

PRUDENTIAL SUPERVISION

OF

GENERAL INSURANCE

Policy Discussion Paper

March 2001

Australian Prudential Regulation Authority

PREAMBLE

One of APRA's key policy objectives in the current year is the finalisation of work that will lead to the introduction of a new prudential framework for the general insurance sector. This paper marks the beginning of the third round of consultations with the industry and other stakeholders on the development of the new regime.

The history of the project has been set out in earlier discussion papers on this subject.¹ To summarise, the Insurance Act 1973, which serves as the basis for regulation of the general insurance sector, and the prudential regime that has been designed around it, is in need of significant overhaul. The fact that 28 years has passed since the last major review is argument enough to justify the reassessment. However, more important than the passing of time is the pace of change that has been evident in the financial sector over the period and the dramatic improvements in corporate governance processes and risk measurement and management practices within financial institutions, particularly over the 1990s. These, and corresponding international developments, have had a significant impact on the evolution of the prudential framework in the Australian financial sector. Our aim is to leverage off these contemporary developments and, in so doing, create a modern regime of prudential regulation for the general insurance industry.

Fundamentally, the policy reform aims to provide more effective protection for policyholders, and less intrusive regulation for industry. Policyholders can be expected to benefit from risk-based capital requirements, better internal governance and stronger market discipline. Companies will benefit from the shift to flexible standards, the option to use internal models, and compliance self-assessment.

Central to the proposed new regime is that responsibility for the sound and prudent management of an insurance company rests ultimately with the insurer's board and senior executives. Nothing in the policy proposals detracts from that autonomy, nor from the commercial imperative for companies to maximise shareholder value. However, other stakeholders must also be considered, and prominent among the latter are the policyholders. Under the new standards, the boards and senior executives of companies will also be clearly accountable for establishing risk management and internal control systems, appropriate for their business mix and complexity, within their

¹ "Study of the Prudential Supervisory Requirements for General Insurers", Policy Discussion Paper, September 1999. "Proposed Reform to the Prudential Supervision of General Insurance Companies in Australia", Policy Discussion Paper, April 2000.

respective companies. These requirements should mirror arrangements and practices already in place in well-run companies.

The proposed regulatory framework for general insurance has been designed to dovetail over time with APRA's prudential supervision regimes for deposit-taking and life insurance, and its (still developing) approach to the prudential supervision of financial conglomerates. It is not possible, given the significant changes that would be required, to produce a single prudential supervision regime for all institutions at this time. However, APRA is seeking to progressively introduce generic legislation and harmonised standards as opportunities arise. Under this approach of progressive harmonisation, like risks within the financial sector are increasingly being treated in a like manner.

We expect that more or less 'final' versions of the draft Prudential Standards and Guidance Notes will emerge following the conclusion of Round 3 of the consultation process. This will occur around mid-year. In parallel with this, Treasury will be consulting industry on the drafting instructions for the revised Act.

We therefore welcome further comment on the proposals, and encourage interested parties to attend the General Insurance Seminar that has been organised for 1 May where the proposals will be discussed in depth. Written submissions on this set of papers should be forwarded by 30 June 2001 to:

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ACRONYMS AND ABBREVIATIONS GLOSSARY

AASB	Australian Accounting Standards Board
ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
April Discussion Paper	Proposed Reforms to the Prudential Supervision of General Insurance Companies in Australia, APRA, April 2000
Authorisation Guidance Note	Guidance Note: Guidelines on Authorisation of General Insurers
Banking Act	Banking Act 1959
Board	Board of Directors
Capital Adequacy Standard	Draft Prudential Standard GPS 110: Capital Adequacy for General Insurers
CEO	Chief Executive Officer
DAC	Deferred Acquisition Cost
FSA	Financial Services Authority
IAA	Institute of Actuaries of Australia
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICA	Insurance Council of Australia
ISC	Insurance and Superannuation Commission
Liability Valuation Standard	Draft Prudential Standard GPS 210: Liability Valuation for General Insurers
Life Act	Life Insurance Act 1995
ORR	Office of Regulation Review
OSFI	Office of the Superintendent of Financial Institutions
Reinsurance Arrangements Standard	Draft Prudential Standard GPS 230: Reinsurance Arrangements for General Insurers

Prudential Supervision of General Insurance

REMS	Reinsurance Management Strategy
Risk Management Standard	Draft Prudential Standard GPS 220: Risk Management for General Insurers
RMS	Risk Management Strategy
SIS Act	Superannuation Industry (Supervision) Act 1993
The Act	Insurance Act 1973
UPP	Unearned Premium Provision
Wallis Inquiry	Financial System Inquiry, 1997

KEY ISSUES

Issue	Reference in Discussion Paper	Reference in Draft Prudential Standards
Risk Margins and the 75 th Percentile	Section 2.1	Liability Valuation Standard (GPS 210)
Premiums Liabilities	Section 2.2	Liability Valuation Standard (GPS 210)
Dual Reporting	Section 2.3	Liability Valuation Standard (GPS 210)
Diversification	Section 2.4	Liability Valuation Standard (GPS 210) Capital Adequacy Standard (GPS 110)
Role of Valuation Actuary	Section 2.5	Liability Valuation Standard (GPS 210)
Capital Reductions	Section 2.6	Capital Adequacy Standard (GPS 110)
Capital Factors	Section 2.7 and 2.8	Capital Adequacy Standard (GPS 110)
Investment Concentration Risk Charge	Section 2.9	Capital Adequacy Standard (GPS 110)
Minimum Capital Requirement	Section 2.10	Capital Adequacy Standard (GPS 110)
Fitness and Propriety	Section 3.1	Risk Management Standard (GPS 220)
Boards	Section 3.2	Risk Management Standard (GPS 220)
Reporting	Section 3.3	Risk Management Standard (GPS 220) Reinsurance Arrangements Standard (GPS 230)
Risk Management Framework	Section 3.4	Risk Management Standard (GPS 220)
Branches	Section 3.5	Risk Management Standard (GPS 220) Reinsurance Arrangements Standard (GPS 230) Capital Adequacy Standard (GPS 110)
Calibration of Capital Adequacy Framework	Chapter 4	Capital Adequacy Standard (GPS 110)

CHAPTER 1 – INTRODUCTION

The purpose of this paper is to continue the consultative process with industry on reform of the prudential framework covering general insurance. This paper has been designed specifically to provide the context within which views received from stakeholders during the consultative period have been considered and assessed. It sets out industry comments that have been accepted and subsequently incorporated into the revised proposals for reform. The paper explains why other industry views, having been considered, have not been included in the proposed framework. There is discussion on the rationale and logic underlying our proposals and estimates of possible impacts of the proposals on minimum capital ratios in the industry are provided.

The paper should be read in conjunction with the revised draft Prudential Standards and Guidance Notes.

1.1 Scope of the Proposals

It is intended that the proposals set out in this paper and accompanying draft Prudential Standards and Guidance Notes will be applied to all insurance companies authorised to conduct business under the revised Act other than Lloyd's underwriters (and pure captive property insurers). Part VII of the 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 Act are not considered. Part V and the data collection powers of the 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.

1.2 Objectives

The proposals set out in this paper are intended to create a supervisory regime which:

- makes it explicit and 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;

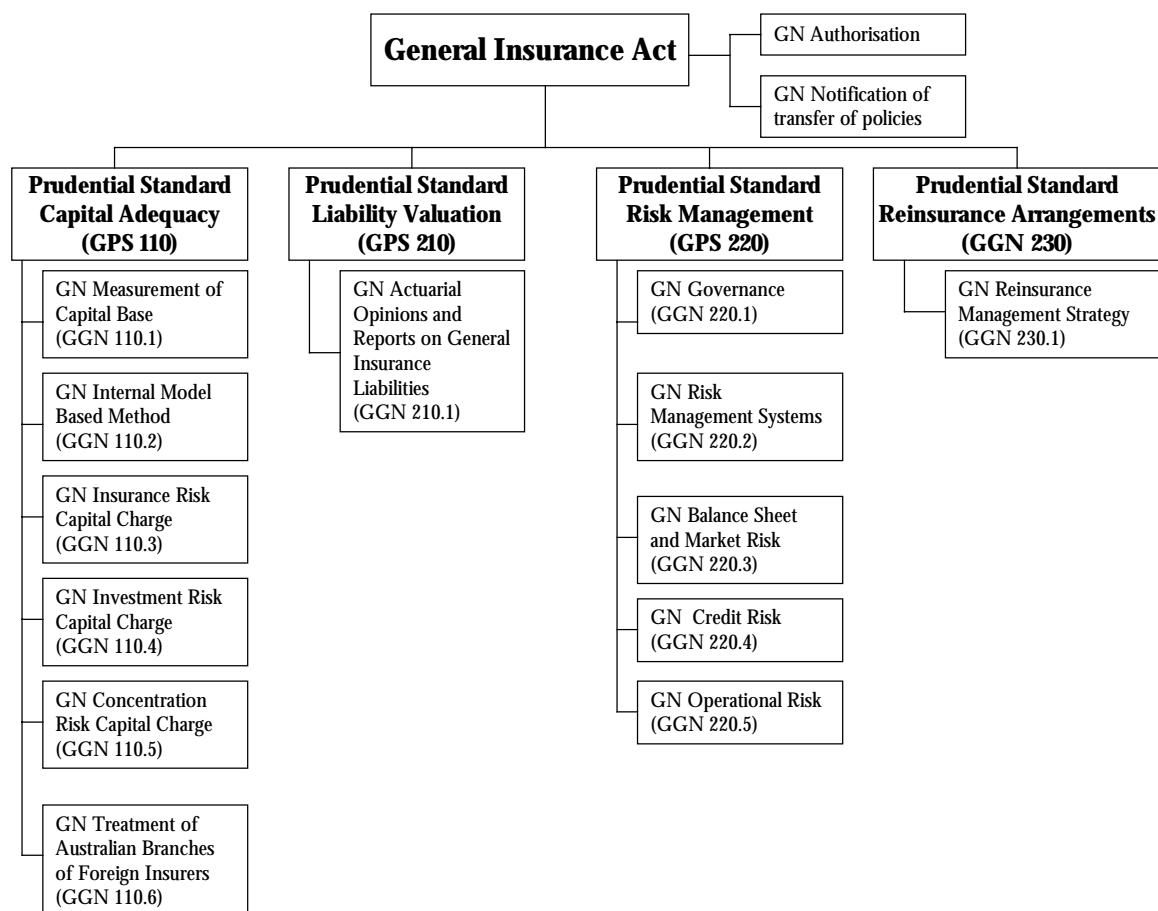
- is broadly in line with the IAIS Core Principles and with examples of international best practice;
- reduces commercial intrusion by placing greater weight on board responsibility and accountability, on internal risk controls and on compliance self-assessment;
- accommodates market developments in a more flexible and timely manner through a standards-making power for APRA;
- minimises restrictions on competition and compliance 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.

1.3 Regulatory Framework

APRA has proposed a three layered system of regulation for general insurance companies authorised to conduct insurance business in Australia.

Figure 1 illustrates the proposed framework.

Figure 1: Proposed Regulatory Framework



1.3.1 The Revised Act

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

- that the objective of the Act is to protect the interests of policyholders and the beneficiaries of general insurance policies and to ensure that primary responsibility for the protection of these interests rests with the board and senior management of a general insurance company;
- a definition of insurance business, unchanged from the existing definition;
- that a person carrying on insurance business in Australia must be authorised;

- that APRA may make Prudential Standards for the purposes of the Act;
- that a mandatory consultation process that has regard to good commercial practice and to cost-benefit considerations be followed in the setting of Prudential Standards under the Act;
- that a company authorised under the Act must comply with 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, auditor and valuation actuary of a company authorised under the Act.

The revised Act will continue to contain provisions relating to Lloyd's underwriters. In addition, the enforcement and wind-up provisions of Part V of the Act will remain within the revised Act subject to the outcome of the harmonisation process outlined in section 1.1 above. Requirements relating to the submission of data (prudential and statistical reporting) by companies to APRA will be taken out of the Act and inserted into a single data collection Act that will apply to all APRA regulated institutions. It is proposed that these amendments will be made to the Act as part of the Financial Sector (Collection of Data) Bill 2001.

The Treasury will separately issue a consultative paper dealing with the proposed changes to the Act.

1.3.2 Prudential Standards

The second layer of the proposed hierarchy of regulation comprises Prudential Standards. These Standards set out the main requirements with which companies authorised under the Act will be required to comply. Our preference is a small number of Standards, each outlining in plain English the key requirements for a particular prudential measure, with any prescriptive or interpretive detail in accompanying Guidance Notes.

Prudential Standards under a modernised Act will cover:

- capital adequacy;
- liability valuation;

- reinsurance arrangements; and
- risk management.

These Standards, in combination, will require general insurers to have in place appropriate risk management procedures and internal systems of control to manage risks with the potential to undermine the financial soundness of the insurer. Risks that cannot be effectively and efficiently mitigated should be covered by capital, giving the insurer a very high prospect of survival as a viable, ongoing concern. Insurance companies will be required to rigorously self-assess and attest to their own compliance with these Standards. APRA will supervise with a light touch wherever industry self-regulation is clearly present and working well.

1.3.3 Guidance Notes

The final layer of the proposed hierarchy of regulation are the Guidance Notes that accompany the Prudential Standards. These Notes set out the details of how APRA expects the Standards will be implemented in practice. There will also be a Guidance Note in relation to procedures and requirements for the authorisation of new entrants under the Act and a Guidance Note in relation to requirements for notification to affected policyholders of a transfer of policies to another authorised insurer.

The Prudential Standards and Guidance Notes have been revised - from those issued in the second round of consultation - to take account of comments received from the industry and other stakeholders over recent months. APRA is committed to issuing Standards that are commercially realistic and broadly acceptable to the industry.

1.4 Structure of this Paper

Chapters 2 and 3 discuss the draft Prudential Standards and Guidance Notes. Comments received are outlined and APRA's response is detailed in the context of the objective underlying the measure concerned. Chapter 4 discusses APRA's approach to the estimation of capital required by the Australian general insurance industry. Chapter 5 raises issues relating to prudential returns and disclosure. Attachment 1 reviews the milestones of the general insurance review project to date and highlights the next steps. A list of respondents to the Round 2 consultative papers is set out in Attachment 2.

CHAPTER 2 – TECHNICAL STANDARDS

This chapter addresses issues raised in response to the draft Liability Valuation and Capital Adequacy Standards. The comments and proposals should be read in conjunction with the respective Standards and Guidance Notes.

The technical standards aim to provide a measure of certainty and consistency by specifying mandatory requirements (in the Standards), while at the same time allowing the use of individual judgements and approaches based on the Guidance Notes. APRA hopes that this approach will produce the prudential benefit of consistency of estimation under the Liability Valuation Standard. There is also consistent (and therefore transparent) risk measurement within the Capital Adequacy Standard to enhance market discipline through minimal, but efficient, disclosure.

The Liability Valuation Standard is designed to produce a reasonable and consistent estimate of the value of insurance liabilities. An obvious requirement of the Standard is that the estimation of insurance liabilities be consistent both between different classes of business and between different insurers. In the same way that market value is used as proxy for fair value in the valuation of assets, the Liability Valuation Standard requires, in the absence of a deep market for insurance liabilities, a level of certainty which the market would require in estimating the value of the liabilities. This has been set at a the 75th percentile of the range of possible outcomes.

Building on the fair value basis of the Liability Valuation Standard, the Capital Adequacy Standard requires an additional layer of capital to ensure that the possibility that an insurer will be unable to meet its claims is reduced to a minimal level. Compared with existing solvency requirements, the calculation of this capital is designed to be a risk based measure that is responsive to changes in an insurer's risk profile. Chapter 4 contains a detailed discussion on the means by which this level of capital has been set.

During previous consultation rounds, the insurance industry and other interested parties indicated widespread support for the principles and proposals contained in the Liability Valuation Standard, the Capital Adequacy Standard and their Guidance Notes. A number of issues, however, attracted specific comment, and in some cases, criticism. It was also clear that there were issues that required further clarification or explanation. The main issues raised, and APRA's response, are discussed in turn below.

2.1 Risk Margins and the 75th Percentile

Comments Received

While there was little disagreement that risk margins over and above the central estimate are a necessary component of valuing insurance liabilities, there was little acceptance that the 75th percentile is necessarily the appropriate level to mandate. Many respondents argued that some flexibility was necessary, while a limited number claimed that the supervisor should not even attempt to be prescriptive on this issue. Most respondents also noted that the 75th percentile did not necessarily equate to 'fair' or 'market' value. Some comments were also received on the apparent lack of linkage between the mandated risk margin and the capital adequacy framework, even though the two are closely related.

Policy Objective

APRA's aim is to achieve more objective, reliable and consistent valuation of insurance liabilities than currently occurs. While the valuation processes should be consistent with the 'fair value' concept being developed within the international accounting framework, an interim measure is required until such time as the accounting standards are updated.

APRA Response

APRA remains of the view that, in the absence of clear accounting standards on 'fair value', a mandated risk margin is necessary to ensure sufficiently objective, reliable and consistent valuation of insurance liabilities. Existing practices have proven to be inadequate to achieve these goals, and have been the subject of some criticism. As a result, supervisory action is required. No alternative to the 75th percentile has been proposed that, in APRA's view, would meet its policy objectives (note that some suggestions may have provided adequate comfort to APRA, but would not produce adequate disclosure to the market more generally). APRA acknowledges that the 75th percentile is an arbitrary proxy for 'fair value', in that it has not been derived from the extensive analysis of a wide range of insurance portfolios. However, we remain of the view that its simplicity more than offsets any potential drawbacks from its general application. Once the accounting standards are updated to produce a more meaningful and rigorous means of establishing the fair value of a portfolio of insurance liabilities, APRA will look to incorporate these within its Prudential Standards.

It must also be noted that, as discussed in section 2.5, in those instances where the board of an insurer believes the 75th percentile is inappropriate, it may set its provisions at another level provided this is disclosed to APRA and the market. In addition, in the case

where an insurer believes additional provisions are required, or chooses to make such provisions for other reasons, the additional provisions over and above the 75th percentile are eligible to be included in the insurer's capital base for the purposes of meeting its minimum capital requirement (this removes a disincentive within the previous draft Standard for companies to be prudent).

See Chapter 4 for more discussion on the linkage between liability valuation and capital adequacy.

2.2 Premiums Liabilities

Comments Received

Respondents expressed concern at the introduction of the Premiums Liability concept. Many commented that it would be difficult to calculate, especially if the insurer did not use an actuary. Others objected to the required 75th percentile. It was suggested that in most cases an insurer's UPP less its DAC would be a sufficient proxy for the Premiums Liability. Others queried the relative size of the capital factors applied to the Premiums Liability for a given class of business compared with the corresponding factors applied to the Outstanding Claims Liability.

Policy Objective

Our objective is to ensure that premium liabilities, ie possible future claims on policies in force, are adequately valued.

APRA Response

We accept that the level of complexity (and cost) involved in the calculation of the Premiums Liability may, in some cases, be high relative to the benefit obtained from the more thorough analysis that has been proposed. The Liability Valuation Standard and accompanying Guidance Note include suggested methodologies for the calculation of the Premiums Liability that acknowledge that a high degree of complex analysis may not always be warranted, and allow the actuary to exercise professional judgement over whether simple estimation methods may be sufficient. However, while APRA remains committed to the concept of the Premiums Liability as a means of assessing the likely cost to an insurer of claims arising from future events, it is willing to discuss this issue further with interested parties. In particular, APRA invites suggestions on benchmarks that might be used to allow insurers with, for example, loss rates and growth rates below a certain level, to use their UPP less their DAC as a proxy for Premiums Liabilities.

The greater uncertainty surrounding such future claims requires a higher capital factor than that charged on the Outstanding Claims Liability for the same class of business. However, the differential between the two sets of factors was quite wide in the previous proposals. As well as providing a general reduction in the capital factors to be applied, the new draft Standard has acknowledged the comments received, and has reduced this differential (particularly for short tail classes of business).

2.3 Dual Reporting

Comments Received

Respondents strongly approved of APRA's objective to increase consistency in the reporting of insurance liabilities and the move to a market value framework. However, respondents were generally of the view that, in practice, dual reporting, and therefore increased compliance costs, would be unavoidable if the proposed approach to Liability Valuation is introduced in its current form. The establishment of a consistent accounting framework and approach under the Liability Valuation Standard for both regulatory and financial reporting purposes was encouraged. Respondents requested that the proposed standard should be consistent with AASB 1023 Financial Reporting of General Insurance Activities, and should be developed in consultation with the IAA.

Policy Objective

Our objective is to ensure that the insurance liabilities of all insurers are measured and reported consistently on a basis which is appropriate within the context of the market value basis used for valuing assets. The purpose is to ensure that the insurance liabilities are properly valued for prudential purposes and not a product of other influences such as taxation, reported profit or the required prudential capital adequacy of the insurer.

APRA Response

To ensure that the Liability Valuation Standard is developed so as to minimise future compliance costs from harmonising with Australian and international accounting standards, consultation with the AASB (including with a representative on the Insurance Steering Committee of the IASB) is progressing.

The AASB has indicated that AASB 1023 will not be revised until the accounting framework is developed by the IASB. While the timeframe for this is uncertain, at this point the technical requirements of APRA's draft Liability Valuation Standard are consistent with the direction of the Insurance Steering Committee of the IASB for the

purposes of progressing the development of an accounting standard for general insurance activities.

APRA will continue consulting with the AASB and Insurance Steering Committee before the Liability Valuation Standard is finalised. However at this stage, in order to ensure consistency in the reporting of insurance liabilities for statutory purposes and to remain in line with expected future international accounting developments, there has been no change to the technical requirements in the Standard that diverge from AASB 1023.

2.4 Diversification Benefits

Comments Received

Respondents encouraged APRA to develop valuation and capital adequacy methods that recognised the benefits of portfolio diversification – within liability classes, within an asset portfolio, and between the asset and liability sides of the balance sheet – as a means of risk mitigation. Some concerns were also expressed that it was uncertain whether the valuation of insurance liabilities, at the 75th percentile, should occur for each class of business, or at an aggregate portfolio level.

Policy Objective

Our objective is to have a risk-based capital adequacy framework that, wherever possible, allows for the recognition of diversification benefits.

APRA Response

APRA's intention is that insurance liabilities be valued so as to achieve the 75th percentile for the portfolio as a whole. This has been made clearer within the latest draft of the Liability Valuation Standard. While this Standard requires that insurance liabilities be determined on a class by class basis, in addition to the valuation at the portfolio level, the Guidance Note discusses the estimation of insurance liabilities at the class level, and allows for actuarial judgment in determining any difference between the class and portfolio estimates (ie possible diversification benefits). Such benefits are therefore clearly permitted, but must be pro-rated to estimates already made at the class level. This allows total liabilities to be reduced by this benefit, while still ensuring APRA's policy objective that sources of change within the portfolio can be identified to the board of the insurer.

On the asset side of the balance sheet, a slightly different process was proposed. Because the Capital Adequacy Standard has been calibrated using the earnings of insurers with, on

the whole, well-diversified portfolios, APRA proposed to include within the Standard an Investment Concentration Risk Charge. This would require an insurer to hold additional capital against investments that comprised a significant proportion of its balance sheet. For the reasons discussed in section 2.9, this capital charge has been significantly relaxed from the earlier proposals, although APRA remains committed to establishing large exposure limits within the prudential supervision regime for general insurance companies consistent with that proposed for conglomerate supervision more generally.²

Beyond the above, recognition of diversification is available to insurers that are able to develop suitably rigorous internal capital measurement models.

2.5 Role of Actuaries and the Appointment of the Valuation Actuary

Comments Received

Respondents commented that the proposed role of the valuation actuary would significantly compromise the role of the insurer's board, as well as detract from the normal role of management. Comments were also made that the role of the valuation actuary as prescribed was too onerous for any one person to fill, both in terms of the overall workload required, and in relation to the proposed whistle-blowing obligations.

Policy Objective

APRA's objective is to ensure that the board of each insurer is provided with expert advice on the value of its insurance liabilities so that it can make decisions on the value of those liabilities in an informed manner.

APRA Response

The primary responsibility for managing an insurer and determining the value of insurance liabilities will remain with the insurer's board under the proposed Standards. APRA has no intention of weakening the board's role with its proposals, which are designed to be consistent with our supervisory philosophy which says that the "board and management of supervised institutions are primarily responsible for financial soundness".³ Moreover, we do not accept that the establishment of a valuation actuary will erode these responsibilities. The wording of the Standards has been amended in a number of places to make this important point clearer.

² Concentration limits have been recast so as to be expressed as a percentage of an insurer's capital base so as to be consistent with exposure methods employed elsewhere by APRA.

³ *Annual Report 2000*, APRA, p1.

The role of the valuation actuary is to give expert advice to the board to allow the latter to carry out its duties in an informed manner. There is nothing in the proposals which prevents the board from also taking advice from a range of other sources as it sees fit (the senior management of the insurer, the company's accountants and auditors etc). Similarly, there is nothing in the proposals to prevent the board from disregarding the valuation actuary's advice, provided that the board discloses its actions to APRA and the market.

APRA does not accept the view expressed by some respondents that the proposed valuation actuary role would be too onerous for a single person to carry out. It is acknowledged that, in practice, the valuation actuary will need to co-ordinate, and rely upon, work undertaken by other employees or contractors of the insurer. But that does not detract from the usefulness of the role. To the extent that many large insurers already operate with a 'Chief Actuary' or similar role, this merely replicates existing practice. Such a regime works well, and without difficulty, in a range of other fields, including life insurance (where each company has an Appointed Actuary) and in auditing (where an audit partner oversees and takes responsibility for the proper conduct of an audit, but does not work single-handedly).

It is intended that auditors and valuation actuaries will be required to inform APRA in circumstances:

- where there have been breaches, or potential breaches, of prudential requirements applicable to an insurer; and/or
- where there is a material risk to policyholders; and
- where a breach or risk to policyholders has not been remedied after due notification to the insurer.

These circumstances will be identified in the revised Act. The revised Act and Standards make it clear that the valuation actuary is not required to actively search for breaches or potential breaches, but to report them if they become apparent.

2.6 Capital Reduction Policy

Comments Received

A number of respondents expressed concern that the proposed restrictions on capital reductions – in particular, the need to seek APRA's prior approval for dividend payments

out of retained earnings – were too onerous and involved excessive restrictions on an active capital management strategy.

Policy Objective

Our objective is to ensure that capital reductions do not compromise an insurer's ability to meet future policy obligations. Such a restriction is a common feature of supervisory regimes for other industries and in other jurisdictions.

APRA Response

We agree that well-capitalised insurers should not be subject to undue restrictions on their capital management strategies. As a result, two changes have been made to the proposals in the Capital Adequacy Standard. The first clarifies the restriction on dividend payments, ie they should not exceed the after-tax profits of the insurer in the year to which they relate (respondents had expressed concern that, for example, the final dividend for the 2000/01 financial year, which was actually paid in 2001/02, would be subject to APRA's approval unless 2001/02 earnings were sufficient to fund the payment – this was never intended). The second, more important, change introduces a capital adequacy threshold – set at 1.75x an insurer's minimum capital requirement - above which APRA's approval is not required. Insurers that maintain a capital level above this threshold will be able to make capital reductions without the need to seek prior approval. The 1.75x threshold has been chosen with a view to being broadly consistent with the type of benchmarks used by the market and rating agencies for assessing when an insurer is well-capitalised.

2.7 Insurance Risk Capital Factors

Comments Received

There was no disagreement about the need for an insurance risk capital charge, nor the proposal that the capital factors should vary by class of business. Many respondents requested clarification of the distinction between the risk margin within the Liability Valuation Standard and the insurance risk capital factors within the Capital Adequacy Standard, with some suggesting that this approach was 'double counting' and excessively cautious. Others suggested that a more risk-based approach would be to require a higher probability of sufficiency in the calculation under the Liability Valuation Standard, rather than using the Insurance Risk capital factors (a variant of the issues discussed under section 2.2). Finally, some respondents requested further detail on the means by which the level of the capital factors was determined, as well as the relativities between some

factors (particularly those for reinsurance, which many suggested should be based on underlying business and treaty type).

Policy Objective

APRA's objective is to ensure that, once liabilities are valued in an objective, reliable and consistent manner, each insurer holds sufficient capital to reduce to a minimal level the possibility of failing to meet its obligations. The level of capital held should be sensitive to the risk profile of the insurer.

APRA Response

We do not believe that the imposition of a capital requirement based on a liability value that already includes a risk margin represents double counting. The risk margin is intended to ensure that the valuation of liabilities is broadly consistent with the fair value of those liabilities. But it will not be sufficient to cover severe adverse events that an insurer might encounter. The capital requirements, which are applied over and above the risk margin, provide an additional layer of comfort that an insurer will be able to meet its obligations to policyholders in all but the most extreme circumstances.

There is one instance in which some 'double counting' could be said to occur: that is, where the insurer values its insurance liabilities at a level above the 75th percentile. In this case, the capital factor applied to a higher than necessary risk margin would penalise an otherwise prudent insurer for creating additional technical provisions. To prevent this disincentive, the Capital Adequacy Standard has been amended to allow for provisions over and above those required by the Liability Valuation Standard to be counted as part of the insurer's capital base.

We accept the comments received to the effect that capital factors for inward reinsurance could be better structured. As a result, and after consultation with a number of reinsurers, the factors are now based on the underlying business and treaty type, rather than on the basis of the flat factors proposed previously.

Further details on the calibration of the proposed Capital Adequacy Standard can be found in Chapter 4.

2.8 Investment Risk Capital Factors

Comments Received

Respondents suggested a number of possible revisions to the Investment Risk Capital Factors, including:

- removing some internal inconsistencies between capital factors, eg between the capital factors for deferred reinsurance expenses and reinsurance recoverables, and for fixed interest securities with maturities under/over one year;
- creating greater differentiation in some asset classes (e.g. between fixed interest and equity unit trusts);
- considering a revised approach to derivatives (no capital charges were proposed in the initial draft proposals);
- excluding shareholder assets from the Investment Risk Capital Charge; and
- lengthening the period before which unpaid premiums attract a higher capital factor.

Policy Objective

APRA seeks to ensure that an insurer holds sufficient capital to cover the potential for a decline in asset values to impair its ability to meet policyholder obligations.

APRA Response

Where identified, inconsistencies in the capital factors applied to different assets have been removed. However, it is inevitable that, in balancing the desire for greater risk-sensitivity with a wish to maintain a reasonable degree of simplicity with the Capital Adequacy Standard, some anomalies may still arise. For example, despite the suggestion made above, no distinction has been made between investments in fixed interest and equity trusts. This is because of the inability to create a simple set of rules that would cover the multitude of investment strategies that a unit trust might employ (e.g. a balanced fund that invests in both fixed interest and equity, as well as cash, property and a range of other assets).

A capital charge has been introduced within the draft Standards for derivative positions. Given the limited usage of derivatives by the insurance industry, it is not expected that this will have any material impact on capital requirements. However, it will limit the extent to which an insurer might attempt to arbitrage the different treatment of physical and derivative exposures. Recognising that the treatment of derivative positions is not ideal, we have also set a maximum tolerance level on the size of the capital requirement for derivative positions relative to the total capital requirement of the insurer. We reserve the right to impose an additional capital requirement on any insurer taking derivative positions beyond this tolerance level.

APRA does not accept the argument that shareholder assets should be excluded from the Investment Risk Capital Charge. These assets continue to expose the insurer to potential loss, and cannot be quarantined from other assets in the event that an insurer encounters financial difficulties. Nor do we accept that an insurer with more capital will be penalised with a higher capital requirement relative to an insurer with less capital, all other things being equal. While this may be true in dollar terms, the insurer with more capital will always have that reflected in a higher capital adequacy ratio. The insurer will also be less constrained by the Investment Concentration limits (and any large exposure limits that are ultimately introduced) as these will be measured relative to the capital base of the insurer.

Comments received on unpaid premiums have been accepted, and the period in question has been altered from 3 to 6 months.

2.9 Investment Concentration Risk Charge

Comments Received

This aspect of the Standard generated a great deal of comment, mainly focussing on the charge on investments in related entities and the resulting concentration penalty. At the thresholds proposed, many respondents suggested the proposals were completely unworkable. Some argued that the 100% capital charge against related party assets beyond the concentration limit was particularly harsh when compared with the current arrangements. Other respondents noted that the concentration requirement would be a significant issue for branches of foreign insurers, for whom related party balances will account for a large proportion of the balance sheet. It was felt that the investment concentration risk charge would penalise reinsurers who wholly cede back to their parents.

Policy Objective

Our objective is to ensure that an insurer holds a well diversified asset portfolio and, where this is not the case, it holds additional capital to match the resulting concentration in risk. Another objective is to remove the existing section 30 framework, so as to avoid the need for discretionary approvals and improve consistency in the measurement of capital adequacy.

APRA Response

Many of the industry's concerns on the issue are legitimate. The revised Standards, therefore, have been altered to include less onerous restrictions on reinsurance recoveries from a parent company. There are also additions to the Standards dealing with the effects

of derivative positions and “look through” provisions, which should alleviate many of the problems apparent in the previous proposals. However, it should be noted that APRA intends to further examine this issue, with a view to eventually developing large and intra-group exposure limits that are consistent with those proposed for conglomerate supervision more generally.

2.10 Change of Minimum Capital Requirement from \$2 million to \$5 million

Comments Received

Some respondents queried the need for the increase in the minimum capital requirement from \$2 million to \$5 million, suggesting that it would place an unfair burden on smaller insurers.

Policy Objective

Our objective is to ensure that each insurer has a minimum level of capital resources sufficient 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-up.

APRA Response

We acknowledge that this change will affect a large number of insurers. However, the \$2 million minimum that currently applies is low by today’s standards. Banks have a minimum capital requirement of \$50 million, life insurance companies and building societies require \$10 million, and approved trustees require \$5 million. Against those limits, the new proposed minimum for general insurance companies are not onerous. Nor will it significantly affect competition in the industry. To the extent that existing insurers will require time to raise additional capital to meet the new minimum, APRA proposes generous transition arrangements: it is proposed that an insurer will have until June 2007 to meet the new Standard.

2.11 Application of Capital Adequacy Standard to Companies in Run-off

Comments Received

Several respondents asked for clarification on the application of the Capital Adequacy Standard to insurers in run-off, with many arguing that it was difficult for run-off companies to raise additional capital if that was required.

Policy Objective

Our objective is to ensure that, regardless of whether a company is an on-going business or in run-off, the interests of policyholders are protected.

APRA Response

Insurers in run-off are still exposed to risk due to the inherent uncertainty in potential future claims, particularly where the class of business is long tail. In order to protect policyholders' interests, we intend to apply the Capital Adequacy Standard to insurers in run-off. However, there may be certain circumstances where this approach is not warranted or feasible. In these situations, APRA will consider granting an exemption from compliance with the Capital Adequacy Standard where insurers meet certain criteria. These criteria will include a solvency coverage ratio of 1.6x (based on the existing requirements of the Insurance Act) and a liability base of not more than \$2.5 million. A company in run-off must also demonstrate that its existing capital base is sufficient to run its liabilities off in an orderly manner, and will be prevented from making any form of capital repatriation without APRA's prior approval. Compliance with other Prudential Standards will still be required.

2.12 Application of Prudential Standards to Captive Insurers

Comments Received

Several respondents raised concerns regarding a possible loss of certainty within the proposed framework regarding the regulation of captive insurance companies. In their opinion, the new approach compared unfavourably with APRA's previously published guidelines on the regulation of captives, which were seen as providing adequate certainty in the marketing of Australia as a domicile for captive insurance entities.

Policy Objective

APRA's objective is to ensure that the Standards that have been developed apply to all licensed insurers. Any additional requirements for specific sectors within the industry are best left to tailored guidance notes or to correspondence with the insurers concerned.

APRA Response

We do not believe that the new requirements will in any way restrict or tighten existing supervisory standards for captive insurers. However, to the extent that the high-level nature of the Standards has led to some concern within the industry, APRA intends to maintain the level of certainty for captive insurers that existed under the previous regime.

Where possible, specific issues relevant to captive insurers have been included in the Guidance Notes to the Standards.

2.13 Section 37 Insurers

Comments Received

Some insurers currently benefit from exemptions to prudential requirements granted under section 37 of the Act. They requested that the new regime should contain sufficient flexibility to allow them to retain their exempted status.

Policy Objective

In the current review of prudential supervisory requirements for general insurers, it has become clear to APRA that the interests of policyholders need to be protected more effectively. Our view is that it is no longer prudent to grant any new exemptions under section 37 of the Act.

APRA Response

Section 37 of the Act grants APRA the power to exempt an insurer from provisions of the Act where that insurer carries on insurance business for the benefit of a limited class of persons, provided the insurer's premium income does not exceed the exemption limit. Under the new regime, it is proposed that section 37 of the Act be repealed and replaced with a more general exemption provision modelled on section 11 of the Banking Act.

Existing section 37 insurers have been granted similar exemptions from prudential requirements including solvency, reinsurance and quarterly reporting requirements. The proposed new exemptions provision will allow APRA to determine that all or specified provisions of the Act do not apply to a particular insurer. The exemptions currently given to section 37 companies could be accommodated within this new provision. Under the new regime, section 37 insurers seeking to benefit from exemptions will need to satisfy APRA that they meet a set of threshold criteria designed to ensure that they are entitled to continue to take advantage of their privileged status. The threshold criteria examine aspects of the insurer's business relating to commonality, mutuality, sophistication, complexity, size and promotional activities. Those section 37 insurers who fail to meet the threshold criteria will be required to meet the requirements of the new regime. APRA has already commenced discussions with the handful of insurers affected by these changes.

CHAPTER 3 – GOVERNANCE STANDARDS

This chapter addresses issues raised in response to the Reinsurance Arrangements Standard, Risk Management Standard and Authorisation Guidance Note. The comments and proposals should be read in conjunction with the Standards and Guidance Notes.

These Standards and Guidance Notes have been 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 objective is to foster a flexible regime that allows insurers to tailor requirements to the size, business mix and complexity of their operations. However flexibility must be balanced against quality assurance and transparency in order to promote confidence in the protection of policyholders. This balance also promotes competitive equality whilst preventing regulatory arbitrage.

The Standards also aim to ensure that boards make informed and disciplined decisions after receiving the advice of independent experts.

The Reinsurance Arrangements Standard aims to ensure that an insurer has in place reinsurance arrangements contributing to a high likelihood it will be able to meet its obligations to policyholders. Insurers will be required to develop a REMS and obtain APRA's approval prior to its implementation. Insurers will be required to routinely self-assess and certify their compliance with the REMS.

The Risk Management Standard aims to ensure that an insurer is well managed, has access to appropriate independent expertise and has systems for identifying, managing and monitoring risks that may threaten the ability of the insurer to meet its obligations to policyholders. Insurers will be required to develop a RMS and assess and certify their own compliance with the Risk Management Standard.

Where it is demonstrated that self-regulation is working well in everyday practice, APRA will supervise with a commensurately light touch.

The Authorisation Guidance Note provides prospective applicants seeking an authority to carry on insurance business under the Act, with the minimum criteria to be addressed and information to be supplied in an application.

Respondents generally supported the principles and proposals contained in the Governance Standards and Authorisation Guidance Note. Those areas attracting comments or further clarification are addressed below.

3.1 Fitness and Propriety

Comments Received

Respondents to the Risk Management Standard generally supported the move to introduce comprehensive tests for the fitness and propriety of directors, senior management and independent experts. However, it was questioned whether the criteria proposed in the Risk Management Standard appropriately, comprehensively and clearly defined the factors to be considered. Respondents also sought clarification on those persons likely to comprise 'senior management' for the purpose of the Standards.

It was requested that the results of any investigation by APRA into fitness and propriety be made available to the individual concerned upon request.

Policy Objective

Our objective is to ensure that general insurers are subject to high quality control and management - an objective consistent with international codes and standards such as the IAIS Core Principles and the recommendations of the Joint Forum.

APRA Response

Insurers will normally be required to self-assess their compliance against these requirements. However, as a last resort, it is proposed that APRA will have a reserve power under the Act to remove the officer (after providing the person affected an opportunity to be heard).

The criteria listed in the Risk Management Standard set out the *minimum* considerations that should be made in assessing the fitness and propriety of directors, senior management and independent experts. While an insurer is encouraged to develop a more comprehensive approach, it may not implement a less detailed strategy. Compliance should be embedded in the culture and practice of the company, and not regarded as a 'bolted on' checklist or template.

The senior management of an insurer is defined to include those capable of exerting a material influence on the risk profile of an insurer. It is not APRA's intention to

delineate persons that represent senior management since the class will vary depending upon the size, mix and complexity of each insurer. As a result, it is expected that insurers should be capable of identifying those persons occupying senior management positions based on the role and responsibilities imposed on its staff.

3.2 Boards

Comments Received

Respondents believe it is fundamentally important that the board of an insurer is primarily responsible for the business of that insurer, and that independent experts should not interfere with decision-making by the board. Respondents questioned whether the expanded role assigned to independent experts in providing advice to boards was justified given the likely increase in the cost of using these professional services.

In the case of financial conglomerates, it was suggested that where a Board Audit Committee has been established to review group operations, APRA should not require an insurer in the group to set up a separate Board Audit Committee.

It was suggested that executives of a parent organisation should be permitted to serve as non-executive board members on the board of a subsidiary insurance company.

There was further concern as to how the Board Declaration, that certifies an insurer has complied with all supervisory requirements, would be enforced against board members, and whether this declaration should be audited. Some requested a proforma board Declaration to be provided as a guide to what is expected.

Finally, it was suggested that the requirement for the directors of an insurer to have appropriate skills and experience to understand the risks of that insurer's business was unrealistic and that perhaps the requirement should be that the board members collectively possess the skills required.

Policy Objective

Our objective is to encourage the board of an insurer to develop a more objective, reliable and standardised methodology for setting technical provisions.

APRA Response

APRA fully accepts the proposition, indeed strongly encourages the proposition, that boards should be primarily responsible for the business of an insurer. In part, it is in the interest of improving information flows to the boards that this proposal has been introduced. Boards are permitted under the Standard to elect not to follow the advice of a valuation actuary, provided that the insurer supplies APRA with (and discloses to the market) reasons for deviating from the advice of the valuation actuary. It is worth noting that the appointed actuary in life insurance performs a greater role than that envisaged for general insurance and this function has not resulted in the fettering of the autonomy of the board in that industry.

APRA recognises that the requirement for companies to have a valuation actuary and the increased scope of audit requirements may impose an additional cost on insurers. Whilst the role of the auditor will be expanded for statutory purposes, auditors are already required to review and assess an insurer's internal policies and procedures when preparing an audit plan for the purposes of Auditing Standard AUS 402 - Risk Assessments and Internal Controls. As a result, the requirements of the Standard serve to incorporate those existing requirements for auditors. Our view is that on balance, the increase in auditing costs arising from the proposal is likely to be small, and outweighed by the increase in the protection provided to policyholders.

In regard to Audit Committees, we acknowledge that in most circumstances such a Committee established for a financial conglomerate as a whole, is capable of acting as the Board Audit Committee of an insurer within the group. Where an insurer can satisfy APRA that the group audit committee can carry out the tasks expected of a Board Audit Committee, then APRA will grant the conglomerate permission to use the group audit committee. The Standard has been amended to give effect to this position. The board of the insurer should retain the authority to commission the group audit committee to undertake work on behalf of the insurer. Further, the board of the insurer should be able to arrange meetings with the group audit committee in order to determine matters particular to the business of the insurer.

The Risk Management Standard states the board of an insurer should have a majority of non-executive directors. This requirement is flexibly applied to foreign owned subsidiaries, where non-executives of the local board can be executives of the parent. In APRA's deliberations prior to release of the first drafts of the Standards, APRA considered requiring the board of an insurer to comprise a majority of *independent* (in the true sense of the word) directors. However, consistent with the approach adopted for

ADIs, APRA has decided to require only a majority of non-executive directors. A non-executive director of an insurer includes those persons that are not involved in the management of the insurer, nor any group to which the insurer belongs. The Risk Management Standard has been amended to clarify the definition of a non-executive director. APRA is not inclined to change the proposed requirements relating to board composition.

The purpose of the Board Declaration is to ensure that the board undertakes an informed and genuine assessment as to whether the insurer is being prudently managed in accordance with the regulatory framework governing the insurer. It is our intention to enforce this requirement in a practical and reasonable way. APRA would only take action against a board where APRA had reason to believe the board had clearly failed to properly perform its duties as certified under the Board Declaration. A Board Declaration which is reasonable and made in good faith, in accordance with the skills and experience of the board, is highly unlikely to generate enforcement action.

An insurer is not required to have the Board Declaration audited since the board should have considered the advice of the independent experts in making the Board Declaration.

The Board Declaration to be provided to APRA should attest that the board and senior management, commensurate with their ultimate autonomy, have complied with all supervisory requirements, identified all material risks and that systems have been put in place to effectively manage those risks. APRA does not intend to publish a proforma Board Declaration since the matters addressed in each declaration will vary depending on the size, mix and complexity of the insurer. Each board should use its judgement to devise a Declaration appropriate to its circumstances.

APRA recognises that in a modern financial system it would be difficult for a single individual to fully comprehend all significant risks that may impact on the business of an insurer. As a result, the Risk Management Standard has been amended to state that it is expected that the board of an insurer should collectively possess the appropriate skills and experience to understand the risk profile of that insurer.

3.3 Reporting

Comments Received

More detailed guidance on APRA's intended approach to determining matters considered 'material' under the new regime was requested. Additional guidance was also

requested on APRA's approach to determining those matters, which will, or are likely to, adversely affect the interests of policyholders such that an independent expert is required to report to APRA.

It was suggested that a certificate of compliance from the valuation actuary should also form part of the supporting information submitted in conjunction with an application for authorisation of a new general insurance company.

Respondents indicated that it may be necessary to include an element of flexibility in APRA's requirement to adhere to an insurer's RMS and REMS at all times. Respondents submitted that it may be unduly restrictive to require an insurer to seek APRA approval to amend its RMS and REMS and that this would inhibit their capacity to respond quickly to changes in the marketplace.

It was questioned whether the auditor was expected to report on all information supplied to APRA in the course of a financial year.

Policy Objective

APRA's aim is to improve the regulator's understanding of the insurer's financial position and risk profile. The new regime is designed to increase the relevance, clarity and consistency of information included in reports for prudential purposes.

APRA Response

Excessive amounts of information can obscure warning signals, and so irrelevant detail should be screened out. Insurers should use their own judgement in determining what is material in the circumstances, but may wish to have regard to the meaning adopted by the accounting, auditing and actuarial professions, as a guide.⁴

It is intended that auditors and valuation actuaries will be required to inform APRA in circumstances:

- where there have been breaches, or potential breaches, of prudential requirements applicable to an insurer; and/or

⁴ Accounting Standard AASB 1031: Materiality; Auditing Standard AUS 306: Materiality; IAA Professional Standard 300: Actuarial Reports and Advice on Outstanding Claims in General Insurance.

- where there is a material risk to policyholders; and
- where a breach or risk to policyholders has not been remedied after due notification to the insurer.

These circumstances will be identified in the revised Act. The Risk Management Standard has been amended to clearly identify this responsibility under the revised Act.

Independent experts should use their own professional judgement to identify those occasions when the interests of policyholders are likely to be affected during the normal course of a valuation actuary's or auditor's activities. Whilst independent experts are not required to actively seek out instances where the interests of policyholders are likely to be jeopardised, where such circumstances do arise and are noticeable, then the expert must report that situation to APRA.

APRA agrees that it would be prudent to require both the auditor and the valuation actuary to submit a report certifying the compliance of a prospective insurer with all prudential supervisory requirements as part of the supporting information required for an application to conduct insurance business. The Authorisation Guidance Note has been amended to insert a requirement for the valuation actuary of prospective insurers to submit a report certifying the prospective insurer's compliance with the Liability Valuation Standard as part of the supporting documentation to an application to conduct insurance business.

APRA understands that insurers should not be unduly restricted in responding to changes in the marketplace. As a result, the Standards have been amended to make it clear that an insurer must substantially comply with its RMS and REMS at all times. In other words, an insurer is entitled to undertake certain activities not directly considered in its RMS and REMS provided that the activity does not constitute a material breach of its RMS or REMS. However, should an insurer plan to undertake an activity that is likely to constitute a material breach of its strategies, this should first be approved by the board. An insurer should also consult with APRA prior to undertaking any such activity. The insurer should take steps as soon as practicable to amend policies and procedures to take into account new operating circumstances.

The auditor is not required to report on the adequacy and accuracy of all data supplied to APRA over the course of the year. As is currently the case, quarterly information will be unaudited. The Standard has been changed to clarify this point.

3.4 Risk Management Framework

Comments Received

Respondents suggested that the Risk Management Standard and Guidance Notes do not constitute a clear framework for risk management. Whilst the Standard was considered to be well suited to its purpose, the Guidance Notes were seen as being too detailed and narrow in some respects. Respondents proposed that the Guidance Notes be replaced with guidelines that describe a comprehensive risk management framework.

Respondents also commented that there is a lack of alignment between the Risk Management Standard and the supporting Guidance Notes. Respondents proposed that the Guidance Notes were overly prescriptive and that some of the detail contained in the Guidance Notes would be better dealt with in the Standard. It was also suggested that new, uncommon or risk management-based terms be separately defined.

Some respondents believed that the Standard failed to address the variation between insurers with respect to complexity, scale of operations and risk management experience.

Policy Objective

Our aim is to ensure that an insurer is well managed, has access to appropriate independent expertise and has systems for identifying, managing and monitoring risks that may threaten the ability of the insurer to meet its obligations to policyholders.

APRA Response

We acknowledge that the Risk Management Standard could more clearly set out the requirement for insurers to have a comprehensive risk management framework. Accordingly, the Standard and Guidance Notes have been amended to establish a more complete risk management framework for insurers. The revised framework has been drafted having regard to international frameworks and practices.⁵

The Guidance Notes in relation to Balance Sheet and Market Risk, Credit Quality and Operational Risk have not been replaced. Whilst these Guidance Notes may seem

⁵ *Framework for Internal Control Systems in Banking Organisations*, Basle Committee on Banking Supervision, September 1998; *Internal Control – Integrated Framework*, The Committee of Sponsoring Organisations of the Treadway Commission, September 1992 (USA); *AS/NZS 4360: Risk Management*, Standards Australia and Standards New Zealand, 1999; *Guideline: Standards of Sound Business and Financial Practices – Internal Control*, Office of the Superintendent of Financial Institutions Canada; *Operational Risk Regulatory Approach Discussion Paper*, International Swaps and Derivatives Association, September 2000.

prescriptive, it is APRA's preference 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. This approach has been adopted for all the draft Prudential Standards and Guidance Notes for insurers, as well as those in place for ADIs. APRA acknowledges that these Guidance Notes target risk areas, particularly in the area of operational risk, however, this does not preclude insurers considering other risk areas that may affect their operations, and the Standard and Guidance Notes recognise this. The Guidance Notes have been designed to set out the minimum areas that APRA expects to see as part of an insurer's risk management systems. An insurer should seek to develop a risk management system that is appropriate to its size, business mix and complexity of operations. Where the board and senior management consider that certain aspects of the Guidance Notes are not applicable to the risk profile of the insurer, these should be noted and explained in the RMS.

APRA does not propose to incorporate a definition section into the Standard. The Standard and Guidance Notes adequately explain risk management concepts and interpretation should be drawn from their ordinary reasonable meaning. We do not wish to be overly definitive or legalistic in approach.

APRA does not accept the argument that the Standard and Guidance Notes are inflexible and do not accommodate insurers of different size and complexity. The Standard states that the board and senior management of an insurer should develop, implement and maintain risk management systems appropriate to the operations of the insurer. We acknowledge that the extent of these systems will be reflective of each insurer's size, business mix and complexity of operations and will assess the risk management systems of an insurer accordingly. The Standard requires risk management systems in regard to balance sheet and market risk, credit quality and operational risk. These areas of risk are commonly accepted as risks faced by financial institutions and APRA intends to assess the management of these risks as part of its supervisory processes.

3.5 Branches

Comments Received

Respondents commented that some areas of the Standards do not specify the proposed treatment of branches. In particular, the requirement for Reinsurance Policy Statements to be approved by a senior officer from outside Australia was considered insufficient as

compared to the requirement for subsidiaries to have these Statements approved by the board.

Policy Objective

Our objective is to ensure that policyholders of foreign incorporated insurers operating in Australia as branches should be afforded the same protection whether they contract with a branch in Australia or a locally-incorporated insurer. Branches should therefore be required to meet the same prudential requirements as locally incorporated insurers, with the exception of Capital Adequacy Standards, where a variant is imposed due to the nature of a branch's balance sheet.

APRA Response

The board and senior management of an insurer are primarily responsible for the sound and prudent management of the insurer. Where appropriate, the board will be required to approve certain strategies and policies of the insurer. Similarly, in the case of a branch of a foreign insurer, the ultimate responsibility for the safety and soundness of the branch will continue to reside with the board. However, for practical purposes, APRA will allow certain strategies and declarations to be approved by a senior officer outside Australia where that officer has been delegated the authority from the board. The senior officer should have responsibility for overseeing the Australian branch operation. Requirements throughout the Standards for board approval have been amended to reflect this requirement for branches.

In order to simplify the requirements for insurers in relation to reinsurance and risk management, the Reinsurance Arrangements Standard and Risk Management Standard have been amended to require only that the board approve Reinsurance and Risk Management Strategies developed by the insurer. APRA agrees that the strategies of a branch should be subject to approval by the board to ensure adequate and appropriate systems and procedures are put into place. The Standards have been amended to require the Reinsurance and Risk Management Strategies for a branch authorised in Australia to be approved by a senior officer outside Australia who has been delegated the requisite authority from the board.

If the authorised insurer in Australia is part of a global insurance group or operates as a branch of a foreign insurer, APRA would expect the REMS to include information on the global reinsurance policy. This may include policy objectives and strategies in respect of reinsurance management, but would particularly include the reporting arrangements

between Australian and overseas operations, the monitoring of Australian operations by the overseas parent or home office and the home regulator's supervisory arrangements regarding reinsurance. Where elements of the strategy are controlled by home office, these should be identified and detailed. The Reinsurance Arrangements Standard has been amended to reflect this expectation.

Similarly, where a branch is subject to the Reinsurance and Risk Management policies and procedures of its home office, this should be indicated in the strategies of the branch and the policies and procedures of the home office should be included in the branch's own strategies. Again, procedures for monitoring, oversight and compliance with these procedures should be detailed.

Where control mechanisms for reinsurance are in place, and these include reporting to home office or are the responsibility of the home office, the strategy should also identify these mechanisms. Guidance Note 1 of the Reinsurance Arrangements Standard has been amended to make this clear.

The requirement to establish a Board Audit Committee is not applicable to branch operations and this has been clearly stated in the Risk Management Standard.

3.6 Technical Issues

3.6.1 Premium Retention

Comments Received

Some respondents sought detail on the selection of the 40 percent level of participation by an authorised insurer in business written as specified in the Reinsurance Arrangements Standard. It was suggested that the specification of the level of cessions may be misleading and an appropriate level and arrangements should be determined bearing in mind a company's total capital resources and business plans.

For captive insurers, APRA was encouraged to maintain the current relaxation in this guideline which permits captives to cede up to 90 percent of business written.

Policy Objective

Our aim is to minimise the moral risk associated with 'fronting' (fronting occurs when an insurer, often with minimal capital, is set up with the intention of reinsuring the bulk of the risk). The moral risk that arises may stem from the direct insurer having little

incentive to underwrite or administer claims properly, since the exchange of commission far outweighs any likely losses on the small retention, or the selected reinsurer being of doubtful worth. By minimising the associated moral risk, the protection of policyholders is promoted.

APRA Response

General Insurance Circular G 6/97⁶ sets out guidelines for insurers about the types of arrangements which are likely to be approved for the purposes of the Act.⁷ One of these guidelines is that an insurer's total cessions to reinsurers should not exceed 60 percent in the case of direct insurers and reinsurers,⁸ and 90 percent in the case of captive insurers. This longstanding guideline has been incorporated into the Reinsurance Arrangements Standard without change, although there is no specific reference to captives.

APRA believes it is appropriate to maintain this guideline within the Standard to provide an indication of what APRA would normally see as appropriate. We accept that there may be circumstances where a retention of less than 40 percent is warranted, and there is scope for APRA to approve a REMS that identifies higher levels of cessions provided there is sufficient justification.

The Standard has been amended to more clearly acknowledge that captives may cede up to 90 percent of business underwritten.

3.6.2 PML Levels

Comments Received

It was suggested that particular elements of the Reinsurance Arrangements Standard are too wide in their interpretation, for example, determining PML levels requires modelling based on two key assumptions (return periods and confidence limits) that can produce vastly different results. It was expressed that if guidance is not given on the application of these assumptions, outcomes of the process will vary considerably.

⁶ A copy of General Insurance Circular G6/97 can be found on the APRA web site at www.apra.gov.au

⁷ Sections 29(1)(d) and 34 require insurers to have reinsurance arrangements in place at all times; section 34A requires these arrangements to be approved by APRA.

⁸ Although in general, authorised insurers must retain at least 40 percent of underwritten risk, this does not mean that small portions of business cannot be 100 percent reinsured provided that the overall book of the insurer has at least 40 percent retention.

Policy Objective

Our objective is to ensure that the board of an insurer is satisfied with the level of reinsurance cover purchased having regard to the size and mix of the insurer's business. Estimates of PMLs allow insurers to calculate with greater certainty the level of reinsurance cover required and to control exposures to geographical zones or specific risk categories.

APRA Response

It is not APRA's intention to specify to insurers how much cover they should have, but to ensure that the amount of cover arranged is prudent and minimises the risk to policyholders, within commercial bounds. In approving an insurer's REMS, APRA will assess the methods and models used by insurers to calculate PMLs.

3.6.3 Policy Statements

Comments Received

Respondents requested that APRA produce a pro-forma Reinsurance Policy Statement (the current revised drafts no longer require a Reinsurance Policy Statement, only a REMS) as an example so that insurers will provide consistent information and there is no misinterpretation of the 'guidance' rules. APRA has also drawn a parallel between this comment and its application to the requirements of the Risk Management Standard.

Policy Objective

APRA's objective is 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 reinsurance arrangements. APRA recognises that the scope of the REMS will vary among insurers depending on the size, business mix and complexity of their operations.

The Risk Management Standard aims to ensure that an insurer is well managed, has access to appropriate independent expertise and has systems for identifying, managing and monitoring risks that may threaten the ability of the insurer to meet its obligations to policyholders.

APRA Response

In the second round of drafts, the Reinsurance Arrangements Standard required insurers to have in place a REMS, including a Reinsurance Policy Statement, directed towards ensuring that an insurer selects reinsurance arrangements appropriate to its risk profile. Similarly, the second round Risk Management Standard required an insurer to have Risk Management Systems, including Risk Policy Statements, to ensure that there is a process of identification, assessment, management, monitoring and reporting of all sources of risk that may impact upon an insurer and its operations.

In order to streamline the process involved, the Standards have been amended to remove the requirement to have board approved Reinsurance Policy Statements and Risk Policy Statements as part of the REMS and RMS respectively. Now the Standards will require that the board, or an appropriate senior officer for branches, approve the REMS and RMS. Prior to implementation, the REMS must be approved by APRA. The adequacy and appropriateness of an insurer's RMS will be reviewed as part of APRA's normal supervisory activities, including visits to insurers.

Given the diversity among insurers with respect to size, business mix and complexity of operations, APRA does not intend to provide a pro-forma REMS and RMS. We would expect that each insurer develop strategies reflective of the risk profile of their operations and based on their own judgement and understanding of the spirit of the Standard.

3.6.4 Exemptions

Comments Received

It was proposed that an exemption provision should remain in the Reinsurance Arrangements Standard as currently exists under section 34 of the Act.

Policy Objective

Our objective is to ensure that an insurer has in place reinsurance arrangements contributing to a high likelihood of its being able to meet its obligations to policyholders. Insurers will be required to develop and routinely self-assess their compliance with their REMS, which must be initially approved by APRA.

APRA Response

Sub-section 34(5) of the existing Act permits APRA to grant an exemption to an insurer from the requirements of section 34 of the Act, that is, from having reinsurance

arrangements approved. Insurers, whether granted an approval or exemption under section 34, are generally required to meet the same guidelines, that is, those set out in Circular G 6/97.

However, exemptions permitted under section 34 do not translate to a potential exemption from having a REMS in accordance with the Standard. All insurers will be required to have a REMS approved by APRA in accordance with the Reinsurance Arrangements Standard. It is therefore not proposed to include an exemption provision in the Standard. In some circumstances, APRA could approve a REMS for an insurer not to have reinsurance. However, the Strategy would have to clearly outline the reasons for choosing not to take out reinsurance cover and indicate that the board had considered the relevant alternatives carefully. Should an exemption be necessary in a particular circumstance, this will be possible through the general exemption powers under the revised Act.

3.6.5 Audit of Brokers and Ceding Insurers; and Credit Exposures

Comments Received

It was suggested that APRA's recommendation that an insurer's risk management system for claims management should include an audit of brokers is unworkable since it is unlikely that an insurer would be able to conduct such an audit. Similarly, it was noted that whilst the practice does occur in North America, it is not common in the Australian market for reinsurers to audit ceding insurers.

Clarification was sought on APRA's proposal that an insurer's credit risk management system should be set up for monitoring exposures to any one counterparty or asset class.

Policy Objective

Our aim is to ensure that insurers have appropriate systems for identifying, managing and monitoring risks that may threaten the ability of the insurer to meet its obligations to policyholders.

APRA Response

APRA believes that it is best practice for insurers to undertake assessments of brokers' procedures and systems to ensure the quality of information provided to the insurer is of a sufficiently high standard to enable the insurer to appropriately assess the riskiness of business taken on. These assessments may not necessarily include an audit of the broker,

but the insurer should be satisfied one way or another that it has sufficient information to prudently underwrite the risk. Therefore, the Standard has been amended to remove the reference to “audit”.

In respect of reinsurers auditing ceding insurers, we believe that this practice is good risk management and are inclined not to amend the requirement. Reinsurers should be satisfied that the risk being taken on is in accordance with the underlying risk.

We expect that an insurer will have the capacity to identify risk concentrations, for example by aggregating exposures to any one counterparty, asset class or region. Reference to asset class includes all asset classes, such as investments, reinsurance assets or unpaid premiums.

3.6.6 Diversification Benefits

Comments Received

APRA’s guidance on developing a REMS was questioned, particularly in relation to APRA’s suggestion that insurers should consider any concentration of reinsurance counterparties which would create large exposures or detract from diversification benefits.

Policy Objective

APRA’s objective is to ensure that an insurer has in place prudent reinsurance arrangements contributing to its having a high likelihood of being able to meet its obligations to policyholders.

APRA Response

The matters listed in the Reinsurance Arrangements Standard are a guide for insurers formulating their own control mechanisms for managing reinsurance arrangements. APRA may approve Reinsurance Management Strategies that do not involve a spread of reinsurers if the insurer has properly considered and can explain its reasons to justify its divergence from the suggested criteria.

3.6.7 Grounds for Refusing an Application for Authorisation

Comments Received

Respondents expressed a view that it would be fairer if the grounds on which APRA could refuse applications were indicated in the Authorisation Guidance Note. There was also a suggestion that it would seem appropriate to have an appeal process available.

The Authorisation Guidance Note indicates that APRA will process applications within a reasonable time. Guidance on what APRA believes will constitute a reasonable time was requested.

Policy Objective

Our aim is to ensure that financial institutions commence operations with a long-term commitment to the industry, as well as 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 of the financial soundness and the expertise and probity of the board and senior management of a financial institution.

APRA Response

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 APRA is seeking to develop a consistent set of authorisation criteria across all financial institutions. In addition, APRA has had regard to the IAIS Supervisory Standard on Licensing⁹ in forming these requirements.

APRA ultimately assesses new entrants on a case by case basis, and has the discretionary power to put conditions on approvals, as it sees fit.

The authorisation criteria set out in the Guidance Note outline the minimum requirements that an applicant should consider in preparing an application for authorisation under the Act. They are not intended to represent an exhaustive list. Generally a refusal to grant an authority would result from an applicant's failure to meet the minimum criteria, but there may be other prudential grounds in particular cases. It is

⁹ A copy of this standard is available from the IAIS web site at www.iaisweb.org.

not possible for APRA to anticipate in advance what such grounds may be. Grounds for refusal of an application will be made known to the applicant as a part of an informal meeting following notification to an applicant. Accordingly, the Authorisation Guidance Note has not been changed.

Consistent with the current Act and recommendation 33 of the Wallis Inquiry, prudential decisions made under the proposed new arrangements would not be subject to administrative review except in circumstances where the civil liberties of individuals may be affected. For example, administrative review will be available with respect to a decision by APRA to disqualify an auditor or actuary.

Due to the varying quality and complexity of applications to establish an insurance company, and the uncertain course of any related negotiations, APRA cannot accurately foreshadow the amount of time necessary to process an application for authorisation. However, the applicant can always seek advice from APRA on the status of their application. Accordingly, there has been no change to the Authorisation Guidance note in this respect.

CHAPTER 4 – CALIBRATION OF CAPITAL ADEQUACY FRAMEWORK

An important task facing APRA in developing a revised capital adequacy framework for the general insurance industry is to ensure that the new methodology is appropriately calibrated. The objective in this exercise has been to develop minimum capital requirements that establish the basic safety and soundness of the industry at an adequate level, without at the same time imposing an unduly high capital burden on the industry and thereby hampering its development or competitiveness.

4.1 Establishing an Appropriate Benchmark

In APRA's December 2000 Policy Discussion Paper "*Harmonising Prudential Standards: A Principles-Based Approach*" (see www.apra.gov.au/policy), it was noted that:

“The purpose of capital adequacy standards is to ensure regulated institutions achieve and maintain a minimum level of financial soundness. In doing so, institutions will be reducing to some minimal level the probability that they will fail to meet their obligations as they fall due. While the actual probability of default may not be stated within the various standards, such a benchmark is important for policymakers to ensure standards provide the necessary degree of soundness and are comparable and consistent across industry sectors.”

In setting out to establish new capital adequacy standards for general insurers, the key task for APRA was establishing such a benchmark for ‘probability of default’ or ‘risk of ruin’. Importantly, we did not set out with a predetermined view as to whether minimum capital requirements for the general insurance industry should be raised or lowered. While it was always the objective to produce new standards which increased the sensitivity of capital requirements to the underlying risk profile of each institution, the need for a change in the industry-wide level of capital was viewed as a matter for empirical analysis.

In searching for the appropriate ‘risk of ruin’ for regulatory purposes, APRA drew on practice within the finance industry itself. The most sophisticated financial institutions that are currently able to model their own economic capital requirements usually use a default probability derived from their own desired credit rating. Because rating agencies have a great deal of data on defaults by firms of differing quality, it is possible to use the

work of rating agencies to get some sense of the type of default probability that is implied by APRA's mission, ie to:

“establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system”.

The major rating agencies – Moody's Investors Service and Standard & Poor's Ratings Services (S&P) amongst others – have a range of different rating scales. However, their primary scales are similar. Both use a rating scale ranging from AAA (at the higher end) to C (at the lower end),¹⁰ which is in turn split into investment grade and speculative grade categories. In examining these ratings methods, APRA settled on the bottom of the investment grade category (lying between the BBB and BB rating grades) as an appropriate minimum benchmark for regulated institutions.¹¹ Of course, we would expect institutions to operate at levels of soundness above these levels, but as a *minimum* supervisory benchmark consistent with APRA's mission, BBB would appear to be about the right level.

The next step is to look at what these ratings imply in terms of expected probability of default. Both ratings agencies have also maintained sizeable databases on corporate defaults over a lengthy period of time. From this information, they are able to compute the historical loss rates, over a given time horizon, for each rating grade. Based on analysis of the default rates published by relevant rating agencies for BBB and BB ratings,

¹⁰ 'AAA', although widely used as a generic term, is actually a rating given by S&P. The Moody's equivalent is 'Aaa'. Similarly, where S&P uses, for example, 'BB', Moody's employs the rating 'Ba'.

¹¹ Moody's definition for a Baa rated entity is an “issuer offering adequate financial security. However, certain protective elements may be lacking or may be unreliable over any great period of time”. Moody's defines a Ba rated entity as one that offers “questionable financial security. Often the ability of these entities to meet obligations may be moderate and not well safeguarded in the future”. Similarly, S&P defines a BBB rated entity as “an obligor with adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments”, while a BB rated entity is assigned to “an obligor that is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments”.

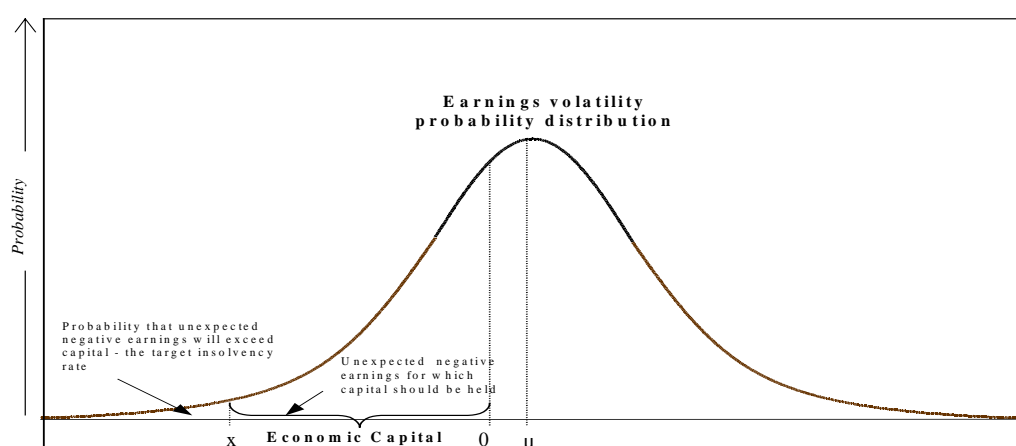
APRA came to the view that a default rate of around 0.5% over a one-year time horizon would be an appropriate benchmark to use in setting capital adequacy standards.¹²

4.2 Translating the Benchmark into Capital Levels

The next step in the calibration process is to convert the chosen benchmark into a measure of required capital. This was done by examining the historical volatility in the profitability of the general insurance industry over the period from 1987 to 1999. To normalise the data, and to assist with comparability with existing standards, profitability was measured as a percentage of each company's outstanding claims provisions, as a percentage of annual premium income, and as a percentage of total assets. Profitability was also examined both at an individual company level, and on the basis of company groups (the latter considers the impact of multiple licences within a corporate group).

Figure 1 illustrates the relationship between capital and the volatility of profits. Under this framework, the role of capital is to cover the potential downside in earnings. Unless wholly funded by equity, an institution cannot be certain of being able to absorb all earnings risk. APRA's goal was to estimate the amount of capital required in order to reduce to the benchmark level (0.5% over a one year time horizon) the probability of negative earnings completely eroding the insurer's capital base.

Figure 1: Generic model of earnings volatility



This approach provides a general, but nevertheless simple and useful, approach for analysing the capital adequacy of the general insurance industry. A major advantage is that very few assumptions are needed. This makes the modelling task significantly easier. For example, because the model is based on an analysis of the historical financial

¹² It is worth noting that the default rates published by ratings agencies are through-the-cycle averages. It could be argued that supervisors should set their supervisory benchmarks based on bottom-of-the-cycle default experience.

performance of an insurer as a whole, the result takes into consideration risks of both short-tail and long-tail business without the need to explicitly model both types of business. Furthermore, correlation between businesses or subsidiary insurers within a the group will also be captured within the analysis.

The result of this analysis suggested that, to achieve the desired benchmark, minimum capital levels of the industry as a whole should be raised to, on average, 1.4-1.5x existing requirements. As might be expected, short-tail and well-diversified insurers generated a result at the lower end of this range, while reinsurers tended to produce a considerably higher result.

4.3 Calibrating the Standards

The final step in calibrating the new standards was to ask companies to 'road test' the capital factors issued in the previous version of the draft standards. The objective of this exercise was to examine whether the resultant capital requirements were consistent with the target increases identified above.

APRA wrote to all licensed insurers in October 2000 asking them to complete a calculation of their estimated capital requirements under the draft capital standards for each of the past three financial years. Although the 'road test' was time-consuming and required considerable effort, APRA was pleased with the responses to this important exercise. In all, 53 insurers responded to the request for assistance, representing 75% of industry assets. More detail of the composition of respondents is provided in Table 1.

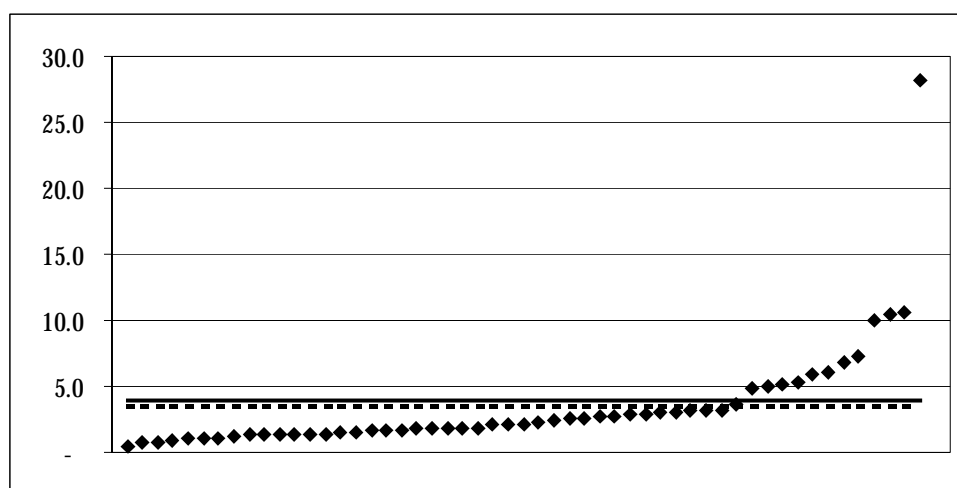
Table 1: Respondents to Capital Adequacy ‘Road Test’

Total Number of Responses	53
- % of Industry Assets	75%
of which, number of:	
- Company Groups	38
- 10 Largest Company Groups	8
- Reinsurers	15
- Primarily Short Tail Insurers	14
- Primarily Long Tail Insurers	8
- Companies subject to \$5m Minimum	13
- Branches of Foreign Insurers	15

Given the distribution, APRA was satisfied that the sample represented a reasonable cross-section of the Australian general insurance industry, and provided an adequate basis on which to draw conclusions about the impact of the new proposals.

Almost across-the-board, the results for individual companies demonstrated that the capital adequacy calculations required of the draft standards produced capital requirements well in excess of desired, or commercially realistic, levels. Chart 1 shows the relative impact on all 53 respondents; the (weighted) average increase across the industry was 4.0x (shown as a solid horizon line in the Chart, with the simple average increase of 3.5x shown as a dotted line).

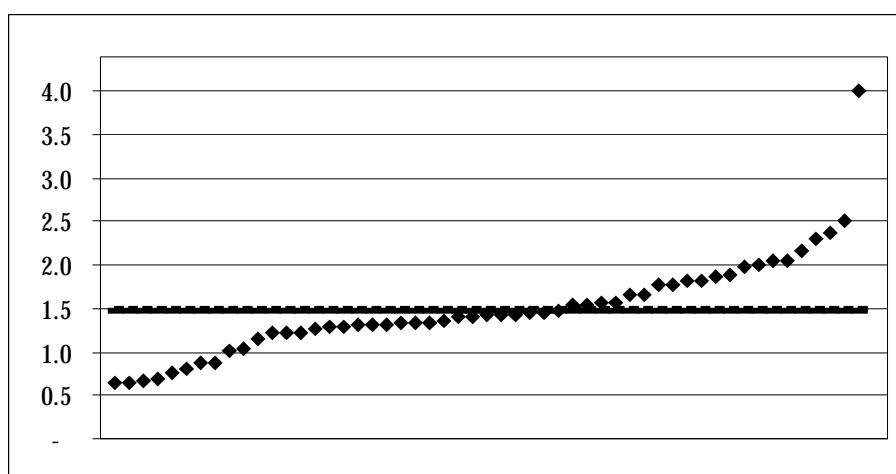
Chart 1: Capital Requirements Under Draft Standards as a Multiple of Existing Requirements



Two main themes emerged from an analysis of the results. First, and most importantly, the Investment Concentration Charge proved to be excessively onerous for almost all companies, and produced large and unjustifiable capital imposts. Secondly, even after removing the impact of the Investment Concentration Charge, the capital factors generally produced slightly higher than anticipated capital levels.

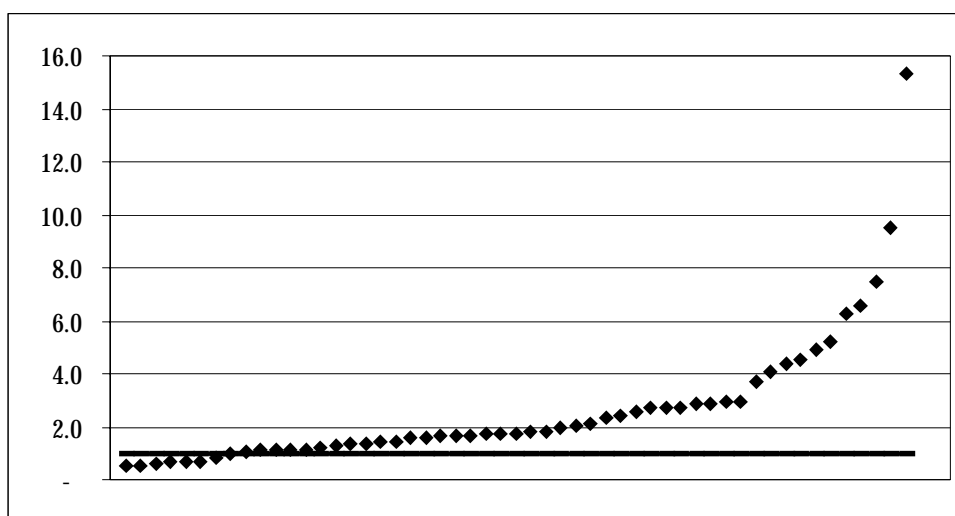
As a result of these outcomes, APRA has reworked the capital standard to eliminate these unintended consequences (as discussed in more detail in Chapter 2). The expected impact of these changes is shown in Chart 2: the incidence of significant increases in capital requirements is substantially reduced, and the overall weighted average increase for the industry is 1.47x (on a simple average basis, the increase is 1.5x). This is consistent with the target levels identified above.

Chart 2: Capital Requirements Under New Draft Standards as a Multiple of Existing Requirements



It is also important to note that, although regulatory capital requirements will increase, the generally healthy financial position of the industry means that only a few companies are expected to require new capital as a result of the proposals. This is shown in Chart 3, which shows the expected capital multiples under the new regime, ie actual capital levels as a multiple of minimum capital requirements. Overall, the industry is still expected to report a capital adequacy multiple of around 2.0x (for the 53 companies in the sample, the weighted average multiple was 2.1x). In those cases where the multiple is less than 1.0x and additional capital is required, for the most part the entity concerned either is subject to the new \$5 million minimum required, or forms part of a larger insurance group, and the group as a whole has more than sufficient capital to meet regulatory needs.

Chart 3: Existing Capital Base as a Multiple of Capital Requirements Under New Draft Standards



4.4 Individual Capital Factors

While overall capital levels within the new proposals appear reasonable, it is also important to make some comment about the determination of the individual capital factors that are used within the capital calculation.

Neither the Insurance Capital Factors nor the Investment Capital Factors have been determined solely on the basis of empirical analysis. Indeed, given that the contribution of an individual asset or liability exposure to the overall risk profile of the insurer will depend on the size of that exposure and its correlation with each and every other exposure in the insurer's portfolio, it is not possible to come up with a set of capital factors which will be completely appropriate for all.

As a result, there has been a fair amount of pragmatism used in selecting the individual factors. They have been chosen with a view to, at a minimum, ensuring appropriate relativities, eg between short tail and long tail insurance classes, and between the capital charges for Insurance Risk and Investment Risk. APRA has also been mindful of the potential for unwarranted inequality between the general insurance standards and those applied to similar risk exposures under the capital adequacy regimes for life insurance and banking, and has tried where possible to avoid major inconsistencies.

The end result is a set of capital factors that, when taken together, provide a simple measure of the capital requirement of a general insurance company. While they must be used for the purposes of assessing regulatory capital adequacy, the factors are not

intended to be a substitute for an insurer's own judgement about the amount of capital it requires for its own business. Subject to meeting minimum regulatory requirements, ultimate responsibility for making that assessment always remains with the board and management of each company.

4.5 International Comparisons

APRA is conscious of the need to ensure that, in altering the capital adequacy arrangements applicable to Australian general insurers, the changes do not result in the Australian industry being disadvantaged internationally. This might occur if, for example, regulatory capital levels were set well above those required in other major jurisdictions, and hence made it difficult for Australian companies to price competitively in international markets.¹³

In the absence of any agreement on international accounting or capital adequacy rules, comparisons between countries are fraught with difficulty. Many countries, for example, take a conservative stance and do not allow discounting in the valuation of insurance liabilities. Some do not allow the full value of assets to be eligible to meet capital requirements (eg where market value exceeds book value, only a portion of the excess can be included when assessing capital adequacy). A number of supervisors set a minimum multiple over the basic capital requirement that insurers must achieve if they wish to avoid supervisory intervention, usually structured as part of a prompt corrective action framework. As a result of these differences, any international comparison that focuses simply on the capital factor applied to a single class of assets or liabilities will not provide a true measure of the 'competitiveness' of the various international regimes.

Given the differences above, it is difficult to say with absolute certainty that the capital adequacy framework in one country is necessarily harsher than another. In many cases, the impact will depend on the balance sheet structure of the individual company, eg some countries with more risk-based regimes might benefit, for example, short tail insurers relative to those countries with simpler, but harsher regimes applied equally to all. APRA has attempted to examine the impact of our proposed requirements relative to those of our supervisory peers (eg those countries with well-developed and sophisticated financial systems). On the basis of that analysis, we do not have any reason to believe that the proposals are harsher than those applied in 'peer' jurisdictions. Indeed, it is worth noting that OSFI in Canada and the FSA in the UK have both proposed a review of their respective supervisory regimes for general insurance. In the case of OSFI, a set

¹³ Of course, much of the retail market is not subject to competition from companies regulated in other jurisdictions.

of draft proposals have been released that look very similar to those APRA proposes to introduce. The FSA's detailed proposals have yet to be released, but the broad objectives of their review – development of a more risk-based approach, with capital requirements that are more sensitive to the underlying risk profile of the insurer – are the same as our own.

CHAPTER 5 – PRUDENTIAL RETURNS AND DISCLOSURE

Financial institutions are required to make disclosures to the regulator and the general public about the nature and the performance of their business. Disclosure provides the regulator with hard information to help the assessment of whether the regulated entity is being managed prudently. Further, these disclosures help the regulator to identify financial institutions at risk and minimise the extent of policyholder losses in the event of failure.

The purpose of public disclosure in the context of prudential regulation is to assist consumers' understanding of the nature of contracts they are party to and the strength of the company they are dealing with. It also allows them to make more informed choices between price and risk in the services being considered. Disclosure requirements expose providers of financial services to public scrutiny and competitive pressure from players in the market (including competitors, creditors, analysts and investors). In this way, disclosure assists in ensuring that market disciplines apply against imprudent behaviour by the managers of financial institutions.

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

Consistent with Recommendation 44 of the Wallis Inquiry, APRA intends to promote more transparent disclosure. APRA is also seeking to promote improved disclosure of indicators of the risk assumed by insurers as recommended by the Wallis Inquiry.

General industry support was indicated in response to the principles of disclosure outlined in the APRA Discussion Paper issued in September 1999. To further consultation in respect to disclosure, APRA plans to issue to the industry revised Prudential Statutory Returns. However, at this stage APRA is not in a position to release draft Prudential Statutory Returns, nor specify what type of information will be proposed to be subject to public disclosure (with the exception of some simple information on capital adequacy – see Capital Adequacy Standard). APRA is consulting with the AASB and reviewing international practices in this area. The industry will be kept informed of this process and be provided with adequate opportunity to comment on any proposals before they are introduced.

ATTACHMENT 1 – TIME LINE OF THE REVIEW OF THE PRUDENTIAL SUPERVISORY REQUIREMENTS OF GENERAL INSURANCE COMPANIES

A1.1 History of the General Insurance Review Project

- March 1995
- The then ISC flagged its interest in reforming methodologies in general insurance, and instigated the formation of two working groups (on liability valuation and statutory solvency) of the IAA
- August 1998
- APRA Board commissioned a broader assessment of the prudential supervisory requirements for general insurers with a view to eventually making recommendations to the Government on ways of modernising and improving the general insurance regime
 - APRA CEO announced at the ICA's annual conference that APRA would be reviewing the capital adequacy and solvency requirements under the Insurance Act 1973 and issues of transparency and general insurance reporting
 - Formation of an internal APRA working group to review the Insurance Act 1973
- March 1999
- APRA hosted a one day industry seminar: "General Insurance Solvency Seminar"
 - IAA working groups presented their papers on liability valuation and solvency
 - APRA formed a consultative committee with the ICA to exchange views and provide APRA with preliminary feedback on work undertaken by APRA's internal working group
- September 1999
- First formal round of consultation commenced with the release of three APRA policy discussion papers:
 - Study of the Prudential Supervisory Requirements for General Insurers in Australia;
 - A Statutory Liability Standard for General Insurers;
 - A New Statutory Solvency Standard for General Insurers

Prudential Supervision of General Insurance

- April –
September 2000
- Second formal round of consultation commenced with the release of an APRA policy discussion paper in April 2000 and draft Prudential Standards issued successively thereafter:
 - Proposed Reforms to the Supervision of General Insurance Companies in Australia;
 - Liability Valuation Standard;
 - Reinsurance Arrangements Standard;
 - Authorisation Guidance Note;
 - Capital Adequacy Standard;
 - Actuarial Guidance Note; and
 - Risk Management Standard
- May 2000
- APRA hosted a one day industry seminar: “A review of the Prudential Supervisory Requirements for General Insurers in Australia”
- September 2000
- APRA hosted a half day seminar: “Interim Guidance for Actuaries implementing the Liability Valuation Standard”
- October 2000
- APRA requested all general insurers to participate in a “road-testing” exercise on the draft standards on liability valuation and capital adequacy
- November 2000
- Minister for Financial Services & Regulation, The Hon. Joe Hockey MP, announced the Government’s decision to reform the regulatory framework for the general insurance industry, consistent with the recommendations made in APRA’s policy discussion paper issued in April 2000
 - APRA requested all general insurers to participate in a “Related Body Assets” questionnaire to assist in the development of their treatment under the draft Capital Adequacy Standard

A1.2 Next Steps

- March 2001
- Third round of formal consultation commenced with the release of this APRA policy paper, revised draft Prudential Standards and Guidance Notes
- May 2001
- APRA to host a one day industry seminar: “The New General Insurance Regime”
- July 2001
- Fourth round of formal consultation to commence if necessary

ATTACHMENT 2 – RESPONDENTS TO THE SECOND ROUND OF CONSULTATIVE PAPERS

1. Accountants and Actuaries Liaison Committee
2. ACE Insurance Limited
3. American Home Assurance Company
4. American International Assurance Company (Australia) Limited
5. AMP Limited
6. Australian Unity Limited
7. BHP Insurance
8. BHP Marine & General Insurances Proprietary Limited
9. Boral Insurance Pty Limited
10. Robert Buchanan
11. Catholic Church Insurances Limited
12. CGU Insurance Limited
13. CGU Lenders Mortgage Insurance Limited
14. Commonwealth Insurance Limited
15. Commonwealth Steamship Insurance Co Pty Limited
16. Credicorp Insurance Pty Limited
17. CUMIS Insurance Society Inc
18. EIG-ANSVAR Limited
19. First American Title Insurance Company of Australia Pty Limited
20. FM Insurance Company Limited
21. Gerling Australia Insurance Company Pty Limited
22. General & Cologne Reinsurance Australasia Limited
23. HIH Insurance Limited
24. ING Group

25. Institute of Actuaries of Australia
26. Insurance Council of Australia
27. International Risk Management Group
28. Mercantile Mutual Holdings Limited
29. MTQ Insurance Limited
30. Munich Reinsurance Company of Australasia Limited
31. NRMA Insurance Limited
32. Orica Limited
33. PriceWaterhouseCoopers
34. QBE Insurance Group Limited
35. RACT Insurance Pty Limited
36. Taxi Insurance Co-operative Limited
37. Zurich Financial Services Australia Limited