Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia

Policy Discussion Paper
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PROPOSED REFORMS TO THE PRUDENTIAL SUPERVISION OF GENERAL INSURANCE COMPANIES IN AUSTRALIA

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Australian Prudential Regulation Authority

PREAMBLE

General insurance companies have been supervised in largely the same manner since the inception of the Insurance Act in 1973. In September 1999, the Australian Prudential Regulation Authority (APRA) issued three policy discussion papers setting out the scope for modernising the prudential supervisory requirements for general insurers in Australia.

This paper now continues the dialogue with industry by setting out more detailed proposals on how the reforms discussed in the September Discussion Papers could be implemented. We invite written comments on issues raised in this paper by Friday, 14 July 2000.

Over coming months, further papers, in the form of draft prudential standards, will be released for discussion. As this project progresses, we are committed to extensive industry consultation.

It should be noted that the reforms outlined in this paper will eventually require amendment of the *Insurance Act 1973*. While APRA will be discussing proposals with the Government, responsibility for the legislative framework, including the Insurance Act, does not rest with APRA, but with the Government.

APRA is aware that the insurance industry is currently subject to a number of different Government reform processes, and that the Government will need to balance these in determining its legislative priorities.

Comments and any questions about this discussion paper should be submitted in writing by 14 July to:

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CHAPTER 1 - INTRODUCTION

In September 1999, the Australian Prudential Regulation Authority (APRA) released three policy discussion papers (the September Discussion Papers) for consultation with industry on proposals to modernise the prudential supervisory regime for general insurance companies authorised to conduct insurance business in Australia. 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. 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 the institution's capital as a buffer against unexpected or extreme losses.

The purpose of this paper is to continue the dialogue with industry by setting out more detailed proposals on how a new and more modern regime of prudential supervision could be applied to general insurance companies. Any new regime should be in line with APRA-wide prudential objectives and supervisory techniques, should promote greater market efficiency and should not place Australian insurers at a competitive disadvantage in the international marketplace. The proposals set out in this paper are designed to shift the regulatory approach away from black letter law requirements to one where companies will apply more risk-based practices to identify, measure and manage the risks that arise from their activities.

The proposals set out in this paper will form the basis of recommendations to the Government to reform the *Insurance Act 1973* (Insurance Act).

1.1 Responses to the September Discussion Papers

Comments received on the September Discussion Papers have been considered in the formulation of the approach set out below. Specific comments and APRA's responses are included in the relevant chapters of this paper. General comments received on the September Discussion Papers are set out in Appendix 1.

It has been noted that some respondents to the September Discussion Papers questioned the need for any significant change to the prudential regime on the grounds that existing requirements had been effective in minimising losses to policyholders in the past. APRA is seeking to improve the risk responsiveness of the regulatory regimes for all APRA-regulated institutions and does not accept that there is no case for doing so with respect to general insurance.

1.2 Scope of the Proposals

It is intended that the proposals set out in this paper will be applied to all insurance companies authorised to conduct business under the Insurance Act other than Lloyd's underwriters. 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. In addition, the enforcement powers contained in Part V of the Insurance Act are not considered. Further, as it is proposed that the Financial Status Report will only be required of "at risk" insurers, it is now considered to be an enforcement matter, and thus is not considered in this paper. Part V and the data collection powers of the Insurance Act are currently subject to separate consideration as part of parallel initiatives to harmonise enforcement provisions and data collection provisions across all APRA-regulated institutions.

1.3 Objective

The objectives of the proposals set out in this paper are to create a new supervisory regime which:

- makes it clear that the supervisory regime is designed to protect general insurance policyholders;
- is more responsive to the risk profile of individual insurance companies and their business size, mix, and complexity;
- enhances the transparency of the general insurance industry by increasing the relevancy, consistency and accessibility of disclosures to the market;
- is broadly in line with the International Association of Insurance Supervisors (IAIS) Core Principles and with examples of international best practice;
- minimises restrictions on competition and direct costs on industry where these costs and restrictions cannot be justified on cost/benefit grounds;
- reflects APRA's supervisory objective to regulate like risks in a like manner across financial institutions, where appropriate and practicable; and
- responds appropriately to risks that may affect the ability of a general insurer to meet its policyholder liabilities.

1.4 Harmonisation of Supervisory Requirements Across APRA

APRA is planning, over time, to engage in a process of harmonising the prudential supervisory requirements for different types of industries. However, APRA also recognises that fundamental differences between industries exist and that certain parts of standards will remain industry specific.

1.5 Prudential Standards for General Insurance Companies

The components that make up any sound prudential supervisory regime are authorisation criteria, capital requirements, risk management strategies, (on and off-site) surveillance and, if necessary, enforcement. In many circumstances, these components can be supplemented by market discipline, a strong ally of the supervisor. As financial institutions become more diversified and complex, prudential supervisors internationally are necessarily increasing the sophistication and flexibility of their supervisory regimes. One-size-fits-all approaches to supervision, comprising blunt, externally imposed rules and standards, are becoming less relevant in today's marketplace.

In recognition of these developments, regulators are moving towards systems of regulation that are more market based and more consistent with the sound risk management practices employed by well-run financial institutions for their own commercial purposes. That is, prudential supervisors are setting standards that require financial institutions to put in place their own policies and procedures for controlling risks that are material to the solvency position and on-going viability of that institution. The regulator is then able to place greater reliance on the institution's self-assessment of its own risks and controls. In this world, the role of the regulator is one of quality assurance of control systems, and risk management practices more generally.

1.6 Proposed New System of Regulation

APRA is considering how best to structure the regulatory framework. At this stage, the approach is to adopt a three-layered system of regulation for general insurance companies authorised to conduct insurance business in Australia, but the structure outlined below will be subject to further consideration.

1.6.1 The Insurance Act

The Insurance Act will sit at the top of the hierarchy and contain the high-level principles necessary for prudential supervision. It is proposed that the Insurance Act will provide:

- that the objective of the Act is to protect policyholders and that primary responsibility for this rests with the board of directors (Board) and chief executive officer (CEO) of the insurer, who must certify annually in writing that the risk management systems of the insurance company are adequate for and appropriate to this objective;
- a definition of insurance business;
- that a person carrying on insurance business in Australia must be authorised;
- that APRA may make Prudential Standards for the purposes of the Insurance Act;
- that a mandatory consultation process that has regard to good commercial practice and cost-benefit considerations be followed in the setting of Prudential Standards under the Insurance Act;
- that a company authorised under the Insurance Act must meet a Capital Adequacy Standard at all times;
- that a company authorised under the Insurance Act must make provision in its accounts for its liabilities in accordance with a Liability Valuation Standard;
- that a company authorised under the Insurance Act must have reinsurance arrangements in place at all times in accordance with a Reinsurance Arrangements Standard;
- that a company authorised under the Insurance Act must comply with any other Prudential Standards set by APRA from time-to-time under that Act; and
- for the imposition of whistle-blowing rights and responsibilities and accompanying privilege on the directors, approved auditor and valuation actuary of a company authorised under the Insurance Act.

1.6.2 Prudential Standards

The second layer of the proposed hierarchy of regulation will be made up of Prudential Standards. These Standards will set out the bulk of requirements that companies authorised under the Insurance Act will have to comply with. The Prudential Standards will be issued by APRA after consultation with industry. The consultation process will be mandated in the Insurance Act.

APRA's preference is to have a small number of Standards, each outlining in plain English the key requirements for a particular prudential measure, with any prescriptive or interpretive detail relegated to accompanying Guidance Notes.

APRA proposes to make Prudential Standards in respect of:

- capital adequacy;
- liability valuation;
- qualitative requirements for reinsurance arrangements; and
- operational risk (including prudential management, advice from experts, product design and pricing, underwriting management, claims management, liquidity management, internal controls and asset exposures).

It is intended that the Capital Adequacy Standard will specify capital charges for each of the broad risk categories which are relatively easy to quantify: asset risks; liability risks; and asset/liability mismatch risks. At present, methodologies for calculating an operational risk capital charge are not sufficiently advanced, and reliance for this area will be placed on qualitative guidance set out in an Operational Risk Standard, dealing with internal governance issues.

The Liability Valuation and Reinsurance Arrangements Standards will be unique to general insurance, the former feeding into both capital adequacy and reporting requirements, and the latter outlining qualitative guidance for reinsurance.

When issued, these Standards in combination will require general insurers to have in place appropriate risk management procedures and internal systems of control to manage risks that may otherwise undermine the solvency position of the insurer. Risks that cannot be efficiently mitigated should be covered by capital, giving the insurer a very high prospect of survival. Insurance companies will be required to rigorously self-assess and attest to their own compliance with these Standards.

1.6.3 Guidance Notes

The final layer of the proposed hierarchy of regulation will be a set of Guidance Notes for each Prudential Standard. These Notes will set out the details of how APRA expects the Standards to be interpreted. There will also be a stand-alone Guidance Note in relation to procedures and requirements for the authorisation of companies under the Insurance Act. Work on the Prudential Standards and Guidance Notes is relatively advanced, and there will be future rounds of consultation as these details become available and are released for comment.

1.7 Self-assessment

The proposed new system of regulation will be based on companies assessing their own compliance with the new regime. The Standards and Guidance Notes are designed to provide a benchmark by which directors of an insurance company can ensure they have in place appropriate risk management policies and procedures. APRA's role in the supervision of the new regime will focus on quality assurance designed to ensure, as far as practicable, that the required policies and procedures have been effectively implemented. APRA will assess an insurer's compliance with the proposed Standards when it conducts its regular on-site inspections and through audit reports and other techniques.

Insurers with well-developed risk management practices already in place will find that they comply with the proposed Standards and Guidance Notes with a minimum of additional regulatory burden. Moreover, the proposed Prudential Standards and accompanying Guidance Notes will set out the minimum requirements; an insurer should always seek to implement a higher standard that aligns with the size, mix and complexity of its business.

1.8 Structure of this Paper

Chapters 2 through 6 of this paper discuss authorisation requirements and the ground that will be covered by each of the Prudential Standards outlined above. The issue of deregulation of selected segments of the insurance industry is discussed in Chapter 7.

General comments received on the September Discussion Papers are set out in Appendix 1. Appendix 2 briefly describes the solvency regimes currently operating in other jurisdictions.

Prudential reporting and disclosure are not addressed in this paper. Companies will be requested at a later stage to test the proposed Liability Valuation and Capital Adequacy Standards against several years of actual data. At that time, a complete set of draft returns will be issued for comment and completion. Consultation on disclosure issues will follow this process.

CHAPTER 2 - AUTHORISATION REQUIREMENTS FOR GENERAL INSURERS

Prudential supervisors use minimum entry requirements as a tool to ensure that financial institutions commence operations with adequate resources and appropriate systems for the business they are proposing to undertake. Minimum entry requirements also provide consumers with a minimum level of assurance as to the financial soundness of the institution with which they are doing business, and the expertise and probity of its Board and senior management.

Section 23 of the Insurance Act requires general insurance companies to obtain an authority from APRA to commence operations in Australia. In order to gain an authority, a general insurance company needs to satisfy APRA that it has sufficient capital, expertise and appropriate risk management strategies in place to enable it to comply with the prudential supervisory requirements on an on-going basis.

A stand-alone Guidance Note setting out draft minimum requirements in this area will be issued in the near future.

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. All APRA-regulated institutions (except standard employer-sponsored superannuation funds) are subject to requirements relating to the authorisation process. Many of these processes are generic and, accordingly, the aim is to develop a consistent set of authorisation criteria across all regulated financial institutions.[1] In forming these requirements, regard will be given to the IAIS Supervisory Standard on Licensing.[2]

2.1 Capital Adequacy Requirements

The September Discussion Papers noted that the current minimum capital requirement of $2 million is low when compared to those for other institutions regulated by APRA: $10 million shareholders' capital for life insurers; $5 million capital for approved trustees of public offer superannuation funds and $50 million minimum Tier 1 start-up capital for locally incorporated banks. These amounts can be increased at APRA's discretion on a case-by-case basis. That said, 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 most likely have a substantial impact on many players in the industry (although not necessarily the competitiveness of the industry given that the top 20 companies write around 90 per cent of premium revenue across the industry).

The September Discussion Papers also proposed the introduction of risk-based capital adequacy requirements that more accurately reflect the underlying risk profile of individual insurers. This proposal is designed to ensure that insurers intending to write long-tail or reinsurance business are subject to higher capital adequacy requirements commensurate with the higher level of risk that these entities tend to assume.

Respondents to the September Discussion Papers were generally supportive of differing capital adequacy requirements for different lines of business. It is proposed, therefore, to apply differing capital adequacy requirements for general insurers by line of business.

APRA is concerned that the $2 million minimum is insufficient to ensure that companies have resources to support future business, put in place appropriate risk management systems and, at an absolute minimum, provide funds to pay out an administrator and staff and related costs in the event of a wind-

1 The authorisation requirements for general insurers will mirror the proposed authorisation guidelines for authorised deposit-taking institutions (ADIs) that will be available in May 2000.

2 A copy of this standard is available from the IAIS website at www.iaisweb.org.

up. Accordingly, it is proposed to increase the minimum capital requirement. In the case of new authorisations, APRA will assess the adequacy of start-up capital on a case-by-case basis according to the scale, nature and complexity of the business operations proposed in the business plan. However, APRA will not consider applications where the start-up capital is less than $5 million.

Incumbent insurers will be required to increase their capital to at least this minimum level. The proposed changes would be introduced over a lengthy transition period - up to five years - in recognition of the potentially large impact on market participants.

2.2 Management

Upon authorisation, general insurers should have in place a Board and senior management with appropriate integrity, reputation, experience and skills. The September Discussion Papers recommended - consistent with international Core Principles for financial regulation - that "fit and proper" tests be imposed on the Board and senior management of financial institutions (see Chapter 6). It is proposed that new entrants will have to meet the requirements of an Operational Risk Standard with respect to, inter alia, prudential management.

2.3 The Appointment of Experts

The September Discussion Papers recommended that general insurers be required to have an appointed valuation actuary and approved auditor. The role and responsibilities of the appointed valuation actuary and approved auditor are discussed in Chapter 6. New entrants will be required to have these experts appointed prior to authorisation.

2.4 Risk Management

To obtain an authority from APRA to carry on insurance business, it is proposed that general insurance companies will be required to submit to APRA their risk management strategies. These risk management strategies should at the very least address the requirements of the Prudential Standards with respect to: Capital Adequacy; Liability Valuation; Reinsurance Arrangements; and Operational Risk.

APRA will require an insurer's approved auditor and valuation actuary to certify that the risk management strategies forming part of their respective areas of prudential responsibility conform to these requirements prior to authorisation.

2.5 Draft Guidance Note on Authorisation Requirements

A draft of the proposed Guidance Note on Authorisation Requirements will be released by APRA for comment in the near future.

CHAPTER 3 - CAPITAL ADEQUACY

General insurance companies are currently subject to a minimum statutory solvency requirement. The requirement represents a test of claims-paying ability. Insurers are required to satisfy the test in order to be allowed to continue to write business. The purpose of a statutory solvency requirement is to provide an additional safety buffer over and above commercial solvency against events that may (and do) occur outside the range of events for which risk prevention measures have been taken.

Section 29 of the Insurance Act requires, inter alia, that general insurance companies meet two conditions relating to solvency. The first, which is applicable only to companies incorporated in Australia, requires that total assets exceed total liabilities by not less than $2 million, 20 per cent of premium income, or 15 per cent of outstanding claims, whichever is the greater.[3] This is commonly referred to as the "total test". The second, which applies to all companies, including foreign companies which operate in Australia through branches, requires that assets in Australia exceed liabilities in Australia by not less than $2 million, 20 per cent of premium income in Australia, or 15 per cent of outstanding claims in Australia, whichever is the greater.[4] This is referred to as the "inside Australia test".

In addition, 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 on-going basis. General Insurance Circular G 6/97[5] 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 so as to protect the insurer's balance sheet against catastrophic events.

Special solvency requirements apply to mortgage insurers. A mortgage insurer is required to have an excess of assets over liabilities of not less than two per cent of its aggregate risk exposure.[6] A rolling 10-year claims equalisation reserve is also required (funded by 25 per cent of annual earned premiums).

The current statutory solvency requirement is a blunt measure designed to take into account any residual risks of a general insurer. The September Discussion Papers proposed the introduction of a new Solvency Standard for general insurers. It was proposed that the Standard would contain explicit capital charges against particular risks such as asset risks, liability risks, asset/liability mismatches and catastrophes.

In general, respondents to the September Discussion Papers showed cautious support for the introduction of a new statutory Solvency Standard that contained more specific risk charges. One major concern was that the new statutory solvency requirement does not increase the required solvency level across the general insurance industry as a whole.

An optional solvency test based on companies' internally generated risk measurement calculations was also proposed in the September Discussion Papers. Within a framework to be established by APRA, companies will be encouraged to develop their own internal models for the purposes of determining the capital requirement for statutory purposes. Use of an internal model will be conditional on APRA's approval and will require the model to be suitably rigorous and robust.

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3 Section 29(1)(b).

4 Section 29(1)(c).

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

6 The aggregate risk exposure relates to contracts of insurance written by the mortgage insurer within the last 10 years and still in force. A mortgage insurer's aggregate risk exposure is the sum of the amount insured under contracts where the value of the loan exceeded 66.7 per cent (or 60 per cent in the case of residential property) of the value of the property at the date the insurance was issued.

3.1 Form of the Standard

It is proposed to set out requirements for statutory solvency in a new Prudential Standard. The basis of the solvency standard will change from an assets-required basis to an approach based on capital adequacy. Accordingly, the new Standard will be known as the Capital Adequacy Standard. The purpose of moving the test toward a capital adequacy approach is to specifically relate capital to risks on both the asset and liability side of the balance sheet. The Standard relates to both existing liabilities (current business) and liabilities projected to be written over a reasonable period into the future.

The Capital Adequacy Standard for general insurers will encourage insurers to adopt more sophisticated approaches for the calculation of the regulatory capital requirement, including the use of internal risk models. General insurers lacking the resources and expertise to construct an appropriate internal model will be subject to a more prescriptive (or standard) approach as set out in the Standard.

Generally speaking, we expect that insurers will be required by market forces or for supervisory purposes to hold capital greater than the regulatory capital requirement calculated in accordance with the Standard. The Capital Adequacy Standard will capture asset, liability, catastrophe, and off-balance sheet risks and, for insurers with validated internal models, an asset/liability mismatch component. The standard approach may also include an asset/liability mismatch capital charge, provided that it is practicable to construct a charge that is relatively simple to calculate. At this time, there will not be a separate charge for operational risk; APRA will await developments in this area. We welcome suggestions on methodology with respect to asset/liability mismatch and operational risk charges. Asset/liability mismatch risks and other risks that ultimately prove to be hard to quantify will be implicitly included within the risk charges applied for other risks under the standard approach.

The proposed Standard will be designed to redistribute the current industry-wide level of statutory solvency towards higher risk insurers rather than to substantially increase the absolute level of required capital across the industry.

3.2 Forms of Capital

Capital has no fixed servicing or repayment obligations and is subordinated to all other claims on the company. The more capital a company has, the more capable it is of withstanding shocks to either the asset or liability sides of the balance sheet.

It is proposed that the new Capital Adequacy Standard will define acceptable forms of capital. Acceptable capital must provide support to the insurer in periods of financial stress and afford protection to policyholders. Under the proposed new Capital Adequacy Standard, acceptable forms of capital must provide funds that:

- represent a permanent and unrestricted investment of funds;
- are freely available to absorb losses and thereby enable the insurer to keep operating whilst any problems are resolved;
- do not impose any unavoidable charge on the earnings of the insurer; and
- rank below the claims of policyholders and other creditors in the event of wind-up.

The September Discussion Papers stated that it may be appropriate for the prudential supervisory regime to give credit to hybrid (debt/equity) capital instruments in calculating compliance with the minimum solvency requirements. Respondents to the September Discussion Papers universally agreed with this proposal. We intend to adopt this recommendation. However, it should be recognised that shareholders' funds provide the ultimate support in times of crisis. This is primarily because equity and other components of shareholders' funds are permanent and have no servicing requirements. Accordingly, limits

will be imposed on the amount of hybrid equity and other like instruments that may be counted toward compliance with the Capital Adequacy Standard.

3.3 Asset Risks

In order to address the differing qualities of assets, prudential regulation typically imposes restrictions on the type of assets that can be counted towards compliance with the capital adequacy requirement, sets out requirements for the valuation of those assets, and may impose concentration limits.

Currently, most assets of a general insurer may be counted towards compliance with the minimum statutory solvency requirement. An exception relates to those assets that are not readily realisable or subject to uncertainty in valuation. Thus, intangibles and non-arm's length assets are excluded for solvency compliance purposes. Section 30 of the Insurance Act specifically excludes certain assets from the calculation of compliance with the minimum statutory requirements. These 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 three months;
- future tax benefits; and
- intangible assets (including goodwill).

Under section 30, related-party assets and guarantees may be included in calculating compliance with the minimum statutory solvency requirement on approval by APRA. Reinsurance recoveries are hard to quantify as the estimation of reinsurance recoveries depends on the estimation of losses during any given period. Under the current supervisory requirements, the minimum statutory solvency requirement is based on the net account. Full credit is given for all reinsurance recoverables.

The September Discussion Papers proposed that the minimum statutory solvency requirement take into account the relative riskiness and diversity of reinsurance and related body and other assets in deciding whether, and to what extent, these assets should be allowed to count towards an insurer's statutory solvency requirement. The Papers proposed the consideration of a system of risk weighting the assets of general insurers. It was proposed reinsurance assets be risk weighted according to ratings assigned by ratings agencies.

Respondents broadly agreed with the proposal to risk weight reinsurance, related party and other assets, subject to more information on how the risk weights would apply in practice and, in particular, what effects this would have on solvency requirements. In addition, more information was sought on how risk weights would be applied to reinsurance assets such as those relating to incurred, but not reported, claims liabilities where it was uncertain which reinsurer would be called upon.

In June 1999 the Basel Committee on Banking Supervision issued a consultative paper, *A New Capital Adequacy Framework,*[7] which set out proposed reforms to the Basel Capital Accord. The proposed reforms include the introduction of credit risk weights based on the ratings assigned by rating agencies. While it is proposed to use the same general principles in the risk weighting of reinsurance assets for general insurers, it is accepted that banking and insurance are different, and so it is not proposed to adopt the complex set of risk weights proposed by the Basel Committee.

It is proposed that the pool of reinsurance recoveries will be risk weighted according to the risk-weighted

[7] A copy of this document can be found at www.bis.org and a copy of APRA's submission to the Basel Committee in relation to this document can be found on the APRA web site at www.apra.gov.au.

average of premiums ceded in the previous reporting period. Details will be set out in the Capital Adequacy Standard.

It is proposed that other assets, including related-party assets will be risk weighted according to their realisability, liquidity and the availability of market prices. A separate capital charge against the risk associated with holdings in prudentially regulated entities is envisaged. A capital charge against the risk associated with excessive asset concentration is also envisaged under the standard approach.

The asset risk charge for the purposes of the standard approach under the Capital Adequacy Standard will therefore comprise:

- the value of each asset multiplied by an asset risk factor, summed across all assets;

  plus

- the related body holdings charge;

  plus

- the asset concentration risk charge.

3.4 Liability Risks

The liability risk charge for the purposes of the standard option will be based on the value of the net insurance liabilities' as determined under the Liability Valuation Standard (see Chapter 4).

Separate reserving risk and new business risk charges will also be determined.

3.5 Catastrophe Risks

The risk associated with a concentration of liabilities is currently addressed through the reinsurance requirements applied to insurers. Under Circular G6/97 a general insurer is required to:

- have net tangible assets equivalent to at least 20 times its highest net risk retention;[8] or
- hold net tangible assets of at least its minimum statutory solvency requirement plus its maximum event retention,[9]

whichever is the greater.

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

- that participates in proportional or working excess of loss treaties[10] has net tangible assets in Australia equivalent to at least 13.33 times its highest net risk retention; or
- that underwrites a major proportion of its business as catastrophe treaties,[11] holds net tangible assets in Australia of at least its minimum statutory solvency requirement plus its maximum event retention.

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8 An insurer's highest net risk retention is the single biggest loss the insurer may be exposed to (taking into account the probability of incurring that loss) under a single policy of insurance after netting out any reinsurance recovery.

9 An insurer's maximum event retention is the biggest loss an insurer may be exposed to (taking into account the probability of incurring that loss) due to a concentration of policies after netting out any reinsurance recovery.

10 An excess of loss treaty is a contract that requires a reinsurer to pay a direct insurer a proportion of, or all of, an amount incurred under any claim incurred during a set period (usually a year) where that claim exceeds an amount agreed to in the terms of the contract.

11 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.

The September Discussion Papers proposed that these requirements be explicitly built into the new solvency requirement. Respondents to the September Discussion Papers broadly agreed with this proposal. It is proposed that the new Capital Adequacy Standard will include a catastrophe component modelled on the current maximum event retention (MER) test.

It is proposed that a Guidance Note to the Standard will set out qualitative guidance on how the MER should be calculated. Special guidance will be issued in relation to some specialised insurers, such as mortgage insurers and professional indemnity insurers, where the concept of the MER is more difficult to quantify.

3.6 Off-balance Sheet Risks

Currently the solvency requirements for general insurers do not address the risks associated with off-balance sheet instruments. This is one area in which Australia's prudential supervisory regime is not in line with the IAIS Core Principles. Therefore, it is proposed that risks associated with these items will be subject to a specific capital charge under the Capital Adequacy Standard. The capital charge for off-balance sheet instruments will follow the approach for ADIs, and thus take into account:

- the value of the instrument;
- the value of any collateral or guarantee attaching to the instrument;
- the creditworthiness of the counterparty to the instrument; and
- the nature and maturity of the instrument.

3.7 Diversification Benefits

APRA has considered whether the various risks contributing to the capital adequacy calculation are sufficiently offsetting so as to generate a material diversification benefit. At this stage, we are not convinced that the likely correlations involved justify a diversification discount to the capital charge. Indeed, the possibility exists that correlations between risk factors may well be positive and rising in certain situations such as one of financial strain, leading to compounding risks. This broad question is open to further analysis.

3.8 Branches

The September Discussion Papers recommended that the supervisory requirements for branches be reviewed to ensure that effective supervision is possible. The major concern that APRA has with respect to the supervision of branches relates to reinsurance recoveries.

For the great majority of companies that rely on reinsurance, a substantial proportion of such recoveries, particularly for catastrophic events, may be due from overseas reinsurers. The size and capital base of the Australian market and the nature of underwriting risks necessitate international reinsurance.

The Financial Laws Amendment Act 1997 amended the Insurance Act to deem moneys recoverable in Australia under the terms of an overseas reinsurance contract to be assets in Australia for solvency purposes, provided the recovery relates to an Australian claims liability.

Three criteria must be satisfied before an overseas reinsurance asset will be deemed to be an asset in Australia:[12]

- an authorised insurer must expect to recover an amount under a contract of reinsurance entered into

[12] Section 30(5AA).

with a person who is outside Australia;

- the amount must relate to claims in respect of insurance liabilities, whether or not those liabilities relate to claims that have been paid by the insurer; and
- under the terms of the contract, payments by way of reinsurance are to be made in Australia.

The rationale for deeming outside Australia reinsurance assets as inside Australia assets derives from the fact that these recoveries transform from being an overseas debtor asset to being realised as cash in Australia. Overseas reinsurance assets will not always be applicable to Australian liabilities because there are instances when the insurer will undertake to satisfy liabilities outside Australia. That component cannot be counted for inside Australia solvency purposes.

There are potential and actual problems associated with reinsurance "assets" of branch operations. These problems are particularly apparent in situations where Head Office acts as the banker for the global group and reinsurance (or retrocession) transactions are handled solely by Head Office. Given that Head Office is not a separate legal entity from a branch, no account can be taken of any amounts "owed" by the Head Office to the branch. In addition, in circumstances where the home supervisor of the Head Office puts a freeze over the assets of the insurance company, the Australia branch may be left without reinsurance.

Therefore, an asset of this kind would normally only be established as an Australian asset when it is physically remitted to Australia, but not before.

However, APRA has allowed branches to count reinsurance recoveries that flow directly to the Australian branch for the purposes of the inside Australia test. Reinsurance recoveries have been taken as flowing directly to the Australian branch if, under the terms of the contract of reinsurance, the reinsurer is required to remit reinsurance recoveries directly to the Australian branch. APRA is not satisfied that this provides sufficient protection to the Australian policyholders of branch operations. In particular, there is nothing to prevent the Australian branch remitting the reinsurance recoveries back to the Head Office so that the Head Office can continue to act as banker for the entire group.

It is proposed to improve the security surrounding, in particular, the reinsurance assets of branches. This could be achieved, for example, by: requiring the branch to hold an irrevocable letter of credit supporting the reinsurance recoverables due from the overseas counterparty; requiring the insurer's Agent in Australia to be a party to contracts of reinsurance to be counted toward a branch's assets in Australia; and by the imposition of criminal penalties on the insurer's Agent in Australia who knowingly or recklessly engages in conduct which permits a reinsurance recoverable to be paid outside Australia or remitted overseas in the circumstance where the insurer will become unable, or likely to become unable, to meet its liabilities or where it will be in breach of the Insurance Act or any other prudential requirement imposed by APRA.

3.9 Inside Australia Test

The inside Australia test is designed to ensure that the minimum statutory free assets of an insurer are held within the jurisdictional reach of APRA and are available to pay Australian policyholders. The September Discussion Papers noted that in some cases the inside Australia test may drive a mismatch of foreign exchange assets and liabilities and recommended that further work be carried out to determine whether it is necessary to maintain this test. Respondents to the Papers agreed that further consideration was necessary.

The inside Australia test is viewed by many as being commercially restrictive. At this stage we are not convinced that the inside Australia test can be discarded. One concern is how security over the Australian

policyholders of branches of foreign incorporated companies can be retained without the inside Australia test.

One option would be to impose restrictions on all assets backing policies written by the branch similar to those set out in section 3.8 above. Comments are welcome on how this could be applied in practice and whether such an approach would be preferable to the inside Australia test.

3.10 Draft Prudential Standard on Capital Adequacy

A draft of the proposed Prudential Standard on Capital Adequacy will be released by APRA for comment in the near future.

CHAPTER 4 – VALUATION OF LIABILITIES

Provisioning for liabilities requires estimation of the amount and frequency of future claims payments. Prudential regulation surrounding liabilities centres on ensuring the consistency, rigour and robustness of liability estimation.

The Insurance Act and Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities require a general insurer to make provision for its liabilities. Subsection 31(2) of the Insurance Act 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 outstanding claims provision (OCP).

Accounting Standard AASB 1023 requires a general insurer to make provision for unearned premiums. Where there is a deficiency in the Unearned Premium Provision (UPP) (ie the amount of unearned premium is insufficient to cover the amount of risk still attaching to the policy), the insurer must write down the asset class, deferred acquisition costs (DAC). DAC can be written down by the lesser of the value of the deficiency and value of the DAC (ie the DAC can only be written down to zero).

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. However, Accounting Standard AASB 1023 is silent on the issue of prudential margins. As a result, the level at which the OCP is set may vary widely between companies and depends on each individual company's assessment of, and attitude to, risk, taxation, profit and loss implications, and the amount of capital available. There is no "routine" regulatory requirement for actuarial involvement and no standard approach, in particular, to the setting of prudential margins.

To address this problem, we proposed in the September Discussion Papers the introduction of a new Standard under the Insurance Act setting out the requirements surrounding the valuation of liabilities. The purpose of the proposed Standard is to ensure that the OCP and the liability relating to unexpired risk are properly valued for statutory purposes and not a product of other influences such as taxation, reported profit or the statutory solvency position of the insurer.

Respondents to the September Discussion Papers generally agreed that greater uniformity in the setting of the OCP was desirable. However, there was concern expressed about the compatibility with Accounting Standard AASB 1023.

APRA believes that decision-makers, particularly Boards, are not always adequately informed about the adequacy and uncertainty of liability estimates in setting provisions. From a regulatory perspective, an objective and consistent measure of insurance liabilities is critical to the integrity of the prudential supervisory requirements for general insurers. Accordingly, a Prudential Standard for Liability Valuation is proposed. The Standard will consider the valuation of insurance liabilities, the estimation of recoveries, the involvement of actuaries in the estimation of insurance liabilities and reporting requirements imposed on the actuary.

4.1 The Valuation of Insurance Liabilities

Under the proposed Liability Valuation Standard, insurance liabilities are considered in two parts: the outstanding claims liabilities and the premiums liabilities. The term "premiums liabilities" considers unexpired risk on a prospective, rather than retrospective basis. The Standard requires the determination of a central estimate of insurance liabilities by class of business and a discount rate is prescribed under the Standard for this purpose. The Standard also requires the calculation of a risk margin with respect to

insurance liabilities by class of business. The risk margin is intended to secure the insurance liabilities with a probability of sufficiency broadly in the order of 75 per cent. In APRA's view, a 75 per cent probability of sufficiency would be commensurate with prudently set technical provisions under the current regime. If a lower (eg 50 per cent) benchmark were to be adopted, then a corresponding increase in the capital adequacy charge would be required.

4.2 The Involvement of Actuaries and Reporting Requirements

The September Discussion Papers recommended that general insurers be required to have an approved valuation actuary. The approved valuation actuary would have responsibility for ensuring compliance with the Prudential Standards for Liability Valuation and Capital Adequacy, and would be required to place a value on the liabilities of the general insurer for the purposes of the accounts and report material changes in the value of liabilities to the Board.

The Papers also proposed that some exemptions may be made to this general requirement 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.

There was a mixed reaction from respondents to the September Discussion Papers on the proposal to require general insurers to have a valuation actuary. Even amongst those supporting the proposal, there was general concern that the role of the approved valuation actuary should not diminish the Board's ultimate responsibility for the setting of provisions.

The proposed Liability Valuation Standard will make it clear that it is the responsibility of the company to ensure that appropriate provision is made in the accounts and to comply with the principles of the Standard. APRA considers that leaving this responsibility to the Board can only be justified if the Board is appropriately informed on the level and variability of liability estimates.The approved valuation actuary will be required to advise the Board in writing on the level of provisions which, in his or her opinion, is consistent with the requirements of the Standard. A copy of the actuary's written advice must be made available to APRA on request.

A company may choose to set a provision in its accounts for insurance liabilities which is inconsistent with the advice of the actuary or is not determined in accordance with the Liability Valuation Standard. Where this occurs, the company must disclose the particular assumptions adopted in obtaining the alternative setting to APRA, and in its Annual Report. APRA may require an independent actuarial assessment or require the provisions for insurance liabilities to be increased if the company does not provide a convincing case.

A company would normally be exempt from the general requirement to have an approved valuation actuary if:

- the total insurance liabilities of the company at the last reporting date (the ex post technical provisions) were less than $20 million; and
- the insurance liabilities of the company do not include an amount in respect of a class of business which is long-tail business; and
- any amount in respect of a long-tail class of business is not material relative to the total insurance liabilities of the company.

Requirements that actuaries must meet in order to be approved by APRA for the purposes of the approved valuation actuary will be set out in a Guidance Note to the Operational Risk Standard discussed in Chapter 6.

4.3 Draft Prudential Standard on Liability Valuation

A draft of the proposed Prudential Standard on Liability Valuation will be released by APRA for comment in the near future.

CHAPTER 5 - QUALITATIVE REQUIREMENTS FOR REINSURANCE ARRANGEMENTS

Under the Insurance Act, insurers are required to have reinsurance arrangements in place at all times.[13] These arrangements must be lodged with, and approved in advance by, APRA annually.[14]

General Insurance Circular G 6/97[15] sets out guidelines for insurers about the types of arrangements which are likely to be approved for the purposes of the Insurance Act. The Circular contains requirements about the quality of a direct writer's reinsurance arrangements. It is proposed that guidelines on qualitative requirements for reinsurance arrangements will be incorporated into a new Prudential Standard.

5.1 Proposed New System of Supervision

The proposals set out in this chapter are designed to shift the regulatory approach away from black letter law requirements to a more risk-based approach requiring companies to develop their own policies, procedures and risk management practices in relation to reinsurance arrangements. The proposed Reinsurance Arrangements Standard will require insurers to have in place a reinsurance management strategy directed toward ensuring that an insurance company selects reinsurance arrangements appropriate to its risk profile. This proposal is consistent with the recent recommendations of the OECD Council on Assessment of Reinsurance Companies.[16] In this report, the OECD stated that it is the responsibility of an insurer to identify the information needed for the assessment of the soundness of reinsurance companies it deals with.

APRA's role in the supervision of reinsurance arrangements of the new regime will be to ensure that policies and procedures complying with these requirements are in place and that these policies and procedures have been, and will continue to be, implemented. For example, APRA would expect to see diversification and creditworthiness addressed in reinsurance policies.

Insurers with well-developed risk management practices should already have in place appropriate internal controls governing the placement of reinsurance business. As a result, those insurers should be able to comply with the Reinsurance Arrangements Standard and accompanying Guidance Note with a minimum of additional regulatory burden.

5.2 Self-assessment

The proposed Reinsurance Arrangements Standard aims to ensure that insurers have in place appropriate internal controls over the placement of reinsurance business. Insurers will be required to develop their own reinsurance management strategy and that strategy must be approved by APRA. Insurers will be required to rigorously assess and certify their compliance with the reinsurance management strategy. APRA will examine compliance with the strategy during on-site inspections and through audit reports and other techniques.

Insurers will no longer be required to routinely submit their reinsurance arrangements to APRA for approval. Responsibility will be transferred to the insurer to monitor its reinsurance arrangements to ensure the insurer complies with APRA's prudential requirements. Changes to the reinsurance management strategy will require approval from APRA.

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[13] Sections 29(1)(d) and 34.

[14] Section 34A.

[15] A copy of General Insurance Circular G 6/97 can be found on the APRA website at www.apra.gov.au.

[16] OECD, "Recommendation of the Council on Assessment of Reinsurance Companies", 1998. APRA has provided a copy of this document to all authorised insurance companies.

5.3 Reinsurance Management Strategy

As part of the process of improving the qualitative requirements for reinsurance arrangements, the Reinsurance Arrangements Standard will require an insurer to prepare an in-house reinsurance management strategy.

This reinsurance management strategy must, at a minimum, address how the company:

- identifies when reinsurance is required;
- selects appropriate reinsurance counterparties to diversify and limit credit risk;
- applies appropriate procedures for documenting and recording reinsurance arrangements; and
- applies appropriate procedures to monitor and control reinsurance activities.

5.4 Draft Prudential Standard on Reinsurance Arrangements

A draft of the proposed Prudential Standard on Reinsurance Arrangements will be released by APRA for comment in the near future.

CHAPTER 6 - OPERATIONAL RISK

Operational risk was defined in the September Discussion Papers 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.

It is proposed to set out requirements for operational risk in a new Prudential Standard. The Operational Risk Standard will include requirements for the prudent management of insurance companies, advice from experts such as auditors and actuaries, and requirements for risk management strategies to be in place for other operational areas of a general insurance company.

Some areas of operational risk, particularly those relating to the management of institutions and requirements on auditors, are common to all APRA-regulated institutions. As a result, these parts of the proposed Operational Risk Standard will be broadly consistent with the draft Prudential Standards issued for comment to industry as part of the ADI harmonisation project.

6.1 Prudential Management

As with all risks, managing operational risk is the responsibility of the Board 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. Operational risk is therefore linked to requirements for the prudent management of an institution. It is of paramount importance that the Board and senior management of a financial institution are "fit and proper" for that purpose.

The September Discussion Papers proposed that "fit and proper" tests apply to the Board and senior management of insurance companies. They also proposed that a self-assessment approach to fitness and propriety would be followed, broadly in line with proposals by APRA in relation to the prudential supervision of conglomerates. In addition, it was proposed that, in line with sound risk management practices, general insurance companies should establish audit committees of the Board.

Respondents to the September Discussion Papers generally agreed with the proposal to put in place "fit and proper" tests for general insurers consistent with those being developed for other APRA-regulated institutions. Respondents also agreed that insurers should establish an audit committee of the Board. APRA is now proposing to adopt these recommendations. Requirements relating to the prudential management of companies, including "fit and proper" tests, Board composition and audit committees will form a Guidance Note to the proposed Operational Risk Standard.

6.2 Independent Experts

In addition to the Board and senior management of the company, prudential regulation traditionally relies on internal and external experts to monitor and report on the financial position of a regulated institution and the adequacy of its internal controls. The September Discussion Papers proposed that general insurers be required to have an approved valuation actuary in addition to an approved auditor. The approved valuation actuary would ensure compliance with the Liability Valuation and Capital Adequacy Standards.[17] It was proposed that APRA should have the power to require an ad hoc external audit review of a specific risk management issue that would be determined by APRA.

The September Discussion Papers also proposed that the approved auditor of a general insurance company have "whistle-blowing" obligations - that is, the approved auditor should be required to draw

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[17] Some exemptions are proposed to the 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 or the low risk class of business written or the strong solvency position of an insurer.

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 the interests of policyholders. Where the auditor believes the company has failed to take appropriate action after notifying the company of the matter, the auditor should be required to report the matter to APRA. It was proposed that the approved valuation actuary would have similar responsibilities in relation to compliance with the Liability Valuation and Capital Adequacy Standards. The approved auditor and approved valuation actuary[18] will be provided with privilege to ensure that the auditor provides full and frank information to APRA and the company without fear of litigation.

In general, respondents stated that the scope and responsibilities of the role of appointed valuation actuary should be more clearly defined. In particular, respondents were anxious to ensure that ultimate responsibility for setting provisions remained with the Board of the company. Respondents were cautious about the proposal to require auditors to undertake reviews of particular risk areas. In particular, respondents sought more information on how the proposal would be implemented. Most respondents to the September Discussion Papers were supportive of "whistle-blowing" duties being imposed on the approved auditor and valuation actuary of insurance companies, also subject to the role of the valuation actuary being more specifically defined.

It is proposed to adopt these recommendations. More details on the scope of the role of the approved auditor and valuation actuary will be set out in a Guidance Note to the proposed Operational Risk Standard.

6.3 Other Areas of Operational Risk

Currently the prudential supervisory requirements for general insurers in Australia do not specifically address operational risk. The certificate of "Reporting Approach and Compliance" required under section 45 of the Insurance Act focuses almost solely on the accounts and financial position of the insurer.

The September Discussion Papers proposed that a general insurer be required to provide APRA with up-to-date descriptions of its risk management systems. It was proposed that the certificate of "Reporting Approach and Compliance" be upgraded to include a tightly prescribed attestation from the Board that all supervisory requirements had been fully complied with, that all material risks had been identified, and that systems were in place to manage those risks effectively.

The September Discussion Papers also recommended that consideration be given to requiring general insurers to submit a prospective annual plan for managing liquidity. It was also recommended that the requirements for operational risk take into account the adequacy of pricing policies for short-tail classes and that further consideration be given to the desirability of requiring actuarial involvement in the pricing of long-tail classes.

Respondents to the September Discussion Papers were generally supportive of the upgrading of requirements of the certificate of "Reporting Approach and Compliance". More clarification was sought as to what would be classified as material risks by APRA. Most respondents did not think that an annual liquidity plan was warranted for general insurance companies. Respondents agreed that the operational risk requirements should include requirements in respect of pricing. There was some disagreement as to whether the approved valuation actuary should have responsibilities with respect to the pricing of long-tail classes of business.

[18] The September Discussion Papers mistakenly referred to statutory protection for the approved auditor of a general insurance company only. It has always been intended that this statutory protection would also apply to the approved valuation actuary of a general insurance company.

In response to the request for more clarification on material risks, it is proposed to incorporate requirements for particular risk management strategies into the proposed Operational Risk Standard. In addition, instead of requiring an annual liquidity plan, it is proposed to include this as an area for which insurers must have in place a risk management strategy under the Operational Risk Standard. Pricing for both short and long-tail insurance business will be covered under the Operational Risk Standard. However, the scope of the responsibilities of the approved valuation actuary may be extended in the future to cover the pricing of long-tail business. Areas where companies will be required to have risk management strategies include:

- outsourcing;
- product design and pricing;
- underwriting;
- claims management;
- liquidity;
- asset exposures; and
- internal controls.

6.4 Proposed New System of Supervision

The proposals set out in this chapter are designed to shift the regulatory approach away from black letter law requirements to one where companies will be required to develop their own policies, procedures and risk management practices in relation to operational risk. The proposed Operational Risk Standard will require insurers to have in place risk management strategies to ensure that the Board and senior management of the institution are "fit and proper" and that other areas of operational risk have appropriate safeguards in place. The risk management strategies are intended to ensure that an insurance company organises and controls its affairs effectively. This proposal is consistent with Principle 9 of the IAIS Principles for the Conduct of Insurance Business and IAIS Core Principles in relation to corporate governance and internal controls.

APRA will continue to have a role in approving auditors of insurance companies and this will be extended to the approval of actuaries. APRA's role in the supervision of other operational risk requirements of the new regime will be to ensure that appropriate policies and procedures complying with these requirements are in place and that these policies and procedures have been, and will continue to be, implemented.

Insurers with well-developed risk management practices should already have in place appropriate internal controls governing operational risk. It is noted that the requirement for companies to have an approved valuation actuary[19] and the increased scope of audit requirements will impose a cost on insurance companies. However, APRA is of the view that these costs would be outweighed by an increase in the protection provided to policyholders.

6.5 Self-assessment

The intention of the proposed Operational Risk Standard is to ensure that insurers have in place appropriate management expertise and probity, expert oversight and internal controls. Insurers will be required to develop their own risk management strategies in relation to operational risk and those

[19] Some exemptions are proposed to the 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 or the low risk class of business written.

strategies must be approved by APRA. Insurers will be required to assess their own compliance with the Operational Risk Standard. APRA will examine compliance with the Standard during on-site inspections and through audit reports and other techniques. Changes to the risk management strategies will require prior approval from APRA.

6.6 Draft Prudential Standard on Operational Risk

A draft of the proposed Prudential Standard on Operational Risk will be released by APRA for comment in the near future.

CHAPTER 7 - DEREGULATION OF SELECTED MARKET SEGMENTS

The September Discussion Papers canvassed the possible deregulation of selected segments of the general insurance market in Australia. Four categories of insurer were highlighted as operating in areas in which retail policyholders were not directly at risk and thus deregulation could occur: reinsurers; captives without third-party beneficiaries; lenders' mortgage insurers; and insurers underwritten by a state or territory government.

7.1 Reinsurance

Prudential regulation of the insurance industry is justified on the basis that relatively unsophisticated policyholders lack the capacity to determine the risk of an insurer defaulting on its promise to indemnify the insured. However, 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.

The September Discussion Papers suggested that, in conjunction with other changes proposed to the prudential supervisory regime, it may be possible to deregulate the reinsurance market in Australia.

Respondents to the September Discussion Papers were generally uncomfortable or uncertain about possible adverse effects of deregulation. While we were not convinced by the arguments put forward against the proposal, given the recent instability in the reinsurance market and the greater priority of other changes proposed to the supervision of insurers, it is proposed that reinsurers will not be deregulated at this time. This decision may be reconsidered at a later date.

7.2 Captives Solely Underwriting Property Risks

The September Discussion Papers proposed the deregulation of pure captive insurers where there are no third-party beneficiaries. A pure captive insurer underwrites only the risk of the corporate group in which it is a member. The proposal to deregulate these insurers is based on the premise that domestic consumers in the retail sector do not have access to them. Members of the same corporate group should have greater capacity than a prudential regulator to assess their creditworthiness.

Most respondents to the September Discussion Papers did not comment on the proposal to deregulate captives with no third-party beneficiaries. Those that did were in broad agreement with the proposal. Accordingly, it is APRA's view that this proposal should be implemented. It is proposed that captives without third-party beneficiaries will be defined as those captives solely underwriting property risks. Classes of insurance that are proposed as being defined as comprised solely of property risks are:

- commercial motor vehicle insurance;
- comprehensive motor vehicle insurance;
- construction insurance;
- fire and industrial special risks insurance; and
- marine and aviation insurance.

7.3 Lenders' Mortgage Insurance

The September Discussion Papers proposed that lenders' mortgage insurers could be exempted from the operation of the prudential supervisory requirements for general insurers. The rationale for exempting lenders' mortgage insurers from the regime is that the prudential interest with mortgage insurers lies not

in the insurance sector, but rather with the creditworthiness of an authorised deposit-taking institution's (ADI's) assets. The ADI prudential supervisory regime requires ADIs to hold capital against the risk of mortgage insurer default. Most ADIs should have the capacity to understand the risk of the insurance product provider.

Respondents to the September Discussion Papers were not generally supportive of the proposal to deregulate mortgage insurers. While the arguments given were not persuasive, APRA has decided, given the greater priority of other issues, not to proceed with the proposal to deregulate mortgage insurers at this time. This decision may be reconsidered at a later date.

7.4 Insurers Underwritten by a State or Territory Government

The September Discussion Papers proposed that insurers underwritten by a State or Territory government be exempt from the prudential supervisory requirements for general insurers. 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 was an anomaly that these insurers required authorisation under the Insurance Act while State-owned insurers did not.

Most respondents to the September Discussion Paper disagreed with the proposal to deregulate insurers underwritten by a State or Territory government on competitive neutrality grounds. As a result, APRA has decided not to proceed with the proposal.

APPENDIX 1 - RESPONSES TO THE SEPTEMBER DISCUSSION PAPERS

In September 1999, APRA released three[20] discussion papers to industry setting out the scope for modernising the prudential supervisory requirements for general insurers in Australia. There were 21 responses.

General Comments

The majority of respondents indicated broad support for the stated objectives underlying the APRA proposals and encouraged further consultation to assist in the development of the papers' proposals and concepts. Respondents indicated, however, that more details on the key principles and concepts of the papers was required.

It was accepted that prudential supervision of general insurers should protect the interests of policyholders and promote confidence in the general insurance industry. Respondents also agreed that the prudential supervisory framework should provide a minimum assurance to policyholders of the capacity of insurers operating in the Australian market.

Respondents welcomed the use of a cost/benefit approach to determine the appropriate mix and level of minimum standards under the prudential supervisory regime and requested that transitional arrangements be put in place to allow time for general insurers to adopt any new arrangements.

Some respondents also proposed that APRA conduct a cost/benefit analysis of past industry failures, to determine whether the new proposals will effectively improve the existing supervisory regime.

A handful of respondents were concerned that in some proposals APRA may be moving ahead of international best practice. Further clarification of the meaning of current international best practice was also seen as desirable.

Authorisation

Overall, respondents were supportive of the review of authorisation requirements. The proposal to recognise hybrid (debt/equity) capital instruments in calculating compliance with the minimum start-up capital requirements and on-going solvency requirements was strongly supported.

Some respondents believed that the capacity to vary entry requirements according to the risk profile of the business written may restrict the capacity of a company to act outside of its business plan. Support was generally provided for a review of the supervisory requirements for branches.

"Fit and Proper" Testing

The majority of respondents endorsed "fit and proper" persons requirements. However, respondents were concerned that this might impose unnecessary delay in the appointment of senior management.

Solvency

Respondents broadly supported the concept of a new Statutory Solvency Standard provided that minimum capital requirements were not significantly increased. The proposal for a reserve to be held against large concentrations of assets with a particular obligor or in a particular asset was generally endorsed.

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[20] APRA, "Study of the Prudential Supervisory Requirements for General Insurers", "A New Statutory Solvency Standard for General Insurers" and "A Statutory Liability Valuation Standard for General Insurers", 1999.

Considerable support was received for the proposal to split Circular G 6/97 so that those requirements which act as a solvency measure would be reviewed and, where appropriate, built into the solvency requirements such that their application is obvious and transparent. Those requirements relating to cessions would remain as a risk management guideline to be applied by APRA as appropriate to each individual insurer's commercial circumstances. Respondents also supported the proposal to review the inside Australia test.

Respondents requested more detail on the proposal to allow APRA to recongnise alternative risk transfer instruments in calculating compliance with the minimum statutory solvency requirement.

Internal Modelling

The internal modelling concept for determining statutory solvency contained in the proposed new Solvency Standard was broadly approved. Some respondents queried whether sufficient incentive would exist under the proposed Standard for an insurer to develop its own internal model.

Asset Liability Mismatch

Respondents welcomed the principle that insurers should be able to hold whatever assets they choose on commercial grounds so long as they have appropriate financial and managerial capabilities to effectively handle the chosen asset allocation. Respondents also broadly agreed that the proposed new Solvency Standard should take into account the extent to which the assets and liabilities of the general insurer are mismatched.

Reinsurance

The principle of risk weighting reinsurance assets through the use of the rating assigned to a reinsurer by ratings agencies attracted considerable debate in relation to how such a principle could be employed. The primary areas of concern relate to how risk weightings will impact on compliance costs, and the role of the ratings agency.

Respondents agreed that consideration should be given to removing the 60 per cent limitation on cessions of total premium income guideline set out in Circular G 6/97.

Risk Management Strategies

The proposal that general insurers should be required to provide APRA with up-to-date descriptions of their risk management systems was encouraged as being consistent with best practice techniques. However, some respondents were of the view that it is unrealistic to expect an insurer to account for all risks. It was suggested that it may be more reasonable to require insurers to attempt to address all material risks and that more information should be provided on what risks were material for this purpose.

The proposal to require all general insurers to publicly report prudential management practices on an annual basis was also identified as best practice. It was suggested that APRA should have the power to grant an exemption to this requirement for certain low risk companies. Respondents typically approved of the proposal to establish an audit committee of the Board.

Respondents were keen to ensure extensive consultation with industry in determining the scope of responsibilities of the actuary in completing a Financial Status Report (FSR). In particular, respondents were concerned that actuarial responsibility may be extended to an assessment of all risks during the preparation of an FSR. Respondents were generally cautious of the proposal that APRA have the power to require an ad hoc external audit review of a specific risk management issue in relation to a general

insurer. There was a call for more detail on the rules governing any proposed audit review.

It was suggested that to the extent that more volatile insurance books may be subject to more rapid changes in an insurer's solvency position, there may be a case for allowing less frequent reporting on less volatile insurance books, where the insurer can demonstrate lower volatility to APRA's satisfaction.

Respondents did not support the proposal that would require insurers to submit a prospective annual plan for managing liquidity.

The Appointment of Experts

The proposal that an insurer should be required to have an approved valuation actuary with the responsibility of ensuring compliance with the prudential standard for liability valuation was met with considerable debate.

Respondents were concerned that the role of the approved valuation actuary would interfere with the principle that primary responsibility for the management of an insurer rests with its Board. In addition, respondents indicated that it would be important that the Board has some mechanism for disagreeing with and removing the approved valuation actuary should the proposal be pursued. Respondents raised mixed concerns about mandating actuarial involvement in pricing for general insurance.

Respondents universally approved of the proposal to provide the approved auditor of a general insurance company with statutory protection to ensure that the auditor provides full and frank information to APRA and the company without fear of litigation. It was also requested by a number of respondents that this protection should be extended to the approved valuation actuary.

Liability Valuation

The majority of respondents supported the concept proposed for the Liability Valuation Standard, subject, primarily, to the comments above concerning the role of the approved valuation actuary.

The establishment of one set of accounts under the Liability Valuation Standard for both regulatory and financial reporting purposes was encouraged. Respondents requested that the proposed standard should be consistent with Accounting Standard AASB 1023, and should be developed in consultation with the Institute of Actuaries of Australia.

Respondents endorsed the proposal to increase consistency in the setting of the outstanding claims provision. Some respondents agreed that improved consistency can be achieved through the role proposed for actuaries; typically, however, respondents disagreed with the proposed scope of the role for the actuary contending that it interferes with the ultimate responsibility entrusted in the Board.

Support for the proposal to address the valuation of unexpired risk liabilities in a Prudential Standard was widespread. Some respondents suggested that unexpired risk should be addressed by an accounting standard rather than through a Prudential Standard.

Disclosure

Respondents maintained that any public disclosure of key indicators should enhance the transparency of the general insurance industry through increasing the relevance, understandability, consistency, comparability and accessibility of information. Respondents widely held that general insurers should only be required to incur the expense of increased disclosure if it will genuinely add value to consumer choice on insurance purchases.

Respondents submitted varying opinions in relation to the issues of relevance and comprehensiveness of publicly disclosed information. Most respondents expressed doubts as to whether all but the most sophisticated of consumers will really benefit from increased disclosure. However, it was suggested that the benefits of increased disclosure could be realised if a comprehensive public education program was implemented.

A number of respondents raised strong concerns about the possible disclosure of commercially sensitive materials. It was suggested that in assessing the relevance of information to the regulator, the focus should be on what is required to ensure effective and appropriate supervision, with information suitable for public exposure reasonably expected to be a subset.

It was typically maintained that in order for public disclosure to be fully effective, information disclosed must be easily accessible to the general public and must be comparable across institutions. Some respondents doubted whether information disclosed would be effectively comparable across APRA-regulated institutions, given the structural differences in those financial institutions.

Respondents did not generally support the proposal that 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. Some respondents contended that consistency issues in regard to OCP need to be addressed first, to ensure solvency information disclosed is meaningful; once this objective is achieved, there will be no need to explicitly disclose OCP calculation information as part of solvency disclosure.

Deregulation of Selected Market Segments

Respondents typically did not agree with the proposal to deregulate reinsurers. Many argued that some regulation was necessary to prevent problems such as reduced competition in the reinsurance market. The proposal was also rejected on the grounds that the requirement to hold capital against the risk of reinsurer default may result in the imposition of onerous minimum capital requirements. Some concern was also raised about the important role to be conferred on ratings agencies, which are not subject to prudential supervision by APRA.

Respondents agreed that there is a case for deregulating captive insurers where the captive has no third-party beneficiaries. The proposal to allow insurers wholly underwritten by a State or Territory government to be exempt from the prudential supervisory requirements for general insurers was typically not endorsed on the grounds that such a proposal may lead to an uneven playing field where these insurers compete with other regulated insurers. Respondents were evenly balanced on the proposal that mortgage insurers be exempted from prudential supervisory requirements.

A list of the respondents to the September Discussion Papers is an attachment to this appendix.

Attachment - Respondents to the September 1999 Discussion Papers

1. AMP General Insurance Ltd
2. Motor Accidents Authority of NSW
3. Oliver, Wyman & Company
4. Swiss Re Australia Ltd
5. CGU Insurance Ltd
6. Munich Reinsurance Company of Australasia Insurance Ltd
7. Robert Glading
8. General & Cologne Australasia Insurance Ltd
9. Insurance Council of Australia Ltd
10. Australian Unity Ltd
11. Guild Insurance Ltd
12. The Institute of Actuaries of Australia
13. NRMA Insurance Ltd
14. HIH Insurance Ltd
15. Suncorp Metway Insurance Ltd
16. Price Waterhouse Coopers
17. Ernst & Young
18. Accountants and Actuaries Liaison Committee
19. New South Wales Government Actuary's Office
20. Swann Insurance (Aust) Pty Ltd
21. Australian Family Assurance Ltd

APPENDIX 2 - COMPARISON OF INTERNATIONAL SOLVENCY REGIMES

United States

The Risk-based Capital (RBC) Model currently regulates the solvency position of insurers in the United States. A company's risk-based capital is calculated by applying factors to various asset, premium and reserve items. Factors are higher for those items with greater underlying risk and lower for less risky items. The adequacy of a company's actual capital is measured as a comparison with its risk-based capital as determined by the formula.

RBC comprises two components:

- formula and reporting requirements, where each insurer calculates and reports to regulators its capital requirement and total adjusted capital; and
- the RBC Model Law that establishes duties for both companies and regulators based upon the figures generated by the formulas.

When a company's statutory capital is less than its minimum RBC level, the RBC Law gives the state insurance commissioner the authority to act to prevent further deterioration. The RBC Model Law is a tiered approach that allows a regulator to implement progressively more forceful intervention strategies as a company's capital adequacy deteriorates. The RBC system overlays the fixed-dollar minimum capital standards that are set by individual insurance commissioners;

The components of the RBC formula for property and casualty insurers are:

(a) insurance subsidiaries risk: an RBC requirement of the downstream insurance subsidiaries owned by an insurer. The parent is required to hold an equivalent amount of RBC to protect against financial downturns of the affiliates. RBC is also held against off-balance sheet items such as non-controlled asset, derivatives, guarantees for affiliates, contingent liabilities and long-term leases;

(b) fixed income assets risk: an RBC requirement on the credit risk that is associated with the risk that the counterparty of a long-term asset may go into default. In addition, the RBC requirement for fixed assets increases if an insurer's assets are highly concentrated. Fixed assets include bonds, mortgages and short-term investments;

(c) equity assets risk: an RBC requirement on the risk of loss in the market value of equity assets. Equity assets include common and preferred stock, real estate and long-term assets;

(d) credit risk: an RBC requirement on the risk of loss from unrecoverable reinsurance and other receivables such as accrued interest, dividends and recoverables from parents, subsidiaries and affiliates; and

(e) insurance risk: containing two parts. Reserve risk includes elements of industry average development, company development, industry loss and loss adjustment expense. Premium and growth risks contain similar components including loss reserve and premium concentration factors. Rapidly growing companies are also subject to an additional charge as they can tend to have larger reserve deficiencies.

There are five action levels which are determined by comparing a company's total adjusted capital (TAC) to its authorised control level RBC (calculated by the formula):

(i) TAC to RBC 200 per cent or greater - no action;

(ii) TAC to RBC 150 to 200 per cent - insurer must submit a comprehensive financial plan including: conditions contributing to the insurer's position, proposals to remedy that position, projections with and without the proposed corrections, key assumptions underlying projections, and the identification and quality of problems associated with insurer's business;

(iii) TAC to RBC 100 to 150 per cent - in addition to a comprehensive financial plan, the insurer must file an action plan and the state commissioner perform any examinations deemed necessary to analyse the insurer's business and operations. The commissioner also issues appropriate corrective orders;

(iv) TAC to RBC 70 to 100 per cent - in addition to the above, the insurance commissioner is authorised by law to take control of the company; and

(v) TAC to RBC less than 70 per cent - this is the Mandatory Control Level, meaning that the state insurance commissioner is required to take steps to place the insurer under control.

Canada

Canadian property and casualty (P&C) insurers are currently subject to a non-consolidated solvency test referred to as the Minimum Asset Test (MAT). The MAT works by comparing assets available to assets required. Assets available comprise total assets plus the excess of market value over book value (assets are valued at book value in Canada) minus some non-admitted assets that include deferred acquisition costs, recoverables from reinsurers,[21] investment valuation reserves and reserve for foreign exchange fluctuations. The assets required are the total liabilities, plus, the reserve for reinsurance ceded to unregistered insurers, plus, a required margin minus recoverables from reinsurers. Under the MAT test, property and casualty companies must hold assets that equal 110 per cent of liabilities plus a margin.

Foreign P&C insurers are subject to the Federal Deposit Adequacy Test (DAT). Under DAT, foreign insurers must maintain a margin of assets over liabilities.

Canadian regulators have proposed to change the current requirements for P&C insurers to a risk-based capital adequacy approach. The proposed approach is known as the Minimum Capital Test (MCT) framework. This framework aims to address the deficiencies of the previous system, better assess the riskiness of the operations and assets of individual P&C insurers and ensure a more consistent approach with other financial sectors, as well as across jurisdictions.

The basis of the MCT will change from an assets required approach under the current tests to a capital adequacy approach. The MCT framework more closely relates capital requirements to the degree of risk that an individual institution assumes. Specifically, the risk-based capital adequacy framework aims to assess the riskiness of assets, policy liabilities, and off-balance sheet exposures, by applying various factors and margins. P&C Insurers are required to meet a capital available to capital required test.

Capital available includes instruments with residual rights that are subordinate to the rights of policyholders and which will be outstanding over the medium term. It also includes 50 per cent of the excess of market value over book value of investments.

A P&C insurer's minimum capital requirement is the sum of capital required for on-balance sheet assets; off-balance sheet exposures; margins for unearned premiums and unpaid claims (provisions on policy liabilities); catastrophe reserves and additional policy provisions; and an amount for reinsurance ceded to unregistered reinsurers.

The MCT determines the minimum capital required and not necessarily the optimum capital required. Although regulators in different jurisdictions will evaluate the optimal capital level, this is a separate process from determination of the minimum capital under the harmonised MCT.

The regulator will retain the discretion to adjust P&C capital requirements, including possibly establishing limits or adopting a tiered approach for capital instruments. For instance, the regulator may prescribe a higher capital requirement, including for an individual P&C insurer, taking into account such factors as operating experience, diversification of the asset of insurance portfolios and retention limits.

21 To allow the test to be put on a net basis.

It is intended that the MCT be completed by all P&C Insurers on a pilot basis in May 2000 for 1999 year-end data with full implementation of the test for year-end 2000 reporting, subject to completion of any required legislative amendments.

European Economic Area

Solvency in the EU centres on the determination of the capital base, whereby insurers are required to keep capital funds of at least the same amount as the so-called target solvency margin. This target solvency margin is determined using the following two components:

(i) minimum guarantee fund

The minimum guarantee fund represents the lowest permissible threshold for the capital funds required. In non-life insurance, minimum capital funds range form EUR 0.2 to 1.4 million, depending on the line of business.

(ii) solvency margin

The solvency margin sets out the amount of capital funds an insurer must have at its disposal during current operations. The requirement is for a capital base of the same amount as either the premium index or the loss index, whichever is the greatest.

premium index:

0.18 or 0.16[22] x gross premiums x retention rate

loss index:

0.26 or 0.23[23] x gross claims x retention rate

retention rate:

net/gross claims (but no less than 0.5).

One third of the solvency margin is defined as the guarantee fund and is the threshold value below which the regulators are authorised to step in.

The law not only sets out the amount of capital funds which the insurer must have (target solvency margin), but the EU directives also prescribe which balance sheet items are acceptable as capital funds. Individual member states are empowered to authorise other forms of capital funds. The actual capital funds available are also termed the current solvency margin.

In addition to the solvency regulations, regulations governing how technical reserves are invested are also aimed at guaranteeing an insurer's solvency. The investment guidelines which apply to technical reserves are defined in the third generation of EU directives. The directive stipulates the type of investment, and the proportion of the total assets which may be invested in this type. When investing technical reserves the insurer should take into account security, profitability, liquidity and concentration. The member states are empowered to restrict the types of investment and adjust the proportion allowed to be invested for each type as they deem proper.

Should the solvency criteria not be fulfilled, the following regulatory steps may be taken:

(a) current solvency margin < target solvency margin: the company must submit a "comprehensive

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[22] 18 per cent of gross premiums up to EUR 10 million and 16 per cent of the gross premiums over EUR 10 million, where the calculation is based on gross premiums from the previous business year.

[23] 26 per cent of gross claims up to EUR 7 million and 23 per cent of gross claims over EUR 7 million; where the calculation is based on average of gross claims over the last three business years (seven years for natural hazards insurance).

financial plan" for approval to the supervisory authorities. In exceptional circumstances the authorities can limit or revoke the free disposal of invested assets;

(b) current solvency margin < guarantee fund: the company must submit a "short-term financial plan" to the authorities. The authorities can limit or revoke the free disposal of invested assets; and

(c) the authorities may also limit or revoke the free disposal of invested assets if the conditions relating to the technical reserves are not fulfilled.