers} issued by APRA in conjunction with this paper.
Chapter 7 - Disclosure

- the assets and investment policy of the company;

- the adequacy of premium rates and charges;

- valuations of liabilities;

- operating earnings;

- solvency and capital adequacy; and

- retained profits.

It is our view that APRA should have the power to require a Financial Status Report (FSR) from a general insurer. This power would be selective and exercised where a company was nearing its minimum statutory solvency requirement. That is, it should apply to “at risk” insurers.

Only listed companies are required to report annually to members on corporate governance practices in accordance with ASX listing rules.

It may be appropriate to require all general insurers to publicly report corporate governance practices on an annual basis.

7.3 Comparison of proposals against the objectives of the study

Improving the transparency, comparability and accessibility of general insurance information disclosed to the market should lead to more efficient capital allocation within the general insurance market.

Improving the statutory forms provided to APRA and the ability to require an FSR where an institution is at risk would improve the ability of the regulator to assess the relative risk of a general insurance company and allow APRA to intervene more effectively where companies are at risk of failure.
The rationale for supervising general insurers is the protection of policyholders in the face of market failure in the form of information asymmetry. Most ordinary consumers lack the capacity to understand the financial accounts of a complex financial institution such as an insurance company. In these circumstances, consumers will differentiate on the basis of advertising, price and service with little reference to the risk that the institution will later fail to honour its promises to the insured.

However, not all consumers of insurance products issued by insurers authorised under the Insurance Act lack the capacity to determine the credit worthiness of an insurer. Prudential regulation imposes a cost on the supervised industry. Where prudential regulation cannot be justified on the basis of market failure or for other systemic risk reasons, deregulation should occur.

Further, one of the key reasons APRA was established as the single prudential regulator of the financial system in Australia was to remove costly overlaps in supervision. Where such overlaps exist, regulation should be reduced. There is a case for deregulation where the only beneficiary of an insurance product is another financial institution and that financial institution is holding capital against the risk of default of that insurer.

### 8.1 Reinsurance

Reinsurers are specialist companies that accept business not by direct underwriting, but by way of transfer (or cession) of liability in connection with a risk or part of a risk from another insurer or reinsurer. Insurers wishing to cede insurance business have bargaining power in the transaction and can ask to see such information as is necessary to determine the relative risk of the transaction. Insurers and reinsurers looking to cede business to a reinsurer typically look at the credit rating of a reinsurer. Compliance with the bare statutory requirements is not, generally, seen as sufficient assurance of the reinsurer's ability to pay.

However, the minimum statutory solvency requirements under the Insurance Act are set net of reinsurance, meaning that a general insurer can reduce the amount of its minimum statutory solvency requirement by purchasing reinsurance. The risk retained by the direct insurer is backed by the statutory minimum solvency requirement, while the risk transferred to the reinsurer is not covered by solvency requirements relating to the direct insurer.
To address this residual risk, the regulator has imposed authorisation and solvency requirements on reinsurers authorised in Australia. Direct underwriters are not prohibited from using unauthorised foreign reinsurers, however they would typically be restricted in the amount they can transfer to an unauthorised reinsurer.

The rationale for supervising reinsurers would not exist if direct insurers were required to hold capital against the risk of reinsurer default. If this were the case, the authorisation status of a reinsurer would be irrelevant in determining the credit to be given to reinsurance assets.

**If direct insurers were required to hold capital against the risk of reinsurer default, conceptually it would be possible to deregulate reinsurers.**

### 8.2 Captive insurers

A pure captive only underwrites the risk of the corporate group to which it is a member. In recognition of the reduced regulatory concern with captives, captive insurers are, in practice, given exemptions from some of the reinsurance requirements of the Insurance Act. However, there does not seem to be any genuine rationale for regulating captive insurers where there are no third party beneficiaries. Domestic consumers do not have access to these types of insurers and members of the same corporate group should have greater capacity than a prudential regulator to assess the credit worthiness of another member of the group. Where financial conglomerates use captive insurers, these insurance assets are typically subject to exposure limits causing duplication in regulation.

There is a case for deregulating captive insurers where the captive has no third party beneficiaries. Domestic consumers do not have access to these types of institutions and where financial conglomerates use these vehicles for risk management; the conglomerate is typically subject to exposure limits.

### 8.3 Insurers underwritten by a State or Territory Government

Workers compensation and compulsory third party motor vehicle and accident insurance (CTP) are regulated at a State level. In some States and territories, State and Territory government insurers provide this type of insurance and are exempted for Constitutional reasons from the operation of the Insurance Act. In other States, the CTP or workers compensation schemes are deregulated, and private sector insurers authorised under the Insurance Act, are licensed by a State or Territory government body to provide either CTP or workers compensation in that State or Territory.
Until recently, there were 14 insurers authorised under the Insurance Act writing workers compensation business in Victoria. The Victorian State Government underwrote these insurers. It is an anomaly that these insurers were required to be authorised under the Insurance Act where State insurers are not.

**Insurers wholly underwritten by a State or Territory government should be exempt from the prudential supervisory requirements for general insurers.**

### 8.4 Mortgage insurers

While in theory it might be presumed that the policyholders of a mortgage insurer are mortgagors, in practice the protection under these policies is afforded to the mortgagee - ie. the ADI or other mortgage provider. From a prudential perspective the only concern is the counter party risk for mortgage insurance assets held by ADIs. Under the regulatory regime for ADIs, lenders are required to hold capital against the risk of mortgage insurer’s default.

**Mortgage insurers could be exempted from the operation of the prudential supervisory requirements for general insurers.** The prudential concern with mortgage insurers lies in the credit worthiness of an ADI’s assets. The ADI prudential supervisory regime requires ADIs to hold capital against the risk of mortgage insurer default.

### 8.5 Comparison of proposals against the objectives of the study

It has been emphasized throughout this paper that the purpose of prudential regulation of the general insurance industry is to protect consumers of insurance products who do not have the skills or for whom it is not cost effective to undertake their own risk assessment of the product provider. The proposals to deregulate captive insurers without third party beneficiaries, insurers underwritten by a State or Territory government and mortgage insurers are in line with Competition Principles. That is, deregulation should occur where there is no clear case for regulation. In the case of reinsurers, the current justification for regulation would not exist if direct insurers were required to hold capital against the risk of reinsurer default.