



Response Paper

Refinements to the General Insurance Prudential Framework – Final Response to Industry

June 2008

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Preamble

The purpose of this paper is to set out APRA's responses to submissions to proposals contained in APRA's discussion paper, *Refinements to the General Insurance Prudential Framework – Response to Industry* released on 19 December 2007. This response paper followed the discussion paper entitled *Refinements to the General Insurance Prudential Framework* issued on 31 July 2007. The 19 December response paper was accompanied by draft prudential standards and draft prudential practice guides incorporating the proposed amendments.

In the 19 December 2007 response paper, APRA proposed:

- modifications and clarifications to its prudential framework to give effect to the Government's policy in relation to Direct Offshore Foreign Insurers (DOFIs) and, more generally, to recognise different categories of insurer based on risk profiles;
- changes to how foreign reinsurance is treated in relation to minimum capital requirement (MCR) calculations;
- revised investment capital factors applicable to equities and real property investment along with other changes to align the investment risk capital charge with the risks of an insurer's investment portfolio;
- details on implementation of the proposals for the treatment of certain capital instruments and APRA's supervisory discretion over an insurer's capital base, first discussed in *Capital adequacy for authorised deposit-taking institutions and general insurers* released on 2 July 2007; and
- a number of miscellaneous, yet important, changes to the prudential framework.

After consideration of the submissions received, APRA has finalised prudential standards and prudential practice guides that are now available on the APRA website. They are effective from 1 July 2008 except for changes to how foreign reinsurance is treated, which are effective from 1 January 2009.

A number of submissions raised matters requiring minor adjustments to the standards and these have been included in the prudential standards and prudential practice guides.

The revised prudential standards and prudential practice guides incorporate the revisions to APRA's proposals relating to foreign reinsurance recoverables and investment capital factors applicable to equities and real property investments announced on 2 April 2008.

Minor changes due to the *Financial Sector Legislation Amendment (Review of Prudential Decisions) Act 2008* (RPD Act), which will come into effect on 1 July 2008, have also been included in those final prudential standards and prudential practice guides. The RPD Act modifies the *Insurance Act 1973* by introducing court-based disqualifications, amending APRA's directions powers, removing some requirements for ministerial consent and amending requirements relating to review of decisions.

The context of the refinements to the general insurance prudential framework is the *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007* (DMF & DOFI Act) which gives effect to the Government's policy with regard to DOFIs. From 1 July 2008, all insurers seeking to carry on general insurance business in Australia, whether directly or through the actions of an intermediary (e.g. an agent or a broker), are required to become authorised under the *Insurance Act 1973*. This general position is subject to limited exemptions as announced by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 8 April 2008.¹

Submissions received from lenders mortgage insurers (LMIs) in relation to the 19 December 2007 paper have led APRA to review certain provisions of Attachment A of Prudential Standard GPS 116 *Concentration Risk Capital Charge*. This review will be undertaken through a consultation process with the LMI industry in the second half of 2008. At the same time APRA will examine possible clarifications to GPS 116 relating to the Maximum Event Retention (MER) to deal with non-property risks and single exposure risks.

APRA will soon begin consulting on draft *Prudential Standard GPS 113 Capital Adequacy: Internal Model Based Method*. GPS 113 and the related prudential practice guide GPG 113 will be finalised in the second half of 2008.

Details of APRA's final analysis of costs and benefits can be found in the Regulation Impact Statement on the APRA website at <http://www.apra.gov.au/Policy/Regulation-Impact-Statements.cfm>.

¹ Refer to <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/021.htm&pageID=003&min=ceb&Year=&DocType>.

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Glossary

AASB	Australian Accounting Standards Board
ADI	Authorised deposit-taking institution as defined in the <i>Banking Act 1959</i>
APRA	Australian Prudential Regulation Authority
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
Business plan	Business plan referred to in GPS 220
Corporations Act	<i>Corporations Act 2001</i>
DMF	Discretionary mutual fund as defined in the DMF & DOFI Act
DMF & DOFI Act	<i>Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007</i>
DOFI	Direct offshore Foreign Insurer which is a foreign insurer that carries on insurance business in Australia, either directly or via an agent or broker, without establishing a subsidiary or branch
FCR	Financial Condition Report referred to in GPS 310
Foreign branch	Foreign general insurer as defined in the Insurance Act
FSCODA	<i>Financial Sector (Collection of Data) Act 2001</i>
GPG	General insurance prudential practice guide
GPG 110	<i>Prudential Practice Guide GPG 110 Capital Adequacy: Capital Management</i>
GPG 245	<i>Prudential Practice Guide GPG 245 Reinsurance Management Strategy</i>
GPG 510	<i>Prudential Practice Guide GPG 510 Governance</i>
GPS	General insurance prudential standard
GPS 001	<i>Prudential Standard GPS 001 Definitions</i>
GPS 110	<i>Prudential Standard GPS 110 Capital Adequacy</i>
GPS 112	<i>Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital</i>
GPS 113	<i>Draft Prudential Standard GPS 113 Capital Adequacy: Internal Model Based Method</i>
GPS 114	<i>Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Charge</i>
GPS 115	<i>Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Capital Charge</i>
GPS 116	<i>Prudential Standard GPS 116 Capital Adequacy: Concentration Risk Capital Charge</i>
GPS 120	<i>Prudential Standard GPS 120 Assets in Australia</i>
GPS 220	<i>Prudential Standard GPS 220 Risk Management</i>
GPS 230	<i>Prudential Standard GPS 230 Reinsurance Management</i>

GPS 231	<i>Prudential Standard GPS 231 Outsourcing</i>
GPS 310	<i>Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation</i>
GPS 510	<i>Prudential Standard GPS 510 Governance</i>
GPS 520	<i>Prudential Standard GPS 520 Fit and Proper</i>
ILVR	Insurance Liability Valuation Report referred to in GPS 310
Insurance Act	<i>Insurance Act 1973</i>
Insurer or general insurer	General insurer as defined in the Insurance Act
Kangaroo Bonds	A debit security issued for the purposes of the Australian market where the insurer does not reside in Australia
LOC	Letter of Credit
MCR	Minimum capital requirement, which is calculated as the sum of the insurance risk, investment risk and concentration risk capital charges as specified under GPS 110
Non-APRA-authorised reinsurer	Reinsurer that may be authorised in a foreign jurisdiction but is not authorised by APRA
APRA-authorised insurer or reinsurer	Insurer or reinsurer that is authorised by APRA under the Insurance Act, including a Lloyd's underwriter as defined in the Insurance Act
PPG	Prudential practice guide
Reviewing actuary	Reviewing actuary as defined in GPS 310
RPD Act	<i>Financial Sector Legislation Amendment (Review of Prudential Decisions) Act 2008</i>
RSEs	Registrable Superannuation Entities
SRR Act	<i>Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007</i>

Summary of refinements

The following tables summarise refinements contained in the prudential standards and prudential practice guides effective 1 July 2008.

Table 1 summarises the refinements that have been modified from the proposals set out in the 19 December 2007 consultation package.

Table 2 summarises the refinements that have been implemented as proposed in the 19 December 2007 consultation package. These refinements are referred to in the body of this paper only where there was significant commentary in the industry responses that were received.

Table 1

Policy	Description
Security of reinsurance recoverables (ref Chapter 1)	<ul style="list-style-type: none"> For all reinsurance arrangements incepting from 31 December 2008: <ul style="list-style-type: none"> after a grace period ending on the second balance date after claims giving rise to the recoverables occur, an increased capital factor will apply on all unsecured reinsurance recoverables. The factors will range from 20 per cent to 100 per cent depending on the counterparty rating of the reinsurer. A 100 per cent capital factor will apply to reinsurance recoverables that have been due and payable for more than six months but remain unpaid. Contracts must stipulate that an Australian jurisdiction is the governing law of the contract and any disputes that reach a court must be dealt with in an Australian court. Where contracts do not meet these requirements reinsurance recoverables will be deducted from capital. For reinsurance arrangements incepting prior to 31 December 2008, recoverables are to be subject to greater scrutiny by actuaries, management and the board in relation to the likelihood of recoverability or possible impairment. There are no additional capital requirements.
Investment capital factors for equity and real property (ref Chapter 2)	<ul style="list-style-type: none"> From 1 July 2008, the capital factor applicable to listed equities will be 16 per cent (applied to net exposure after allowing for derivative hedging) with a 20 per cent capital factor applicable to unlisted equities and direct property.
Assets in Australia (ref. 3.2)	<ul style="list-style-type: none"> Premium receivables of Category C insurers outstanding for more than six months are excluded from assets in Australia. The agent in Australia is required to authorise transactions that will alter the value of a Category C insurer's assets in Australia where those assets are held under a custodian arrangement. Where portfolio adjustments are made that do not alter the assets in Australia of the Category C insurer, the agent in Australia is not required to authorise those transactions. APRA will allow but not require co-signatory arrangements for assets held by a custodian.
Corporate Agents (ref. 3.3)	<ul style="list-style-type: none"> The board of a corporate agent must contain a majority of directors who ordinarily reside in Australia.
Loans back to parents – Category E insurers (ref. 3.4)	<ul style="list-style-type: none"> Any loans to related parties of Category E insurers on non-commercial terms will be subject to a 100 per cent capital factor. Guidance that APRA typically expects loans on commercial terms not to exceed 100 per cent of a Category E insurer's capital base has been included in GPG 220.
Kangaroo Bonds (ref. 3.5)	<ul style="list-style-type: none"> Kangaroo Bonds will no longer be excluded from being recognised as assets in Australia provided they meet the five criteria specified in GPS 120 (paragraph 12).

Table 2

Proposal	Description
Investment capital factors on reinsurance assets	<ul style="list-style-type: none"> The investment risk capital factors applicable to reinsurance assets receivable from non-APRA-authorized reinsurers are 1.5 times those applicable to equivalent assets payable by APRA-authorized reinsurers. Refer to Table 1 in Attachment A of GPS 114.
Intra-group reinsurance	<ul style="list-style-type: none"> The current temporary concessions on intra-group reinsurance exposures are to be discontinued from 30 June 2008. Transitional arrangements will be considered on a case-by-case basis for the insurance groups affected.
Categories of insurer	<ul style="list-style-type: none"> APRA has implemented the following categories of insurer within its general insurance prudential framework: <ul style="list-style-type: none"> Category A: Locally incorporated insurer Category B: Wholly owned subsidiary of a local or foreign insurer Category C: Foreign insurer operating as a foreign branch Category D: Association captive insurer Category E: Sole parent captive insurer. The definition of each category of insurer is incorporated in GPS 001.
APRA reporting requirements	<ul style="list-style-type: none"> APRA will: <ul style="list-style-type: none"> simplify the claims development table and make it more consistent with AASB requirements; require investment income to be allocated between shareholders' funds and policyholders' funds; and require premiums for bound but not incepted business to be identified as a separate item along with data on unearned premium provisions and deferred reinsurance expenses. These changes will be incorporated in the imminent consultation on the reporting framework related to this paper.
Sub-custodian arrangements	<ul style="list-style-type: none"> Investments held by foreign sub-custodians are not to be recognised as assets in Australia. Refer to GPS 120 paragraph 17.
Small insurers – actuarial requirements	<ul style="list-style-type: none"> There is provision for progressive transition to full actuarial requirements for small insurers that grow in size. Refer to paragraph 18 of GPS 310.
Small insurers – APRA reporting	<ul style="list-style-type: none"> Small insurers can use accounting data as approximations for APRA reporting purposes (to be included in reporting standards)
Cession limits	<ul style="list-style-type: none"> GPG 245 (paragraph 5) contains guidance that cessions should be no more than 90 per cent for Category D and E insurers (including insurance group captives) and 60 per cent for other categories.

Proposal	Description
International group actuaries	<ul style="list-style-type: none"> Foreign owned Category B insurers or Category C insurers can use a group actuary who is not an Australian resident. APRA's expectation is that the Group Actuary would be employed within the foreign insurance group. The reviewing actuary must ordinarily reside in Australia and be a Fellow or Accredited member of the Institute of Actuaries of Australia. Refer to paragraph 28 of GPS 520.
Group business plans	<ul style="list-style-type: none"> Business plans can be prepared on an insurance group basis (to align with the risk management framework which may be on a group basis) provided there is adequate detail on each APRA-authorized insurer in the group. Refer to paragraph 19 of GPS 220.
Outsourcing to related parties – Category D insurers	<ul style="list-style-type: none"> Outsourcing of material business activities to related parties must be documented in written contracts for Category D insurers (refer to GPS 231 paragraph 21)
Governance – Category E insurers (ref. 3.23)	<ul style="list-style-type: none"> An insurer can write to APRA to seek an adjustment to or exclusion from the board composition requirements under paragraph 64 of GPS 510. GPG 510 outlines the various conditions that may be attached to an adjustment or exclusion to allow use of an alternative board arrangement.
A lower capital floor of \$2m for Category D and E insurers	<ul style="list-style-type: none"> APRA will apply a lower floor for the calculated risk-based minimum capital requirement of \$2 million for Category D and E insurers (refer to GPS 110 paragraph 16).
Harmonised capital adequacy (ref GPS 112)	<ul style="list-style-type: none"> The criteria for capital instruments to be considered eligible for classification as Tier 1, Upper Tier 2 and Lower Tier 2 capital have been clarified. There are limits on the amount of Residual Tier 1 capital, Tier 2 capital and Lower Tier 2 capital that can be recognised in an insurer's capital base. APRA now has supervisory discretion to adjust these limits.
Run-off plan	<ul style="list-style-type: none"> A run-off plan for a run-off insurer replaces the business plan and financial condition report (FCR). The run-off plan is to be prepared by the insurer on a rolling three-year basis. The Appointed Actuary is to review the run-off plan and make comments where necessary. Refer to GPS 220 Attachment A and paragraph 37 of GPS 310.
Capital buffer	<ul style="list-style-type: none"> The expected capital buffer of 20 per cent of MCR is specified in GPG 110 (paragraph 6). A higher buffer of 50 per cent is expected for Category D and E insurers where the MCR is less than \$5 million. The required 50 per cent buffer for medical indemnity insurers is also specified in GPG 110.

Chapter 1 – Security of reinsurance recoverables

Proposal as at 19 December 2007

Reinsurance recoverables from non-APRA-authorized reinsurers on outstanding claims provisions that are not supported by suitable security arrangements in Australia would be subject to a 100 per cent capital factor from the end of the financial year following the financial year in which the claims giving rise to the recoverables occur. This would provide a grace period of 12 to 24 months. This approach was to apply to all new recoverables from 1 July 2008.

Recoverables on the balance sheet prior to 1 July 2008 that are not supported by suitable security arrangements in Australia would be subject to a 100 per cent capital factor after a transition period.

APRA also proposed that reinsurance arrangements entered into on or after 30 June 2008 include provisions requiring that:

- the reinsurance contract be subject to Australian law and any disputes be heard in an Australian court; and
- the recoverables under the reinsurance contract be payable to the insurer in Australia, with no other payment mechanism to be substituted for convenience.

Proposed guidance on contractual terms for reinsurance arrangements with non-APRA-authorized reinsurers was also provided.

Revised position

The submissions to the December 2007 discussion paper raised a number of important matters of principle as well as some significant practical implications and administrative complexities that have led to a reassessment of a number of the December 2007 proposals. Many of the issues raised in responses are addressed or mitigated with the following changes:

- the implementation date has been deferred until 31 December 2008;
- all reinsurance recoverables in respect of reinsurance contracts entered into prior to 31 December 2008 will be grandfathered so no additional capital charges will apply in respect of existing reinsurance arrangements (refer to GPS 114 Attachment A paragraph 4);
- for reinsurance recoverables relating to reinsurance contracts entered into on or after 31 December 2008, a scale of capital factors that is risk based (see Table 3) will be applied after the grace period (refer to GPS 114 Attachment A paragraph 5);

Table 3

Grade	Risk Charge – Offshore RI
1	20%
2	40%
3	60%
4	100%
5	100%

- reinsurance contracts entered into on or after 31 December 2008 must be subject to Australian law and any disputes be heard in an Australian court (refer to GPS 230 paragraph 31). Failure to have these contractual terms included in reinsurance contracts will lead to a deduction from Tier 1 capital of any reinsurance assets recorded in relation to these reinsurance contracts (refer to GPS 230 paragraph 32 and GPS 112 paragraph 25(n));

- APRA has introduced a new requirement into the Insurance Liability Valuation Report (ILVR) necessitating more explicit consideration by Appointed Actuaries of the likelihood of recoverability of reinsurance recoverables (refer to paragraph 40 of Attachment A of GPS 310);
- additional guidance in *Prudential Practice Guide GPG 220 Credit Risk* (refer to paragraph 3(g)) indicates that it is expected that the risk management framework of an insurer would include this specific consideration of risks of recoverability of reinsurance from non-APRA-authorized reinsurers that are in addition to the usual credit risks. As a result, it is expected that in signing the Financial Information Declaration, the CEO and CFO will consider these additional aspects of risk in relation to foreign reinsurance recoverables. In addition, the Reinsurance Management Strategy of an insurer must include a description of the process of assessing recoverability of reinsurance (refer to GPS 230 paragraph 21(d)(v)); and
- where a recoverable has become a receivable (i.e. it is due and payable) and is overdue for more than six months since a payment request was made to the reinsurer, a 100 per cent capital charge will apply (refer to Attachment A of GPS 114 paragraph 6).

These policy positions are significant changes from the proposals in the December discussion paper. A summary of how they address the major issues raised in industry submissions is provided below.

Industry response

This section contains industry responses in italics and APRA's response directly below in each case. The section only contains the major issues raised in the responses received. Other industry comments and APRA's responses to them are set out in Attachment A of this paper.

It was submitted that APRA's proposals were inconsistent with various international developments such as:

- *proposals to relax the current collateralisation requirements in the US;*
- *proposal for mutual recognition of reinsurers operating within Europe; and*
- *various IAIS proposals on mutual recognition, international group supervision and global solvency standards.*

The US and EU arrangements are currently evolving. APRA is observing developments and continually evaluates their relevance to APRA-authorized insurers.

APRA is a strong supporter of mutual recognition but mutual recognition has some demanding pre-requisites, including acceptance that regulatory and supervisory equivalence exists, extensive exchange of information on individual insurers and a *modus operandi* for assessing or rating insurers and reinsurers.

Equivalence of regulatory and supervisory approaches is fundamental to achieving mutual recognition. Robust capital measurement is the starting point, including valuation of assets and liabilities. Mutual recognition also requires mutual understanding of balance sheet construction, capital measurement, solvency requirements and supervisory approach and advances in understanding and supervising conglomerates. Thorough investigation of these aspects must precede achievement of a sufficient level of understanding of the degree of equivalence to enable APRA to recognise the work of supervisors in other jurisdictions.

Current international developments relating to mutual recognition of reinsurers are at an early stage and have a long way to go before recognition across jurisdictions can be effectively applied. In the meantime, APRA will continue to work with the IAIS and international regulators to achieve an effective mutual recognition and supervisory regime.

There has been a recent decision of the House of Lords (McGrath and Another and Others v Riddell and Others [2008] UKHL 21) acceding to a letter of request from the Supreme Court of New South Wales and ordering that assets held by the HIH group of companies in England be remitted to Australia for distribution in accordance with Australian law. APRA has received submissions since this decision requesting details of how this reversal of the Court of Appeal decision affects APRA's position on reinsurance recoverables from non-APRA-authorized reinsurers.

The Court of Appeal decision was not the sole basis of APRA's position. It was merely one example of the issues relating to reinsurance from non-APRA-authorized reinsurers. The House of Lords reversal of the decision does not diminish the value of the example: the fact that the case had to go all the way to the House of Lords is a reflection of the uncertainty of the law in this regard. Also, the case only relates to the UK position in this case. It may not be applicable in all other cases or in other jurisdictions. The costs and time involved in these legal processes indicate the risks involved.

On closer inspection of the decision, there are still questions that arise. If the case had been decided based on the common law (i.e. aside from the Insolvency Act 1986 (UK)), there would have been considerable doubt over whether the assets could be remitted to Australia. Out of the five Law Lords, only two thought the UK courts had power to order remittance of assets to Australia. Another two held that the court did not have sufficient jurisdiction to make such an order. The fifth judge declined to express a view. This indicates that there may well still be issues in other common law jurisdictions where there is no equivalent to the Insolvency Act 1986 (UK).

Some respondents commented that the credit rating of the reinsurer should not be ignored.

APRA agrees that the capital factors should be risk-based and the revised policy position addresses this issue with different factors applying after the grace period depending on the credit rating of the reinsurer, as shown in Table 3 above.

Some respondents argued that the proposed five-year transition for existing reinsurance contracts was insufficient. One argument is that the proposal is effectively retrospective and reinsurers have no reason or incentive to participate in or honour security arrangements.

All existing reinsurance arrangements will be grandfathered so the revised proposals will only apply to new reinsurance arrangements entered into on or after 31 December 2008.

Some respondents argued that APRA should defer introduction of the proposal to allow time for the industry to prepare for implementation.

APRA has responded to these submissions by delaying introduction of any changes to the treatment of reinsurance assets until 31 December 2008.

Some submissions commented that it is not clear how small insurers that do not have an Appointed Actuary would be able to implement the proposal as the administration is centred on the actuary valuing and identifying the source of reinsurance recoverables.

Footnote 54 in GPS 310 clarifies that, in the case of small insurers, the insurer can make the assessment.

Chapter 2 – Investment capital factors for equities and real property

Proposal as at 19 December 2007

- Insurers to apply investment capital factors of 25 per cent for listed equity instruments and units in listed trusts (an increase from the existing 8 per cent).
- Insurers to apply investment capital factors of 30 per cent for unlisted equity instruments and units in unlisted trusts (an increase from the existing 10 per cent).
- Insurers to apply investment capital factors of 30 per cent for direct holdings of real estate property investments (an increase from the existing 10 per cent).
- Insurers to be able to treat investments in unit trusts on a 'look through' basis where it is administratively practical to do so.
- The investment capital factors applicable to listed equities to apply to net exposures after allowing for equity derivatives. An equity basis risk charge and counterparty risk charge may also be applicable in relation to the derivative positions.

Revised proposal

The investment capital factors will be implemented in two stages. In the first stage, the factors will be twice the existing factors being 16 per cent instead of the proposed 25 per cent for listed equities and 20 per cent for unlisted equities and direct property instead of the proposed 30 per cent. Any further changes to these factors will be considered as part of a wider project to review other components of the MCR. The two-stage approach has been adopted to address concerns raised by the industry regarding the large one-off change in the factors that was proposed and APRA's intention to undertake a wider review of all capital factors.

The proposals relating to 'look through' for unit trusts and derivative adjustments for listed equities will be implemented from 1 July 2008.

Minor adjustments to the treatment of derivatives relative to the original proposal are:

- clarification that the approach to derivatives applies to covered and uncovered positions;
- short selling to be taken as equivalent to a short derivative position for the purposes of determining its capital requirement; and
- introduction of a sliding scale for the equity basis risk component.

Subordinated debt had been subject to the same investment capital factors as equities in GPS 110 and hence the increased factors of 25 per cent and 30 per cent were proposed to apply to subordinated debt in the December 2007 consultation package. However, following consideration of submissions received, APRA has decided to maintain the existing factors of 8 per cent for listed subordinated debt and 10 per cent for unlisted subordinated debt.

Assets classified as 'other assets' will continue to attract the highest capital factor which is now 20 per cent.

Industry response

The comments below concentrate on the revised factors for equity and property investments rather than the proposed approach to unit trust 'look through' and net exposures allowing for equity derivatives. There has been universal support for the latter two proposals, with submissions merely addressing practical matters of application rather than the principles of the proposals.

The submissions on the investment capital factors were less supportive although many submissions acknowledged that the existing investment capital factors of 8 per cent and 10 per cent for equity and property are inadequate. There were several points raised in industry responses, which are set out in italics and APRA's responses shown directly below. This section only contains the major issues raised in the responses.

Given the current and potential state of the property market and the outlook for the Australian equities market, submissions requested that APRA defer the implementation of the increases in capital charges to allow sufficient time for an orderly disposal of assets if required.

The current volatility in financial markets supports APRA's position on the market risks of such investments and APRA's position that the prescribed approach to calculating the MCR should adequately reflect the risks of investments. However, given the significance of the previously proposed increase in investment capital factors, APRA has opted to allow some transition by implementing the proposal in two stages as explained above.

Some submissions suggested that the proposed change should be made in the context of a wide-ranging review of the calibration of the MCR rather than only considering one aspect of the MCR calculation. Some submissions stated that there is no evidence that the 1-in-200 year risk of ruin target is not met in total by the current MCR as some factors may be underestimating risks but other factors may be overestimating risks.

APRA's initial work on the review of the calibration of the MCR requirements suggested that the capital factors for equity and property investments were materially below the target 1-in-200 year level. All aspects of the MCR calculation will be considered in a project to assess the calibration of the prescribed approach to calculating the MCR. In that project, APRA will be considering the need for any further increase in the capital factors for equities and real property.

Some submissions argued that the proposed factors do not sufficiently allow for diversification of risks across an insurer's business.

In choosing the capital factors, APRA selected the bottom of the range of possible outcomes suggested by relevant data and analysis as an implicit acknowledgement that some diversification benefits exist. However, the proposed wider review of the MCR will allow further consideration of the issue of diversification.

Some submissions argued that the proposal does not take account of the matching of long-tail insurance liabilities to the long-term nature of equities. They argued that the proposal is therefore detrimental to long-tail insurers and suggested that there should be some acknowledgement for insurers that have demonstrated an ability to invest with a long-term horizon.

Asset-liability management will be considered in the proposed assessment of the calibration of the MCR.

Some submissions suggested that the higher factors should not apply to the investment of surplus capital but should only apply where equities and property are used to support technical provisions.

A general insurer's balance sheet is not subject to formal segregation and any attempt to segregate is notional. In effect, investing surplus capital in higher risk investments creates greater uncertainty over the value and availability of such capital.

Chapter 3 – Modifications to other proposals

3.1 Cession limits

Proposal as at 19 December 2007 that remains unchanged

APRA's proposal was that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60 per cent of gross written premium for Category A, B and C insurers. Category D and E insurers are not expected to cede more than 90 per cent of gross written premium. This proposal was a restatement of APRA's existing policy but additional guidance is now provided in GPG 245.

Industry response

Respondents supported this proposal but it was suggested that APRA apply a degree of flexibility in its application. Respondents noted that there may be valid reasons why a small Category A, B or C insurer would seek to cede more than 60 per cent of its gross written premium and APRA's requirements should be sufficiently flexible to allow for this.

Some respondents suggested that a 60 per cent limit would be impractical for Category C insurers and recommended that APRA reconsider this proposal. Insurers opposing this proposal noted that branch foreign insurers are integrated within the group's entire reinsurance treaties and that it would be impractical for the group to negotiate separate reinsurance treaties for the Australian branches.

APRA's prudential approach

APRA has included reference to cession limits as guidance in GPG 245, which means that there will be flexibility in relation to cession limits. APRA understands there may be instances where insurers cede more than the maximum specified in a 12-month period but insurers should work progressively towards APRA's normal limits. This approach will provide some flexibility to Category A, B and C insurers when managing their reinsurance arrangements.

3.2 Assets in Australia

Proposal as at 19 December 2007

APRA proposed to review and amend its assets in Australia requirements to clarify that assets held via foreign sub-custodians are not assets in Australia.

Premium receivables outstanding for more than six months.

APRA proposed that additional controls would be required over assets in Australia, since branches are not separate legal entities. Receivables will need to be held by an agent on trust or by a custodian.

Withdrawals from a bank account to be authorised by agent.

The agent and the authorised delegate of the agent (e.g. Australian resident who meets APRA's fit and proper requirements) will be able to authorise withdrawals from bank accounts held in the name of the foreign insurer.

Co-signatory requirements for assets held by a custodian.

APRA proposed to allow but not to require co-signatory arrangements. Where co-signatory arrangements are in place with the foreign insurer, the agent in Australia (or authorised delegate of the agent who is resident in Australia) must maintain authority to issue final instructions to the custodian.

Revised proposal

Term deposits of less than six months duration have been included in the definition of bank accounts and will receive the same treatment as call deposits (refer to paragraph 25 of GPS 120);

In relation to transfer of assets under the custodian arrangement, the agent in Australia's involvement in transactions will only be required where the transfer will alter the value of a category C insurer's assets in Australia (refer to footnote 13 of GPS 120).

GPS 120 now clarifies that investment risk charges are only to be calculated in relation to assets in Australia in determining the MCR of a category C insurer.

Industry response

While there was support from industry on this proposal, it was not unanimous. Industry contended that agents holding assets in Australia may be impractical. Several suggestions were put forward by respondents, which included:

- clarifying the definition of disposal of assets (which has been inserted in footnote 13 in GPS 120);
- clarifying the definition of the term bank account to include short-term deposits with ADIs with less than six months duration. Respondents noted that short-term deposits were not normally handled through a custodian and suggested they be treated by APRA as bank accounts;
- amending the draft standard in order to facilitate investment outsourcing. The requirement for withdrawals from a bank account to be authorised by the agent should only be necessary when additional funds flow in or out of the custodial arrangement. This would ensure that the efficiency of managing investments is not compromised for insurers which outsource their investment processes; and
- removing the requirement for other fixed assets to be held by an agent or custodian. Guidance was sought on how illiquid assets would be handled in order to qualify as assets for capital adequacy purposes.

Some respondents did not agree with APRA's proposal to exclude as assets in Australia premium receivables outstanding for more than six months. It was contended that receivables due to Category C insurers do not pose a greater risk of non-payment than receivables due to locally incorporated insurers.

APRA's prudential approach

APRA revised its position as detailed above in response to the industry comments.

APRA is aware of industry concerns over the proposed treatment of premium receivables that have been outstanding for more than six months. However, in APRA's view, six months is a reasonable timeframe to collect on these receivables. As such, APRA is proceeding with implementing this proposal without modification.

Receivables due to a category C insurer that have been outstanding for more than six months will be excluded from being assets in Australia. As a result, these receivables will not attract an investment capital charge (see footnote 12 of GPS 110).

3.3 Corporate agents in Australia

Proposal as at 19 December 2007

A Category C insurer that appoints a corporate agent as its agent in Australia must ensure that the board of the corporate agent has a minimum of three directors at all times. APRA proposed that its fit and proper requirements also be applied to corporate agents in Australia, including the requirement that all directors and senior managers are residents in Australia.

Revised proposal

The board must contain a majority of directors who ordinarily reside in Australia (see GPS 510, paragraph 25(b)). Senior managers must all be resident in Australia.

Industry response

Industry was supportive of APRA's proposals in relation to allowing corporate agents in Australia. The requirement for all directors and senior managers to be residents in Australia, however, was questioned. It was suggested that APRA amend this requirement to allow the board of the corporate agent to contain a majority of directors and senior managers who ordinarily reside in Australia. This would enable foreign insurers to appoint a foreign person (eg the senior officer outside Australia) to the board of the corporate agent.

Some respondents questioned APRA's intention to exclude assets held under an agreement between a Category C insurer and a corporate agent from being assets in Australia if the corporate agent engages in any business or commercial activity other than activities in its capacity as agent in Australia.

APRA's prudential approach

Assets held by a corporate agent will not be treated as assets in Australia where that agent engages in any business or commercial activity other than activities in its capacity as agent in Australia (refer to GPS 120 paragraph 33). The purpose of these proposals was to ensure that the corporate agent does not carry on other business that might detract from its duties as agent or put the assets it holds for the foreign insurer at risk. These requirements were adapted from similar provisions for RSEs of superannuation entities.

3.4 Loans back to the parent of a Category E insurer

Proposal as at 19 December 2007

APRA proposed to allow up to 100 per cent of the capital base of a Category E insurer to be lent back to the parent group on commercial terms. A Category E insurer making a loan to its parent company would therefore need to hold additional capital if the exposure exceeded 100 per cent of the insurer's total capital base.

Revised proposal

GPG 220 (paragraph 4) includes guidance that a Category E insurer should not lend more than 100 per cent of its capital base to a parent company.

If a loan to a related entity is not made on commercial terms the entire exposure will attract an Investment Capital Factor of 100 per cent (refer to GPS 114, paragraph 31).

Industry response

Industry had mixed views on this proposal. There was support for APRA's proposal but also some reservations about the limitation to 100 per cent of the capital base. It is typical practice internationally for captive insurance companies to invest surplus funds with the parent as a matter of group financial management.

APRA's prudential approach

APRA's proposal was intended to address the concentration risk a Category E insurer may be exposed to with its parent. In order to allow for greater flexibility APRA has included this limit as guidance and would expect the limit to be exceeded only in cases where the security of the loan is of high quality. In instances where the exposure to the parent group exceeds 100 per cent of the insurer's capital base, APRA may consider increasing the insurer's MCR.

3.5 Kangaroo Bonds

Proposal as at 19 December 2007

APRA proposed to cease excluding certain Kangaroo Bonds (bonds issued into the Australian market by a foreign resident issuer) from being assets in Australia provided that all the following criteria are met:

- (a) the underlying bonds are owned by Austraclear's nominee and are registered on Austraclear;
- (b) a separate register recording the Austraclear nominee's ownership of the legal interest in the underlying bonds is kept in Australia;
- (c) the bonds are created by a deed poll under seal and the deed poll is kept in Australia;
- (d) the debt under the bonds is expressed to be payable solely in Australia; and
- (e) if there is a custodian between Austraclear and the insurer, the relevant account and any right the insurer has against the custodian are in Australia.

Revised proposal

APRA has revised the wording of criterion (a) to reflect that the usual structure of a Kangaroo Bond is that the underlying bonds are legally owned by Austraclear Ltd or a nominee for Austraclear Ltd and are lodged in the Austraclear System rather than registered on Austraclear.

Criterion (d) has been modified to allow bonds to provide for payment outside Australia where issuers are legally prevented from making payments in Australia.

Industry response

The industry supported APRA's proposal. It was suggested that wording changes be made to GPS 120 to better align the criteria with how Kangaroo Bonds are structured. The specific issues raised were:

- the wording of criterion (a) should be refined to reflect the usual structure of a Kangaroo Bond with the revised proposal above incorporating the suggested change;
- for criterion (b), consequential changes should be made to align with the changes suggested to criterion (a);
- in relation to criterion (c), there were two concerns. First, deeds constituting Kangaroo Bonds will not always be physically sealed, as many issuers rely on legislative presumptions that a deed in a particular form will be taken to be sealed, eg if it is signed and expressed to be sealed or expressed to be a deed. Secondly, criterion (c) was too limiting as it did not apply to Kangaroo Bonds constituted under trust deed; and
- regarding criterion (d), there may be unforeseen circumstances where a Kangaroo Bond issuer may be legally prevented from making payments in Australia and so the requirement that payments only be able to be made in Australia may be too restrictive.

Some respondents also enquired whether APRA would allow transitional provisions for existing instruments.

APRA's prudential approach

APRA acknowledges that Kangaroo Bonds may be a source of quality assets for an insurer's portfolio. However, APRA's primary concern is policyholder protection. In the event of an insurer being wound up, APRA needs to be satisfied that the Kangaroo Bonds would be considered assets in Australia by a court of law. The changes suggested above to the criteria have now been accommodated in the criteria in GPS 120 (see paragraph 12) except for the suggested changes to criterion (c) relating to bonds constituted by trust deed.

The purpose of requiring the bonds to be constituted by deed poll (to be held in Australia) is that legal precedent indicates this structure is more likely to lead to a court finding that a Kangaroo Bond is a specialty debt and therefore an asset in Australia. When bonds are constituted by trust deed there will be an argument that the property is located by law where the issuer resides (which will be overseas). In the final wording of GPS 120, APRA has required a Kangaroo Bond to be created by a deed poll, which is sealed, or deemed by its governing law to be sealed, and which is governed by Australian law and kept in Australia.

In addition, APRA envisages that legal opinion will be obtained from the issuer's jurisdiction of incorporation (or in the case of international or supra-national organisations, appropriate internal or external counsel) and from the relevant Australian jurisdiction confirming that:

- the relevant deed poll has been validly executed and is binding on the issuer as a matter of law in the issuer's jurisdiction of incorporation (or in the case of international or supra-national organisations, under its constituent documents) and in the jurisdiction in which the deed poll is made; and
- the issuer's obligations under the relevant deed poll are valid, binding and enforceable as a deed poll as a matter of the relevant Australian law governing that deed poll, subject in each case to the usual qualifications and assumptions given in opinions of that nature.

APRA is not proposing to allow transitional provisions for existing Kangaroo Bonds as the proposal to cease excluding Kangaroo Bonds from being assets in Australia is a relaxation of the current position under GPS 120.

3.6 Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007 (SRR Act)

Proposal as at 19 December 2007 that remains unchanged

As a result of the SRR Act, a number of amendments have been made to the Insurance Act. These amendments:

- remove the requirement for auditors and actuaries appointed by insurers to be approved by APRA;
- rationalise and streamline the provisions for APRA to exempt insurers from requirements of the Insurance Act;
- rationalise and streamline breach reporting requirements; and
- introduce whistleblower protection provisions.

In order to reconcile the prudential standards with the revised provisions in the Insurance Act, APRA has made amendments where necessary to its prudential standards, particularly to GPS 310 and GPS 520.

Industry response

Respondents were supportive of changes being made to the prudential standards as a result of the revised provisions in the Insurance Act. One respondent suggested that the whistleblowing requirements in GPS 520 be amended in order to ensure that any provisions in an insurer's fit and proper policy encouraging whistleblowing are adequately communicated not only to directors and employees of the regulated institution but also to the Appointed Actuary, the reviewing actuary and the auditor.

APRA's prudential approach

APRA has amended paragraph 61 of GPS 510 to ensure that employees acting in a whistleblowing capacity can provide information not only to the auditors and the Appointed Actuary but also to the reviewing actuary without being constrained by the regulated institution.

3.7 Financial Section Legislation Amendment (Review of Prudential Decisions) Act 2008 (RPD Act)

The RPD Act received Royal Assent on 26 May 2008. The amendments to the Insurance Act contained within the RPD Act include introducing court-based disqualifications, amending APRA's directions powers, removing some requirements for ministerial consent and amending requirements relating to review of decisions. As a result, consequential amendments have been made to GPS 510, GPS 520 and GPG 520.

Attachment A: Security of reinsurance recoverables – summary of industry comments and APRA’s responses

Industry comments	APRA response
<p>The proposals will reduce the incentives of ceding insurance companies to engage in due diligence in the selection of reinsurance counterparties.</p>	<p>APRA’s revised position ameliorates this possibility. APRA continues to require insurers to undertake prudent risk management and reinsurance management practices in the selection of reinsurance counterparties.</p>
<p>There will be an increase in reinsurance premiums or some reinsurers will reduce capacity or stop offering cover to Australian insurers.</p>	<p>Under APRA’s revised position, it is unlikely that reinsurance premiums will be affected. The international reinsurance market can be expected to adapt to the new requirements without detriment to Australian policyholders.</p>
<p>The reinsurance proposals are likely to contravene existing and future free-trade agreements.</p>	<p>Free-trade agreements, in their current form, include a ‘carve-out’ for prudential requirements.</p>
<p>Obtaining bank letters of credit (LOC) could be difficult and expensive in the Australian market. Banks may require full collateralisation for LOCs and the establishment and drawdown charges would be prohibitive.</p>	<p>Given the experience in the US market with LOCs and trust arrangements, and discussions with potential providers of security arrangements in Australia, APRA does not believe that these arrangements will be as costly or as difficult as the industry has portrayed.</p>
<p>Some branch and subsidiary insurers that are part of large global groups arrange their reinsurances via global treaties. Some argue that it would not be practical or cost effective to set up specialised arrangements for Australia.</p>	<p>For some global reinsurance arrangements, it is uncertain whether the reinsurance recoverables actually constitute ‘assets in Australia’ for the purposes of the <i>Insurance Act 1973</i>. While this is a separate issue from the capital requirements, the implementation of the proposed security arrangements and implementation of the contractual requirements and guidance about reinsurance contracts will ensure that these reinsurance recoverables are treated as assets in Australia.</p>
<p>APRA’s proposals will lead to concentration of risk in the Australian financial market and transfer of risks from foreign reinsurers to the Australian banking industry.</p>	<p>This contention assumes that APRA’s requirements will lead to reduced use of foreign reinsurers and result in undue concentration of risk locally. It also assumes that foreign reinsurers will make substantial use of guarantees and letters of credit from Australian banks. Neither assumption can be confidently made and in any event APRA expects some market evolution that will limit any such potential effects.</p>

Industry comments	APRA response
<p>Requirements for reinsurance contracts to be subject to Australian law and recoverables to be payable in Australia mitigate any risks identified by APRA.</p>	<p>APRA agrees that the requirements on reinsurance contracts will help strengthen the prudential framework relating to the risks of foreign reinsurance recoverables. However, APRA does not believe that having the case heard in Australia will ensure the money is available in Australia and recoverable on a timely basis.</p>
<p>There is a contradiction between the Government’s position on DOFIs and APRA’s reinsurance proposals as the DOFI regime specifically exempts reinsurance on the grounds that it is a global market with insufficient capacity in Australia to meet the market’s needs.</p>	<p>There is a misconception that APRA is forcing APRA-authorized insurers away from non-APRA-authorized reinsurers. APRA’s goal is to make the prudential framework more sensitive to the risks of dealing with non-APRA-authorized reinsurers.</p>
<p>The insurer and the reinsurer may have different estimates of reinsurance recoverables. It is unclear how such disagreements would affect the amount of security required.</p>	<p>The possibility of foreign reinsurers holding lower claims reserves than their Australian ceding companies are assessing as reinsurance recoverables is an example of one of the risks of dealing with non-APRA-authorized reinsurers.</p>
<p>Many proportional reinsurance treaties are ‘clean cut’ at the end of each treaty year with a portfolio transfer to incoming reinsurers. When an APRA-authorized reinsurer is replaced by a non-APRA-authorized reinsurer in a subsequent year, the insurer may incur an increased capital charge at the inception of the new treaty year or require the new non-APRA-authorized reinsurer to provide security for claims assumed under the portfolio assumption. The practical effect of this proposal may be to deter non-APRA-authorized reinsurers from participating on proportional reinsurance programs.</p>	<p>This situation is a straightforward consequence of APRA’s requirements.</p> <p>As most such treaties are for property classes and generally short tail, it is unlikely that reinsurance terms and market capacity will be affected.</p>

Industry comments	APRA response
<p>In relation to trust funds used as security arrangements in Australia, APRA should require:</p> <ul style="list-style-type: none"> the trust is bankruptcy remote; the quality of assets meets specified requirements; that there are regular revaluation processes specified in the trust deed; and when security should be added to the fund. <p>The last point is also valid in relation to letters of credit and guarantees. Processes for matching the exposure to reinsurers and security provided for them should be specified.</p>	<p>GPS 114 paragraph 23 requires that assets in trust funds are bankruptcy remote i.e. unavailable for distribution following insolvency of the reinsurer.</p> <p>GPS 114 paragraph 23 requires assets of a security trust to be held in Australia by a trustee located in Australia.</p> <p>GPG 245 includes guidance on how security trusts should be structured.</p>
<p>The start of the grace period for foreign reinsurance recoverables should be clarified for claims-made policies.</p>	<p>Footnote 14 in GPS 114 clarifies the position on reinsurance of claims-made policies.</p>
<p>Under APRA's policy, unrated reinsurance subsidiaries of insurance groups would be treated as grade 4 counterparties irrespective of the rating of the parent.</p>	<p>GPS 114, Attachment B, paragraph 3 allows APRA the discretion to determine the rating of an unrated reinsurance subsidiary of a general insurance group it supervises.</p>
<p>There was uncertainty as to how reinsurance arranged through Lloyds should be treated.</p>	<p>The definition of APRA-authorized reinsurer in GPS 001 has been amended to clarify that Lloyds should be treated as an APRA-authorized reinsurer.</p>
<p>Captives of groups that meet the 'high-value insured' threshold in the limited DOFI exemption arrangements have a choice to be established in Australia or offshore. The additional charges on reinsurance are a disincentive to establishing and maintaining a captive in Australia. In any event, the group is exposed to the risk of the unwillingness or inability of reinsurers to pay claims.</p>	<p>APRA acknowledges that the risk of unpaid reinsurance recoverables is generally a risk to a captive's parent group. As such APRA will allow the parent of a Category E insurer to provide a guarantee for reinsurance recoverables rather than an ADI. Only well-rated groups (APRA Grade 3 or better) can provide such a guarantee. This guarantee should be considered along with intra-group investments when considering appropriate thresholds for exposure to the group.</p>



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