



Discussion Paper

Refinements to the General Insurance Prudential Framework

31 July 2007

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Preamble

On 3 May 2007, the Minister for Revenue and Assistant Treasurer announced the Government's approach to the regulation of Discretionary Mutual Funds (DMFs) and Direct Offshore Foreign Insurers (DOFIs).

The announcement indicated that:

- the *Insurance Act 1973* (the Insurance Act) would be amended to subject DOFIs to prudential regulation;
- APRA's prudential framework would be explicitly modified to apply to different categories of insurer based on their risk profile; and
- while DMFs would not be regulated at this stage, they would be required to provide data to APRA under the *Financial Sector (Collection of Data) Act 2001* (FSCODA).

The Minister's announcement also indicated that limited exemptions would be provided for DOFIs. The Treasury is developing options for such exemptions and will issue a separate consultation paper on this topic.

The changes to the Insurance Act and FSCODA are described within the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 (DMF & DOFI Bill), which was introduced to the Parliament on 21 June 2007.

The focus of this discussion paper is the modifications and clarifications that APRA is proposing to make to its prudential framework to give effect to the Government's announcement in relation to DOFIs and, more generally, to recognise different categories of insurer based on risk profiles.

APRA's proposals on data collection from DMFs will be addressed in a separate discussion paper to be released later in 2007.

Insurers affected by these proposals, and changes to the Insurance Act more generally, are:

- all existing APRA-authorised insurers;
- DOFIs that intend to become APRA-authorised insurers;
- Australian-owned sole parent captive insurers that are not APRA-authorised; and
- Australian-owned association captive insurers that are not APRA-authorised.

Summary of proposals

The proposals in this paper respond to the Government's policy on the regulation of DOFIs. They will apply to all APRA-authorised insurers, both those insurers currently authorised by APRA and those insurers that will be authorised in the future when the changes to the Insurance Act become effective.

APRA proposes the following categories of insurer within its refinements to the general insurance prudential framework:

- Category A: Locally incorporated insurers;
- Category B: Wholly owned subsidiary of a local or foreign insurer;
- Category C: Foreign insurer operating as a foreign branch;
- Category D: Association captive; and
- Category E: Sole parent captive.

The following table summarises APRA's proposals.

Category	Description
All categories	APRA's reporting framework will be enhanced to facilitate performance analysis of insurers. The claims development table will be reduced in scope.
	Higher investment risk charges will be applied to reinsurance recoverables from foreign reinsurers than from APRA-authorized reinsurers.
	Reinsurance recoverables will be recognised as part of an insurer's capital base where the recoverables have been outstanding for less than 12 months. Where recoverables have been outstanding for more than 12 months they will only be recognised if they are from an APRA-authorized reinsurer or are otherwise supported by assets in Australia that are guaranteed to be available to the insurer when required.
	APRA will clarify that assets held by a foreign sub-custodian are specifically excluded from being 'assets in Australia'.
A	APRA will emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium.
B	Wholly owned Australian subsidiaries of foreign insurance groups will be allowed to use a group actuary who is not an Australian resident.
	APRA will accept strategic plans prepared on an insurance group basis (as it already does for risk management framework) provided there is adequate detail about each APRA-authorized insurer in the group.
	APRA will emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium.
C	APRA proposes to review and amend its 'assets in Australia' requirements for foreign branches to recognise that a trust structure for the agent to hold assets in Australia may prove impractical for some forms of assets.
	The Insurance Act is being amended to allow corporate agents in Australia and this will result in the application of fit and proper requirements for corporate agents.
	The use of a group actuary who is not an Australian resident will be allowed.
	APRA will accept strategic plans prepared on an insurance group basis (as it already does for risk management framework) provided there is adequate detail about the branch.
	APRA will emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium.
D	The floor for the calculated risk-based minimum capital requirement will be lowered from \$5 million to \$2 million. APRA's expected buffer over the minimum capital requirement will increase from 20 per cent to 50 per cent when the insurer's minimum capital requirement is less than \$5 million.
	Outsourcing of material business activities to related parties will be required to be documented in written contracts.
	APRA will emphasise that the total amount of premium an association captive insurer may cede to reinsurers is not expected to exceed 90 per cent of gross written premium.

Category	Description
E	The floor for the calculated risk-based minimum capital requirement will be lowered from \$5 million to \$2 million. APRA's expected buffer over the minimum capital requirement will increase from 20 per cent to 50 per cent when the insurer's minimum capital requirement is less than \$5 million.
	Up to 100 per cent of the capital base of the sole parent captive will be allowed to be lent back to the parent group on commercial terms.
	APRA will clarify that the alternative board composition requirements to which it has agreed for current sole parent captives where there is not a majority of independent directors will be applied to all sole parent captives.
	APRA will emphasise that the total amount of premium a captive insurer may cede to reinsurers is not expected to exceed 90 per cent of gross written premium.

For run-off insurers, it is proposed that a run-off plan can replace an annual Financial Condition Report.

Clarifications relating to small insurers¹ are:

- when an insurer ceases to meet the definition of a small insurer, APRA supervisors will apply a progressive transition to full actuarial requirements; and
- small insurers can, under certain circumstances, use accounting data as approximations to certain data items required for APRA reporting purposes.

There will also be further refinements affecting all categories of insurers that will be part of the second stage of consultation detailed below.

Next steps

Changes to the Insurance Act are expected to be passed by Parliament in the second half of 2007 and are intended to take effect on 1 July 2008. Modifications to APRA's prudential framework will generally be effective from 1 July 2008.

APRA will consult with interested parties on the matters covered in this discussion paper. Following submissions on this paper, APRA intends to publish a response paper and draft prudential standards in the

fourth quarter of 2007. The final prudential standards are expected to be released in early 2008. APRA acknowledges this is a tight but necessary timeframe for the development of these standards, given that DOFIs and others in the insurance industry will wish, as soon as possible, to have certainty about the prudential framework that will apply from 1 July 2008.

Written submissions on APRA's proposals should be forwarded via e-mail to Keith Chapman at GIRFPF@apra.gov.au by 11 September 2007. Submissions should include relevant cost-benefit analysis of the proposals – for further detail see Attachment 2.

Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982 (FOIA)*. APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

¹ A small insurer is one with less than \$20 million of gross insurance liabilities (valued in accordance with GPS 310) and the gross insurance liabilities of the insurer do not include a material amount in respect of long-tail business.

Contents

Glossary	7
Background	9
Refinements to the general insurance prudential framework	10
Categories of insurer	11
Modifications and clarifications	12
All categories	12
All categories – insurers in run-off and small insurers	14
Specific categories	16
Category A: Locally incorporated insurer	16
Category B: Wholly owned subsidiary of local or foreign insurer	16
Category C: Foreign insurer operating as a foreign branch	17
Category D: Association captive	19
Category E: Sole parent captive	20
Attachment 1 – Current general insurance prudential framework	22
Attachment 2 – Cost-benefit analysis	24

Glossary

AASB	Australian Accounting Standards Board
Approved actuary	Approved Actuary as defined in GPS 310
Approved auditor	Approved Auditor as defined in GPS 310
APRA	Australian Prudential Regulation Authority
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
APRA-authorised insurer or reinsurer	Insurer or reinsurer that is authorised by APRA under the Insurance Act
BAC	Board Audit Committee referred to in GPS 510
BCM	Business Continuity Management referred to in GPS 222
BCP	Business Continuity Plan referred to in GPS 222
Business plan	Business plan referred to in GPS 220
Corporations Act	<i>Corporations Act 2001</i>
DMF	Discretionary Mutual Fund as defined under DMF & DOFI Bill
DMF & DOFI Bill	Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007
DOFI	Direct Offshore Foreign Insurer as defined under Explanatory Memorandum, Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007
FCR	Financial Condition Report referred to under GPS 310
Financial information declaration	Financial information declaration referred to in GPS 220
Foreign branch	Foreign general insurer as defined under the Insurance Act
Foreign reinsurer	Reinsurer that may be authorised in a foreign jurisdiction but is not authorised by APRA.
FSCODA	<i>Financial Sector (Collection of Data) Act 2001</i>
GGN	General Insurance Guidance Note
GGN 222.1	<i>Guidance Note GGN 222.1 Risk Assessment and Business Continuity Management</i>
GPG	General Insurance Prudential Practice Guide
GPG 245	<i>Prudential Practice Guide GPG 245 Reinsurance Management Strategy</i>

GPS	General Insurance Prudential Standard
GPS 110	<i>Prudential Standard GPS 110 Capital Adequacy</i>
GPS 120	<i>Prudential Standard GPS 120 Assets in Australia</i>
GPS 220	<i>Prudential Standard GPS 220 Risk Management</i>
GPS 222	<i>Prudential Standard GPS 222 Business Continuity Management</i>
GPS 230	<i>Prudential Standard GPS 230 Reinsurance Management</i>
GPS 231	<i>Prudential Standard GPS 231 Outsourcing</i>
GPS 310	<i>Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation</i>
GPS 510	<i>Prudential Standard GPS 510 Governance</i>
GPS 520	<i>Prudential Standard GPS 520 Fit and Proper</i>
IAAust	Institute of Actuaries of Australia
ILVR	Insurance Liability Valuation Report referred to in GPS 310
Insurance Act	<i>Insurance Act 1973</i>
Insurer or general insurer	General insurer as defined under the Insurance Act
MCR	Calculated risk-based minimum capital requirement, which is the sum of the insurance risk, investment risk and concentration risk capital charges as calculated under GPS 110
Minister	Minister for Revenue and Assistant Treasurer
PPG	Prudential Practice Guide
ReMS	Reinsurance Management Strategy referred to under GPS 230
Reviewing actuary	Reviewing actuary as defined in GPS 310
Risk management declaration	Risk management declaration referred to in GPS 220
RMS	Risk Management Strategy referred to under GPS 220

Background

On 3 May 2007, the Minister for Revenue and Assistant Treasurer (the Minister) announced the Government's approach to the regulation of DMFs and DOFIs. This announcement was followed by the introduction of the DMF & DOFI Bill to the Parliament on 21 June 2007. The Bill has a number of implications for APRA and its prudential supervision of the general insurance industry in Australia. The rationale for the policy can be found in the Minister's announcement and the explanatory memorandum to the Bill².

DOFIs that wish to carry on insurance business in Australia will become subject to prudential regulation effective from 1 July 2008. Amendments to the Insurance Act will extend the definition of 'insurance business' to DOFIs that carry on insurance business in Australia, either directly or through the actions of another (for example, an insurance agent or broker).

Under the DMF & DOFI Bill, APRA will be provided with the necessary additional powers to enforce the amended provisions of the Insurance Act.

The changes to the Insurance Act will not change the position of foreign reinsurers that are not APRA-authorized. These companies will be able to continue to accept business from APRA-authorized insurers without being required to be authorized by APRA under the Insurance Act.

The Minister's announcement and its legislative amendments respond to the HIH Royal Commissioner's Report on *The Failure of HIH Insurance*, released in 2003, which raised concerns regarding the lack of prudential regulation of DMFs and DOFIs. A review was commissioned by the Government to address these concerns and, in December 2005, the Treasury released a discussion paper³ on the subject. Submissions were received from a wide cross-section of the insurance industry and the Minister's announcement in May 2007 has now established the Government's policy.

This paper discusses APRA's proposals in relation to DOFIs. APRA's proposals for data collection from DMFs will be addressed in a separate discussion paper expected to be released later in 2007.

As well as responding to the Government's announcement, APRA's approach in this paper is also motivated by the need to further develop proposals made in APRA's 2005 discussion paper on captives⁴. APRA delayed further development of these proposals pending the Government's review of the regulation of DOFIs, which generally include captives that are not APRA-authorized.

The proposals in this paper are relevant to all APRA-authorized insurers and other insurers (including any captives) that choose to apply for APRA authorisation in order to carry on insurance business in Australia from 1 July 2008.

² Explanatory Memorandum, Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007.

³ Treasury Discussion Paper, *Regulation of Discretionary Mutual Funds and Direct Offshore Foreign Insurers*, released on 16 December 2005.

⁴ Discussion Paper, *Proposed Definition of a 'Captive' and Exemption from Prudential Regulation*, released on 23 February 2005.

Refinements to the general insurance prudential framework

APRA's current general insurance prudential framework is summarised in Attachment 1. The refinements to the framework proposed in this paper will clarify how APRA exercises judgement in the application of the framework to different categories of APRA-authorized insurers. It will also assist other insurers to understand how they will be treated under the framework should they choose to apply for APRA authorisation.

This paper proposes five different categories of insurer:

- Category A: Locally incorporated insurer;
- Category B: Wholly owned subsidiary of a local or foreign insurance group;
- Category C: Foreign insurer operating as a foreign branch;
- Category D: Association captive; and
- Category E: Sole parent captive.

The definition of each category and APRA's proposals are outlined in the following chapters.

The refinements to the general insurance prudential framework will apply to all currently authorised insurers as well as those that are authorised in the future. They will apply to both locally incorporated entities (wholly owned subsidiaries of foreign insurance groups) and foreign branches.

APRA intends to implement the refinements to the general insurance prudential framework by:

- varying the prudential standards where necessary;
- expanding the prudential practice guides to clarify the application of the prudential standards for different categories of insurer; and
- clarifying APRA's guidelines on authorisation of general insurers.

The means of implementing each proposal will be made explicit following submissions received on this paper. A response paper to submissions along with draft prudential standards and draft prudential practice guides are expected to be released in the fourth quarter of 2007.

Categories of insurer

Category A: Locally incorporated insurer

A Category A insurer is incorporated in Australia. This category excludes all insurers falling within any of the other categories.

For the purposes of clarification, wholly owned subsidiaries of corporate groups that are not insurance groups would fall into this category. Category A insurers could be mutual companies or shareholder companies.

Category B: Wholly owned subsidiary of local or foreign insurance group

A Category B insurer is one that is incorporated in Australia and is wholly owned by a local or a foreign insurance group. Category B insurers could be subsidiaries of mutual or shareholder companies.

Category C: Foreign insurer operating as a foreign branch

A Category C insurer is a foreign insurer that chooses to carry on insurance business in Australia through a foreign branch located in Australia. A foreign branch is a foreign general insurer as defined under subsection 3(1) of the Insurance Act to be a body corporate that:

- (a) is a foreign corporation within the meaning of the Constitution;
- (b) is authorised to carry on insurance business in a foreign country; and
- (c) is authorised under section 12 of the Insurance Act to carry on insurance business in Australia.

Category C insurers could be foreign branches of mutual or shareholder companies.

Category D: Association Captive

A Category D insurer is an insurer that is:

- owned by an industry or a professional association, or by the members of the industry or professional association or a combination of both, and

- only underwrites business risks of the members of the association or those who are eligible, under the articles of association or constitution of the association, to become members of the association.

Category D insurers could be mutual companies or shareholder companies.

Medical indemnity insurers owned by medical defence organisations will not be treated as association captives for the purposes of these refinements to the general insurance prudential framework. This is to ensure consistency with the reforms relating to the prudential supervision of medical indemnity insurers introduced in 2003 and the capital transition provisions applied under those reforms. Medical indemnity insurers will generally fall within category A.

Category E: Sole parent captive

A Category E insurer is either a corporate captive or a partnership captive. Category E insurers will generally be shareholder companies.

Corporate captive

A corporate captive insurer:

- is owned by a single company or a group of related bodies corporate as defined by section 50 of the Corporations Act⁵; and
- exists for the purpose of underwriting the risks of the parent company or members of a group of related companies, and perhaps also joint venture partners and contractors of the members of the group of companies.

Partnership captives

A partnership captive:

- is owned by a partnership; and
- exists for the purpose of underwriting the business risks of the partners and/or the partnership.

⁵ A related body corporate is defined under section 50 of the Corporations Act as where a body corporate that is:

- a holding company of another body corporate; or
- a subsidiary of another body corporate; or
- a subsidiary of a holding company of another body corporate;

and where the first-mentioned body and the other body are related to each other.

Modifications and clarifications

In its proposed refinements, APRA will maintain the integrity of the prudential framework but will also introduce certain clarifications and modifications. Some clarifications to the framework are useful where APRA commonly applies judgements to particular categories of insurer. In addition, some modifications to the prudential framework will enable APRA to give recognition to the different categories of insurer.

All categories

The following modifications apply to all insurers, regardless of category.

MODIFICATIONS

Regulatory reporting standards

Current APRA reporting standards focus on capital adequacy and do not facilitate performance analysis.

Principle

APRA's reporting framework should allow performance analysis that will enable early detection of adverse financial performance.

Current position

- APRA requires reporting to be on a prospective accounting basis.
- This results in all premium revenue, acquisition costs and reinsurance expenses being recorded directly into profit and loss. There is no deferral and matching of premium revenue, claims expense and reinsurance expense, as required under the AASB standards.

Modification

APRA proposes to:

- simplify the current claims development table including reducing the period of claims development captured from ten years to five years;
- require investment income to be allocated between assets supporting insurance liabilities and other net assets; and

- require premiums for bound but not incepted business to be identified as a separate item.

In relation to the first two points, the proposed changes will align APRA's reporting requirements more closely with the AASB reporting requirements. Regarding bound but not incepted business, separation from other premiums written will allow a clearer comparison of prospective and accrual bases of reporting.

Investment risk charges on reinsurance recoverables

Reinsurance recoverables from foreign reinsurers not authorised by APRA pose greater credit risk than recoverables from APRA-authorised reinsurers. APRA-authorised reinsurers are required to maintain assets in Australia to support their liabilities in Australia but foreign reinsurers are not.

In 2006 the English Court of Appeal dismissed an appeal made by the Australian liquidators of HIH seeking the transfer of assets in England to Australia for distribution in the Australian liquidation. The English Court was not prepared to direct the transfer of assets from England to Australia as there is a preference under Australian legislation for insurance creditors, in contrast to the position under English insolvency law. This demonstrates that there is a risk that reinsurance recoverables due from a foreign jurisdiction may not ultimately be available for distribution in Australia in the event of liquidation and this increases the credit risk relating to such recoverables.

Principle

APRA's prudential framework should recognise the greater credit risk of reinsurance recoverables due from foreign reinsurers.

Current position

Investment risk charges are applied to reinsurance recoverables based on the credit rating of the reinsurer. There is currently no difference in treatment of reinsurance recoverables between APRA-authorised reinsurers and foreign reinsurers.

Modification

APRA proposes to require a higher investment risk charge on reinsurance recoverables relating to foreign reinsurers. Where an insurer has reinsurance recoverables from both APRA-authorized and foreign reinsurers with the same credit rating, the foreign reinsurers will attract a higher investment risk charge than the APRA-authorized reinsurers. The table below shows the proposed increase in the investment risk charge for counterparty grades and investment risk charges.

Grade	Standard & Poor's	Moody's	AM Best	Fitch	Risk charge – APRA-authorized reinsurer	Risk Charge – foreign reinsurer
1	AAA	Aaa	A++	AAA	2%	4%
2	AA+, AA, AA-	Aa1, Aa2, Aa3	A+	AA+, AA, AA-		
3	A+, A, A-	A1, A2, A3	A, A-	A+, A, A-	4%	6%
4	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	B++, B+	BBB+, BBB, BBB-	6%	8%
5	BB+ or below	Ba1 or below	B or below	BB+ or below	8%	10%

The charges shown in the column headed “Risk charge – APRA-authorized reinsurer” are the same as the charges currently applicable to all reinsurers.

Capital recognition of reinsurance recoverables older than 12 months

Reinsurance recoverables become less certain as time passes. Upon liquidation of an insurer, there can be a substantial risk that reinsurance recoverables due from foreign reinsurers may not be available to meet the claims of Australian policyholders. The availability of assets in Australia to meet claims in the event of the liquidation of an insurer is a fundamental principle of the Insurance Act.

Principle

APRA's prudential framework should respond to the greater risk associated with reinsurance recoverables on claims where settlement is delayed.

Current position

- The only recognition of risk in relation to reinsurance recoverables is that they receive a capital risk-weighting based on the credit rating of the reinsurers.
- Similar provisions apply to retrocessions for reinsurers.

Modification

Reinsurance recoverables will be recognised as part of an insurer's capital base where the recoverables have been outstanding for less than 12 months. Where recoverables have been outstanding for more than 12 months they will only be recognised if they are from an APRA-authorized reinsurer or are otherwise supported by assets in Australia that are guaranteed to be available to the insurer when required.

CLARIFICATION

Assets in Australia – sub-custodian arrangements

Principle

Assets should be excluded from being treated as assets in Australia where there is doubt over whether they would be treated as such under common law.

Current position

- Under section 28 of the Insurance Act, insurers are required to hold assets in Australia that exceed their liabilities in Australia.

- GPS 120 specifies which assets are not considered to be assets in Australia for the purposes of section 28 of the Insurance Act.
- Assets held via foreign custodians are excluded as assets in Australia under GPS 120. GPS 120 is silent on the treatment of assets held by foreign sub-custodians.

Clarification

APRA proposes to clarify GPS 120 by explicitly excluding from the definition of assets in Australia any assets of an insurer held by a foreign sub-custodian.

All Categories – modifications to be incorporated in the next stage of consultation

The next stage of consultation by APRA will incorporate drafts of modified prudential standards and prudential practice guides. A number of additional modifications to the prudential framework will be included:

- amendments to GPS 110 arising from the current consultation process, begun on 2 July 2007, on APRA's discussion paper, *Capital adequacy for authorised deposit-taking institutions and general insurers*;
- consequential amendments to the general insurance prudential framework that result from the Financial Sector Legislation Amendment (Simplifying Regulation and Review) Bill 2007 when it is passed;
- changes to GPS 310 as a result of the IAAust's finalisation of a revised "*Professional Standard 300 – Valuations of General Insurance Liabilities*"; and
- changes in the investment capital factors that APRA proposes to introduce under GPS 110 in relation to property and equity investments, following a reassessment of the volatility of these assets classes.

All categories – insurers in run-off and small insurers

Insurers in each of the five categories can be open to new business or closed to new business (i.e. in run-off). They can also be classified as 'small insurers'.

The modifications and clarifications below relate to run-off insurers or small insurers within any category.

RUN-OFF INSURERS

MODIFICATION

Financial Condition Report (FCR)

An FCR is likely to add limited information for many run-off insurers. A run-off plan may be a more useful document for these insurers. APRA's actuarial requirements should acknowledge this distinction.

Principle

APRA should only impose requirements, such as the need to have an actuary prepare an FCR, where the benefits, to APRA or the insurer, at least match the costs of compliance by the insurer.

Current position

- The approved actuary must provide annually a financial condition report (FCR) and an insurance liability valuation report (ILVR). External peer review of the ILVR is also required annually.
- The current actuarial requirements do not differentiate between run-off insurers and active insurers. Therefore, run-off insurers are also subject to annual FCR requirements.
- GPS 310 allows APRA the ability to vary the frequency of preparation of FCRs and ILVRs.
- Under GPS 310, small insurers that are not required to appoint an approved actuary are not required to have an FCR prepared or to have a peer review of the ILVR undertaken.

Modification

Instead of requiring an FCR for each run-off insurer, APRA proposes to require an initial run-off plan that is reviewed by an actuary. The run-off plan will need to be reviewed annually for the first three years from the time the insurer stops accepting new business. After the first three years, the run-off plan is to be subject to a triennial actuarial review. In all cases, APRA will reserve the right to require an annual FCR or annual run-off plan if it deems it necessary.

SMALL INSURERS

MODIFICATION

Actuarial requirements where the insurer ceases to meet the definition of a small insurer

A small insurer is one that predominantly writes short-tail business and has gross insurance liabilities of less than \$20 million.

Principle

Where an insurer has met the criteria for a small insurer, but grows to the point where it ceases to meet the criteria, APRA should allow transitional arrangements for meeting the full actuarial requirements.

Current position

- A small insurer is not required to appoint an approved actuary but is still required to value its insurance liabilities in accordance with GPS 310.
- A small insurer that is not required to appoint an approved actuary is not required to have an ILVR or an FCR prepared.
- Where an insurer ceases to meet the criteria for a small insurer, it is required to appoint an approved actuary who must then prepare an ILVR and FCR. The insurer is also required to appoint a reviewing actuary to undertake a peer review of the ILVR.

Modification

Where an insurer grows such that it no longer meets the criteria for a small insurer, APRA will clarify that actuarial requirements will be applied in a transitional

manner depending on the insurer's circumstances.

This transitional application of actuarial requirements will be agreed upon between the insurer and its APRA supervisor on a case-by-case basis. One key factor will be the insurer's rate of growth, which will be considered against both historic growth and expected growth according to the insurer's business plan.

CLARIFICATION

Reporting requirements

Principle

The cost of complying with APRA's reporting framework should not be disproportionate to the benefits of the information being sought. Smaller insurers should be allowed to provide APRA with information based on accounting requirements where those requirements are a reasonable proxy for APRA's reporting requirements.

Current position

- APRA requires reporting to be on a prospective accounting basis.
- This results in all premium revenue, acquisition costs and reinsurance expenses being recorded directly into profit and loss. There is no deferral and matching of premium revenue, claims expense and reinsurance expense, as required under the AASB standards.
- APRA allows an insurer to develop an approximate method for valuing insurance liabilities where the result is not materially different from the full valuation process.

Clarification

APRA proposes to clarify that a small insurer can use unearned premium provisions (UPP) less its deferred acquisition costs (DAC) as an approximation to its premium liabilities provided that, in accordance with AASB 1023⁶, its UPP is subject to a liability adequacy test and in applying that test a 75 per cent level of sufficiency is used.

⁶ Australian Accounting Standard AASB 1023 *General Insurance Contracts*.

Specific categories

Category A: Locally incorporated insurer

CLARIFICATION

Reinsurance cessions and retrocessions

Principle

APRA expects authorised insurers to accept significant underwriting risk and to have the resources and infrastructure to do so.

Current position

Prudential Practice Guide GPG 245 Reinsurance Management Strategy (GPG 245) indicates that an insurer would typically cede no more than 60% of total written premium.

Clarification

APRA's expectation about limits on reinsurance cessions and retrocessions may be important for some DOFIs that choose to seek APRA authorisation. In addition, some DOFIs may choose to continue insuring risks from the Australian market by entering into reinsurance arrangements with APRA-authorised insurers (sometimes referred to as 'fronting'). A degree of 'fronting' is acceptable to APRA subject to cession limits that will be applied across the insurer's total portfolio.

APRA will emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium.

Category B: Wholly owned subsidiary of local or foreign insurer

MODIFICATION

Recognition of non-resident actuaries for a foreign insurance group

Principle

Foreign insurance groups operating subsidiaries in Australia should not be precluded from using group expertise to meet at least some of APRA's actuarial requirements.

Current position

The current prudential standards do not allow an approved actuary to be appointed for an APRA-authorised insurer unless the actuary ordinarily resides in Australia.

Modification

- APRA proposes to allow the use of a non-resident group approved actuary if the actuary would satisfy APRA's fit and proper requirements other than the residence test.
- Where a non-resident approved actuary is used, the reviewing actuary must be a resident Accredited Member or Fellow of IAAust.

CLARIFICATIONS

Group strategic plans

Principles

Where a single overarching group strategic plan is used by an insurance group operating one or more wholly owned subsidiaries in Australia, the Australian subsidiaries should not be precluded from using group strategic plans instead of a separate strategic plan for each APRA-authorised insurer in the group.

Current position

A risk management strategy and a reinsurance management strategy can be prepared on a group basis. However, the risk management standard is silent on the use of group strategic plans.

Clarification

APRA will accept group strategic plans provided their application to the APRA-authorised insurers within the group is clear.

Reinsurance cessions and retrocessions

Principle

APRA expects authorised insurers to accept significant underwriting risk and to have the resources and infrastructure to do so.

Current position

GPG 245 indicates that an insurer would typically cede no more than 60% of total written premium.

Clarification

APRA's expectation about limits on reinsurance cessions and retrocessions may be important for some DOFIs who choose to seek APRA authorisation. In addition, some DOFIs may choose to continue insuring risks from the Australian market by entering into reinsurance arrangements with APRA-authorised insurers (sometimes referred to as 'fronting'). A degree of 'fronting' is acceptable to APRA subject to cession limits that will be applied across the insurer's total portfolio.

APRA will emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium.

Category C: Foreign insurer operating as a foreign branch

MODIFICATIONS

Assets in Australia test

There is no separate ownership of assets between a branch and its head office because they are not distinct legal entities. Therefore, APRA's requirements aim to ensure that assets of a branch are kept within the jurisdictional reach of Australian courts so that these assets are available to meet its liabilities in Australia in the event of the winding up of the foreign insurer.

APRA has been informed that there are practical difficulties for a foreign branch in complying with APRA's current requirements that ensure the foreign branch's agent in Australia maintains the control of all its assets in Australia.

Principle

To ensure that assets of a branch are kept within the jurisdictional reach of Australian courts, there needs to be proper control of the assets by the agent in Australia.

Current position

Under section 28 of the Insurance Act, foreign insurers must hold assets in Australia (other than reinsurance recoveries from foreign reinsurers), through either an agent in Australia on trust or a local custodian, that at least cover their liabilities in Australia.

Modification

APRA proposes to review and amend GPS 120 to recognise that the requirement for a trust structure may not be essential for some forms of assets and that imposing such a requirement may be impractical. APRA will continue to ensure that a foreign insurer is not allowed to change the location of its assets in Australia without the authorisation of its agent in Australia. The proposals are:

- to remove the requirement for real estate in Australia to be held by an agent or custodian, as real estate is not typically very liquid;
- for debt and equity assets, to allow delegation of authority by the agent holding the assets on trust, to avoid involving the agent in day-to-day dealings;
- to remove the requirement for receivables to be held by an agent on trust or by a custodian. In effect, this means that the receivable can be in the name of the foreign insurer with the expectation that it will be paid into a bank account controlled by the agent or custodian. Receivables outstanding for more than six months will not be recognised as assets in Australia to allow for the gradual impairment of such assets with time;
- for assets held by a custodian, to allow co-signatory arrangements but to restrict any transaction involving disposal of assets in Australia unless authorised by the agent in Australia; and
- to allow bank accounts to be held in the name of a foreign insurer but to require any withdrawal from such accounts to be authorised by the agent in Australia.

Corporate agents in Australia

To allow the greatest flexibility to foreign insurers that wish to commence or continue carrying on insurance business in Australia, the Insurance Act is to be amended by the DMF & DOFI Bill to allow insurers to appoint corporate agents rather than only individual agents. The structure of a corporate agent addresses risk management concerns that control over all of a foreign insurer's assets in Australia must be vested in a single individual agent.

Principle

Corporate agents should have to comply with fit and proper requirements that are equivalent to those imposed on individual agents in Australia.

Current position

As corporate agents are currently not allowed, there are no requirements for corporate agents in APRA's prudential framework.

Modifications

Current fit and proper requirements for an individual agent will be applied to the directors and senior managers of a corporate agent. APRA also proposes that there be a minimum of three directors for the board of a corporate agent.

Recognition of non-resident actuaries for a foreign insurance group

Principle

Foreign insurance groups operating through a foreign branch in Australia should not be precluded from using group resources to meet at least some of APRA's actuarial requirements.

Current position

The current prudential standards do not allow an approved actuary to be appointed for an APRA-authorized insurer unless the actuary ordinarily resides in Australia.

Modification

APRA proposes to allow the use of a non-resident group approved actuary if the actuary would satisfy

APRA's fit and proper requirements (except for the residence test).

Where a non-resident approved actuary is used, the reviewing actuary must be an Accredited Member or Fellow of IAAust.

CLARIFICATIONS

Group strategic plans

Principles

Where a single overarching group strategic plan is used by an insurance group operating through a foreign branch in Australia, the foreign branch should not be precluded from using a group strategic plan instead of a separate strategic plan for the foreign branch.

Current position

A risk management strategy and a reinsurance management strategy can be prepared on a group basis. However, the risk management standard is silent on the use of group strategic plans.

Clarification

APRA will accept a group strategic plan provided its application to the foreign branch is clear.

Reinsurance cessions and retrocessions

Principle

APRA expects authorised insurers to accept significant underwriting risk and to have the resources and infrastructure to do so.

Current position

GPG 245 indicates that an insurer would typically cede no more than 60% of total written premium.

Clarification

APRA's expectation about limits on reinsurance cessions and retrocessions may be important for some DOFIs that choose to seek APRA authorisation. In addition, some DOFIs may choose to continue insuring risks from the Australian market by entering into reinsurance arrangements with APRA-authorized

insurers (sometimes referred to as ‘fronting’). A degree of ‘fronting’ is acceptable to APRA subject to cession limits that will be applied across the insurer’s total portfolio.

APRA will emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium.

Category D: Association captive

MODIFICATION

Minimum capital requirement

Principle

The MCR should not be a material barrier to the setting up of association captives in Australia, provided that policyholder protection is not compromised.

Current position

- The MCR is subject to a floor of \$5 million.
- The MCR consists of:
 - an investment risk capital charge based on the assets of the insurer; plus
 - an insurance risk capital charge based on the insurance liabilities of an insurer; plus
 - a concentration risk capital charge equal to the maximum event retention of the insurer based on a 1-in-250 year event and the cost of one reinstatement of catastrophe cover.
- APRA expects an insurer to hold a buffer above its MCR of 20 per cent.

Modification

The MCR is proposed to be subject to a lower floor of \$2 million instead of \$5 million, on the condition that the expected buffer over the MCR is 50 per cent where the MCR is less than \$5 million. To ensure adequate policyholder protection a higher capital buffer will be imposed to recognise that smaller insurance portfolios are usually subject to greater volatility of claims experience.

CLARIFICATIONS

Outsourcing

Principle

Outsourcing of material business activities should not result in an increase in risk for policyholders.

Current position

Where material business activities are outsourced to a related party within the insurer’s corporate group, the insurer does not need to have the agreement documented in a written legally binding contract, unless specifically required by APRA.

Clarification

Typically, APRA only allows material business activities to be outsourced without the need for written contracts where the insurer’s group is headed by an APRA-regulated entity.

APRA will apply the current outsourcing standard to require an association captive that outsources material business activities to a related entity to formally document the arrangement.

Reinsurance cessions and retrocessions

Principle

APRA expects authorised insurers to accept significant underwriting risk and to have the resources and infrastructure to do so.

Current position

GPG 245 indicates that a captive insurer would typically cede no more than 90% of total written premium.

Clarification

APRA expects that Category D insurers may cede more premium to the reinsurance market than open-market insurers. APRA will emphasise that the total amount of premium a captive insurer may cede to reinsurers is not expected to exceed 90 per cent of gross written premium.

Category E: Sole parent captive

MODIFICATIONS

Minimum capital requirement

Principle

The MCR should not be a material barrier to the setting up of sole parent captives in Australia.

Current position

- The MCR is subject to a floor of \$5 million.
- The MCR consists of:
 - an investment risk charge based on the assets of the insurer; plus
 - an insurance risk charge based on the insurance liabilities of an insurer; plus
 - a concentration risk capital charge equal to the maximum event retention of the insurer based on a 1-in-250 year event and the cost of one reinstatement of catastrophe cover.
- APRA expects an insurer to hold a buffer above its MCR of 20 per cent.

Modification

The MCR is proposed to be subject to a lower floor of \$2 million instead of \$5 million, on the condition that the expected buffer over the MCR is 50 per cent where the MCR is less than \$5 million. To ensure adequate policyholder protection, a higher capital buffer will be imposed to recognise that smaller insurance portfolios are usually subject to greater volatility of claims experience.

Assets lent back to parent company

Where a sole parent captive has assets in the form of loans to group companies, there is an alignment of interests among policyholders and debtors; however, the alignment will often not be complete. For instance, there may be minority interests in some companies within the group and there may also be some third-party risks underwritten by the captive.

Principle

Shareholder funds of the captive should be available to be lent back to the captive's parent but assets supporting policyholder liabilities should be kept at arm's length from the parent.

Current position

There are no specific rules relating to investments by insurers in related parties.

Asset concentration charges are applied to exposures to unrated or lowly rated counterparties. If a captive invests in a related company, there may be a limit imposed depending on the counterparty rating of that related company. The limits are:

- 25 per cent of capital base if rated below BBB-; and
- 50 per cent of capital base if rated from BBB- to BBB+ or unrated).

Where exposures exceed these limits, the excess of the exposure over the limit is added to the insurer's MCR.

Modification

APRA proposes that a captive be permitted to loan funds to its parent or related group companies subject to limits. The limit proposed is the lower of 100 per cent of the total capital base and the current limit that applies based on the credit rating of the related company or companies. Any loans to related companies will be required to be made on commercial terms.

CLARIFICATIONS

Board composition

Principle

In view of the alignment of interests between a captive insurer and its parent, directors of the captive who are directors or executives of the parent company, or a related group company, may be accepted by APRA for governance purposes.

Current position

- Majority independent board with at least five directors.

- Independent directors on the parent board regarded as independent on the regulated entity board (this also applies to joint ventures).
- Independent chairman.
- For sole parent captive insurers, APRA has agreed alternative board arrangements on the same basis as the clarification detailed below.

Clarification

A majority non-executive Board is acceptable for sole parent captives.

Conditions under which APRA would grant alternative arrangements for a Category E insurer are:

- no board member is employed in an operational business unit⁷ of the group that is insured by the insurer nor is there a concentration of representatives from the same reporting line within the group; and
- any insured not wholly owned by the parent company, such as a contractor or joint venture partner, should have the right to choose whether or not its insurances are underwritten by the captive insurer.

Reinsurance cessions and retrocessions

Principle

APRA expects authorised insurers to accept significant underwriting risk and to have the resources and infrastructure to do so.

Current position

GPG 245 indicates that a captive insurer would typically cede no more than 90% of total written premium.

Clarification

APRA expects that Category E insurers may cede more premium to the reinsurance market than open-market insurers. APRA will emphasise that the total amount of premium a captive insurer may cede to reinsurers is not expected to exceed 90 per cent of gross written premium.

⁷ Operational Business Unit does not include the corporate service functions of the group (i.e. risk management, audit, finance and treasury, etc), but represents core business function of the group.

Attachment 1 – Current general insurance prudential framework

APRA's prudential framework comprises general insurance prudential standards, prudential practice guides and authorisation guidelines. The framework applies to all insurers but in practice APRA exercises judgement in its application.

Capital adequacy (GPS 110)

An insurer's capital base must be greater than its minimum capital requirement (MCR) as specified by APRA.

For insurers incorporated in Australia (including subsidiaries of foreign insurers), the capital base⁸ is generally equivalent to the net assets of the insurer, including any excess reserves above the minimum 75 per cent probability of sufficiency level of net insurance liabilities. For a foreign branch, the equivalent of a capital base is the net assets in Australia adjusted for any deductions specified by APRA.

The MCR consists of the:

- insurance risk capital charge – determined by applying specified percentages, which differ by class of insurance business, to the value of insurance liabilities for each class of business; plus
- investment risk capital charge – determined by applying specified percentages, which differ by class of assets, to the value of the assets of the insurer in each class; plus
- concentration risk capital charge – equal to the maximum event retention of the insurer based on a 1-in-250 year event and the cost of one reinstatement of catastrophe cover.

There is a floor of \$5m applied to the MCR.

If APRA approves and the Treasurer agrees, an insurer may use an internal model to determine its MCR.

Assets in Australia (GPS 120)

All insurers are required to maintain assets in Australia at least equal to their liabilities in Australia, with the location of assets and liabilities determined according to the common law. APRA can determine whether certain assets or asset classes are to be excluded as assets in Australia.

Governance (GPS 510)

The board bears ultimate responsibility for the sound and prudent management of the insurer. APRA imposes requirements relating to the composition of the board, the role of the board audit committee, the internal audit function, external auditor independence and the approved actuary's and external auditor's access to the board.

A foreign branch is not required to maintain a board in Australia but there is a requirement for a senior officer outside Australia to have responsibility for the branch. In addition, the Insurance Act requires a foreign branch to have an agent in Australia.

"Fit and Proper" (GPS 520)

The board must have a policy to ensure the fitness and propriety of individuals who hold positions of responsibility with the insurer. This includes directors, senior officers, approved auditor, approved actuary and the agent in Australia (for foreign branches).

Risk management (GPS 220)

An insurer is required to have a dedicated risk management function and a risk management framework. The risk management framework must be described in a high-level risk management strategy. Insurers that are part of groups may comply with some requirements on a group basis, if APRA agrees.

Business Continuity Management (BCM) (GPS 222)

An insurer must implement a whole-of-business approach to BCM appropriate to the nature and scale of its operations.

⁸ GPS 110 specifies treatment of different capital instruments and capital deductions that may apply.

Reinsurance management (GPS 230)

An insurer is required to maintain a reinsurance management framework documented in a reinsurance management strategy. Reinsurance arrangements must be legally binding and formally agreed to by all parties within a timely period. A statement detailing the insurer's reinsurance arrangements must also be submitted to APRA at least annually.

Outsourcing (GPS 231)

All outsourcing arrangements of material business activities must be documented in the form of written contracts except for some intra-group arrangements. An insurer must consult with APRA prior to entering into offshoring arrangements. Insurers are also required to maintain a policy relating to outsourcing which ensures there is sufficient monitoring of the outsourced activities.

Actuarial reporting and valuation (GPS 310)

All insurers, except for small insurers, must appoint an approved actuary. Small insurers are insurers with less than \$20 million of gross insurance liabilities and no material long-tail insurance liabilities.

All insurers that are required to have an approved actuary must obtain an annual Insurance Liability Valuation Report (ILVR) and Financial Condition Report from the approved actuary and have the ILVR peer reviewed by another actuary. Insurance liabilities must be valued at a 75 per cent level of sufficiency.

External audit (GPS 310)

All insurers must have an approved auditor. The approved auditor must prepare a certificate in relation to the insurer's annual APRA reporting requirements and prepare a report annually about the systems, procedures and controls within the insurer.

Reporting framework

APRA requires insurers to submit quarterly returns and annual audited returns. APRA's prudential reporting requirements are different from financial reporting required under accounting standards issued by the Australian Accounting Standards Board (AASB). Insurance contract transactions are accounted for on a "prospective accounting basis" which results in all premium revenue, acquisition costs and reinsurance expenses being recorded directly into profit and loss. There is no deferral and matching of premium revenue, claims expense and reinsurance expense, as required under the AASB standards.

Insurers who underwrite public and product liability insurance or professional indemnity insurance business, where the underlying risks are Australian-based, are also required to submit data on individual claim and policy information relating to such business. This information is collected by returns for the National Claims and Policies Database (NCPD).

Attachment 2 – Cost-benefit analysis

Measuring the economic impact of this proposal

Entities affected by these proposals

There are currently 132 authorised insurers in Australia. The proposals in this paper will affect all existing authorised insurers to varying degrees. APRA has not been provided with any reliable estimates of how many DOFIs are operating in the Australian market so it is difficult to reliably estimate the total number of those entities directly affected by these proposals.

Assessing the costs

As part of developing prudential requirements, APRA undertakes an assessment of costs and benefits to stakeholders likely to be affected by any proposals. If significant costs are likely to be incurred by stakeholders, APRA may be required to prepare a Regulation Impact Statement (RIS). APRA expects that its proposals will be captured within the RIS prepared for the introduction of the DMF & DOFI Bill. APRA therefore does not expect that it will have to prepare a separate RIS unless it is made aware of significant costs relating to any of the proposals that are not identified in the RIS for the DMF & DOFI Bill.

In keeping with *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (the Banks report), APRA is further enhancing its approach to cost-benefit analysis. These enhancements will generally focus on obtaining more granular cost data from the affected stakeholders, in particular the affected industry. The Business Cost Calculator (BCC) is the preferred tool of the Commonwealth Government in calculating business compliance costs. To ensure APRA gathers such data in a uniform manner, respondents are asked to use the BCC to make their assessments of compliance costs of the proposals in this paper. The BCC can be accessed at: <http://online.industry.gov.au/costingmodel>. Costs of the proposals that are not covered by cost categories in the BCC are to be advised to APRA separately along with the assumptions underlying the estimated costs.

The outcomes of the analysis of costs will be used, where adequately robust, in preparing a RIS if required for the introduction of the proposals.

Assessing the benefits

Most of the proposals described in this paper are intended to reduce the cost of compliance. APRA is interested in any information insurers in those categories would be able to provide about the reduction in the cost of compliance. These are the benefits of the proposals to insurers.

APRA requests that respondents provide commentary on these benefits and would be interested to learn of additional benefits that could be foreseen by any stakeholders.

Further information is sought from insurers, both authorised insurers and DOFIs, to help APRA assess the benefits and net impact of the proposals contained in this paper, and ensure that they are as effective and efficient as possible. Respondents are invited to refer to the Australian Government guidance on cost-benefit analysis: *Introduction to Cost-Benefit Analysis and Alternative Evaluation Methodologies* and *Handbook of Cost Benefit Analysis* which are published by the Commonwealth Department of Finance. These publications are available online at http://www.finance.gov.au/finframework/fc_2006_01.html.

Submissions regarding benefits identified, where the analysis is suitably robust, will be used in formulating any required RIS for the introduction of the proposals.



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