

Regulation Impact Statement

(OBPR ID: 2008/9596)

Executive summary

The proposals contained in this Regulation Impact Statement (RIS) have been developed in the context of the *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007 (the Act)*, which was passed on 24 September 2007 with relevant amendments taking effect from 1 July 2008.

At the same time as making the modifications and clarifications to the prudential framework to give effect to this legislative change, APRA has taken the opportunity to make other changes to the prudential framework. The need for these changes is detailed in the 'Problem' section.

Most proposals relevant to this RIS affect the suite of capital adequacy standards applicable to general insurers. In essence, the capital adequacy standards set a risk-based Minimum Capital Requirement (**MCR**) for a general insurer and the capital base of the general insurer must at all times be greater than this amount.

There are three different policy proposals covered by this RIS. These are:

- from 1 July 2008, APRA proposes to harmonise the definition of the capital base for general insurers and authorised deposit-taking institutions (**ADIs**);
- from 1 July 2008 in calculating the prescribed MCR of an insurer, APRA proposes a doubling of the capital factor for investments in listed equities from 8 per cent to 16 per cent (applied to net exposure after allowing for derivative hedging) and to double the factor applied to investments in unlisted equities and direct property from 10 per cent to 20 per cent. It also proposes that investments in unit trusts to be treated on a 'look through' basis where it is administratively practical to do so; and
- from 1 January 2009, APRA proposes to require insurers to recognise the greater risk arising from reinsurance from non-APRA-authorized reinsurers through three changes to the prudential standards:
 - in calculating the prescribed MCR of an insurer, APRA proposes to require a higher investment capital charge on reinsurance recoverables from non-APRA-authorized reinsurers compared with reinsurance recoverables from APRA-authorized reinsurers. It is proposed to increase each existing factor by 1.5 times (e.g. two per cent becomes three per cent and eight per cent become 12 per cent) for all grades of reinsurers;
 - APRA proposes that, after a grace period, the MCR relating to reinsurance recoverables from non-APRA-authorized reinsurers would be increased when they are not supported by suitable security arrangements in Australia. This will be applied to unsecured reinsurance recoverables

arising from new reinsurance arrangements commenced from 31 December 2008. Recoverables from reinsurance arrangements prior to that date are to be subject to greater scrutiny by actuaries, management and the board of the insurer but no additional capital requirements will apply; and

- APRA also proposes that reinsurance arrangements must specify that Australian law will apply to the contract and that any disputes heard in a court must be heard in an Australian court.

Two options are assessed in this RIS:

- Option 1 - To implementing the policy proposals detailed above; and
- Option 2 - To maintain the existing prudential standards (i.e. *status quo*).

APRA has consulted extensively on all the proposals. Because of their proposed simultaneous introduction, all of the proposals were subject to consultation at the same time. Based on feedback received, the implementation of the proposals relating to non-APRA-authorized reinsurance will be delayed six months. Further details of the consultation process are provided below.

After the analysis of the impact of the costs, benefits and risk for each of the identified groups - APRA, policyholders and insurers - option 1 is the recommended option.

1 Background

This RIS follows the previous related preliminary assessment OBPR ID: 2008/9547 on Refinements to the General Insurance Prudential Framework which was submitted to OBPR on 13 March 2008. That preliminary assessment detailed APRA proposals to modify and clarify its prudential framework to give effect to the Australian Government announcement in relation to the regulation of Direct Offshore Foreign Insurers (**DOFIs**) and, more generally, to recognise different categories of insurer based on risk profiles. In line with the passing of the *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007 (the Act)*, all insurers wishing 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 (Insurance Act)*¹.

At the same time as making the DOFI-related modifications and clarifications to the prudential framework, APRA has taken the opportunity to propose other changes to the prudential framework. The need for these changes is detailed in the 'Problem' section.

There are, in essence, three sets of policy proposals covered by this RIS. These are:

- harmonisation of the definition of capital base for general insurers and ADIs;
- changes to the calculation of the Minimum Capital Requirement (**MCR**) for equity and real property investments; and
- a better recognition of the risks of reinsurance due from non-APRA-authorized reinsurers through changes to the calculation of the MCR and requirements covering reinsurance contracts.

Insurers affected by these proposals generally are:

- all existing APRA-authorized insurers; and
- DOFIs that intend to become APRA-authorized insurers.

There are currently 132 authorized insurers in Australia, with total assets of \$88 billion as at June 2007.

¹ This general position is subject to limited exemptions announced by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 8 April 2008.

2 Problem

This section details three separate problems identified with existing prudential requirements.

2.1. Harmonised definition of capital base

The capital base of a general insurer is the cornerstone of its strength. It provides a buffer against losses that have not been anticipated and, in the event of problems, enables the general insurer to continue to operating while those problems are addressed or resolved. In this way, the maintenance of an adequate capital base can engender confidence in the financial soundness and stability of the general insurer.

Capital also serves as a benchmark against which the financial condition of a general insurer can be measured. Accordingly, APRA has in place prudential standards on capital adequacy. The capital adequacy standard requires a general insurer to maintain a capital base greater than the MCR.

APRA takes the view that there are benefits to both APRA and industry (given the increasing prevalence of conglomerate groups) in maintaining a broadly consistent approach to the definition of capital base between ADIs and general insurers. The prudential standard on capital adequacy for general insurers has maintained a definition of capital base consistent with ADIs since its introduction in 2002.

The Basel II capital adequacy regime for ADIs, which APRA introduced effective from 1 January 2008, required APRA to make some changes to the definition of capital base for ADIs. Relevant changes now need to be made to general insurers in order to maintain the alignment of the definition of capital base for ADIs and general insurers.

These changes are not significant in the general insurance context although some clarifications may result in capital instruments of an insurer no longer meeting the requirements for a specific component of capital. This would be rare as most of the clarifications are based on precedent supervisory decisions made by APRA when assessing capital instruments under previous standards. The supervisory discretions being introduced are ones that are likely to be exercised infrequently but they are beneficial tools for APRA to have to properly achieve the intent of prudential requirements.

2.2. Investment capital factors for equity and real property

The required MCR to be maintained by general insurers consists of three components when calculated using the prescribed method,² one of which is the investment risk capital charge. This is calculated by multiplying the value of investments and other assets on the balance sheet with the investment capital factors set by APRA in prudential standards.

Investment capital factors are based on the volatility of both returns and realisable values of different type of assets. The greater the volatility, the greater the likelihood

² Well-resourced insurers can use an Internal Model Based method to calculate MCR.

of a significant downward revaluation and hence negative impact on the position of an insurer.

APRA's target for MCR is 99.5 per cent probability of sufficiency over a one-year period. APRA's capital framework has been in place since 2002 and it was appropriate for APRA to review whether its framework is achieving the stated target level of sufficiency. The first outcome of that review was that the investment capital factors for equity and real property were not achieving the appropriate level of sufficiency and therefore needed to be reviewed urgently.

The current prescribed method of determining MCR does not recognise that derivatives can be used to reduce the equity risk position of an insurer. The risk-reducing role that derivatives may play in an insurer's investment strategy warrants recognition. A further inconsistency in the current prescribed method of determining MCR is that unit trusts are treated in the same manner as equity investments no matter what the underlying assets and their risk profile – this can be penal where those investments, if held directly, would attract lower investment charges.

2.3. Reinsurance from non-APRA-authorized reinsurers

The current prudential framework, also does not consider the additional risk of settlement of reinsurance recoverables from non-APRA-authorized reinsurers compared to that of APRA-authorized reinsurers.

The Australian Government has introduced new legislative requirements requiring that overseas insurers be authorized in order to carry on insurance business in Australia. This has the potential to exacerbate the anomaly in respect of reinsurers, since an alternative for non-APRA-authorized insurers wishing to operate in Australia in future will be to do so as reinsurers (via "fronting arrangements", where the insurer acts a shop front for the reinsurer and the latter takes on a substantial amount of the insurer's risk). Hence, the Australian Government's changes enhance APRA's interest in the level of security for reinsurance recoverables.

The recoverability risk for foreign reinsurance assets increases over time. In addition, these foreign reinsurance assets represent risk that has been transferred out of Australia and, if it had not been, the risk would otherwise be matched with capital in Australia which is permanent in nature. Thus there is a diminution in the protection afforded to Australian policyholders.

There is risk that reinsurance due from a foreign jurisdiction may not ultimately be available for distribution in Australia in the event of:

- liquidation of either the overseas reinsurer or the APRA-authorized insurer;
- the reinsurer is experiencing financial stress; or
- there is a dispute between the parties.

In the current prudential framework, investment risk factors are applied to reinsurance assets based only on the credit rating of the reinsurer. This ignores the greater risk associated with settlement of reinsurance recoverables from non-APRA-authorized

reinsurers. This risk increases with time. APRA considers that there is a need to introduce some specific requirements to ensure that the protection of Australian policyholders is not appreciably weakened by the additional risks arising from the use of non-APRA-authorized reinsurers.

3 Objectives of APRA's initiative

3.1. Harmonised definition of capital base

The objective is to harmonise the definition of the capital base for general insurers and ADIs.

3.2. Investment capital factors for equity and real property

The objective is to align the current equities and real property investment risk capital factors with APRA's stated objective of targeting an MCR with 99.5 per cent sufficiency over a one-year period. At the same time, adjustments should be made to the MCR calculation, to better reflect the risks of equity portfolios that are hedged with derivatives and to better reflect the risks of unit trust investments.

3.3. Reinsurance from non-APRA-authorized reinsurers

The objective is to enhance policyholder protection by requiring insurers to recognise the greater risk arising from reinsurance from non-APRA-authorized reinsurers through an MCR calculation that is more sensitive to this risk.

4 Options

4.1. Option 1 - To amend the existing prudential standards, as per each proposal listed below.

4.1.1. Harmonised definition of capital base

From 1 July 2008, APRA proposes to harmonise the definition of the capital base for general insurers and ADIs.

4.1.2. Investment capital factors for equity and real property

From 1 July 2008 in calculating the prescribed MCR of a general insurer, APRA proposes a doubling of the capital factor for listed equities from eight per cent to 16 per cent (applied to net exposure after allowing for derivative hedging) and to double the factor applied to unlisted equities and direct property from 10 per cent to 20 per cent. It also proposes that investments in unit trusts to be treated on a 'look through' basis³ where it is administratively practical to do so.

4.1.3. Reinsurance from non-APRA-authorised reinsurers

From 1 January 2009, APRA proposes to require a higher investment capital charge on reinsurance recoverables from non-APRA-authorised reinsurers compared with reinsurance recoverables from APRA-authorised reinsurers. It is proposed to increase each existing factor by 1.5 times (e.g. two per cent becomes three per cent and eight per cent become 12 per cent) for all counterparty grades applicable to reinsurers as set out in Table 1 below. The investment capital charge, which forms a part of the MCR required to be held by the general insurer, is calculated by multiplying the value of an asset recorded by the insurer by an investment capital factor set out in APRA's standards.

APRA proposes that, after a grace period, the MCR relating to reinsurance recoverables from non-APRA-authorised reinsurers would be increased when they are not supported by suitable security arrangements in Australia. The factors to be applied to these unsecured reinsurance recoverables after the grace period range from 20 per cent to 100 per cent depending on the credit rating of the reinsurer, as set out in Table 1. This will be applied to unsecured reinsurance recoverables arising from new reinsurance arrangements commenced from 31 December 2008. Recoverables from reinsurance arrangements prior to that date are to be subject to greater scrutiny by actuaries, management and the board but no additional capital requirements. APRA also proposes that reinsurance arrangements must specify that Australian law will apply to the contract and that any disputes heard in a court must be heard in an Australian court.

³ A 'look-through' approach means that the insurer's interest in the underlying assets of the trust will be treated as if the insurer owned those assets directly. The investment capital factors will reflect the risk of the underlying assets rather than treating the trust itself as the investment.

Table 1 Counterparty grades of reinsurers and applicable investment capital factors

Counterparty Grade	Existing investment capital factor (to continue to apply to APRA-authorized reinsurer)	Investment capital factor: non-APRA-authorized reinsurer	Investment capital factor: non-APRA-authorized reinsurer after the grace period
1	2%	3%	20%
2	2%	3%	40%
3	4%	6%	60%
4	6%	9%	100%
5	8%	12%	100%

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 factor will apply irrespective of the counterparty rating.

4.2. Option 2 - To maintain *status quo*.

Under this option, APRA would not make changes to existing standards. General insurers would continue on the existing prudential standards resulting in:

4.2.1. Harmonised definition of capital base

There would be a different definition of capital base of a general insurer compared to an ADI.

4.2.2. Investment capital factors for equity and real property

The prescribed MCR may not reach 99.5 per cent sufficiency over a one-year period.

4.2.3. Reinsurance from non-APRA-authorized reinsurers

Insurers using foreign reinsurance arrangements would not be subject to a higher MCR even though there are greater risks for policyholders from these arrangements.

Foreign reinsurance arrangements may still specify other jurisdictions as the governing law and disputes may need to be heard in foreign courts.

5 Impact analysis – costs, benefits and risks

5.1. Impact group identification

The parties impacted by the identified options are expected to be APRA, policyholders, and insurers.

5.2. Assessment of costs and benefits

APRA sought from the general insurance industry two forms of data to assess the impact of the proposals in option 1. First, as with all discussion papers issued by APRA, the impacted parties are asked to provide details of the impact on them and are invited to use the Business Cost Calculator. This would be particularly useful in assessing compliance costs. No insurer has provided such data in relation to these proposals.

Second, general insurers were asked to voluntarily complete a survey that would enable APRA to assess the impact of the second and third proposals assessed in this RIS. APRA received 26 responses to this survey out of 132 authorised general insurers at the time. The combined MCRs of these 26 insurers is 61.7 per cent of the total industry combined MCR. As detailed below in section 5.3.3, these data has been used to determine the estimated impact on the entire general insurance industry by extrapolating it across the entire industry.

5.3. Option 1

5.3.1. APRA

Benefits

The benefits in maintaining a broadly consistent approach to the definition of capital for ADIs and general insurers are that a body of precedent decisions can be built up that apply across the two industries and APRA's internal training can be consistent across the two industries in this respect. The nature of capital alignment would provide APRA with added flexibility to allow supervisory discretion to be applied where required.

The investment capital factors would be more consistent with the desired target for the MCR of 99.5 per cent probability of sufficiency over a one-year period. The greater focus on risks in the prescribed MCR calculation would result in a better focus on risks by both insurers and APRA supervisors, improving the quality of APRA supervision of general insurers.

The increased focus on recoverability of reinsurance from non-APRA-authorised reinsurers would result in a better focus on risks by both insurers and APRA supervisors, and therefore improve the quality of APRA supervision for general insurers.

Costs

Under this option, APRA would incur costs associated with modifying the prudential standards. Such costs include those associated with the effort and resources necessary to develop the new standards, internal training and changes to supervisory processes.

5.3.2. Policyholders*Benefits*

The updating of, and improvement in, the general insurance capital requirements will provide improved policyholder protection. The changes will ensure that there continues to be high-quality capital available to support policyholder claims.

Policyholders would benefit from the greater protection afforded by a more risk-sensitive prescribed MCR calculation. This is applicable to both the investment changes and the recognition of the increased risk of reinsurance with non-APRA authorised reinsurers.

Costs

There is potential for additional costs to policyholders under this option, should general insurers decide to pass on any additional costs in the form of increased fees and charges.

5.3.3. Insurers*Benefits*

For those insurers operating in conglomerate groups, a consistent definition of capital base between general insurers and ADIs will lead to lower compliance costs. The clarifications to defining capital instruments proposed may lead to lower compliance costs as insurers would not expend effort in developing capital instruments with features that are not acceptable.

An insurer will be able to recognise the economic benefit of hedging equity portfolios in their MCR calculation. If insurers invest in unit trusts that include assets with a lesser risk profile, and therefore lesser investment capital factor than equities, those insurers will benefit from a lower MCR. In the assessment of costs below, these benefits are taken into account so the net costs are assessed.

Another benefit is that given the prescribed MCR calculation will be more sensitive to risks, it can be expected to lead to better focus on these risks within insurers' risk management frameworks.

Costs

With regard to the clarifications of the definition of capital base, there will be no costs to insurers as these changes are simply making clear existing APRA interpretations.

There is a potential for insurers to incur higher costs through the action of supervisory discretions about the composition of an insurer's capital base and through the new form and substance requirements for capital instruments. However, those costs would only apply to those insurers that attempt to develop capital instruments that are not consistent with the substance of the definition of a particular capital instrument or have engaged in high risk activities that justify the use of a supervisory discretion. For most insurers, there will be no impact from these changes.

Insurers will need to hold more capital against the equity and real property investments. It must be noted that only some insurers hold such assets; holdings of equity and real property are far from universal across the industry.

Insurers will have a higher MCR in relation to reinsurance recoverables from non-APRA-authorized reinsurers. In addition, those insurers may experience a further increase in MCR when there are reinsurance recoverables that continue to be recorded after a grace period but are not secured in Australia. Table 2 below sets out an estimate of the extent of those increases in MCR based on the assumption that there is no change in reinsurance buying behaviour by insurers.

Insurers could choose to reinsure with reinsurers who are APRA-authorized or non-APRA-authorized reinsurers willing to lodge security in Australia. The precise cost of taking any of these actions is difficult to assess as each insurer has a different cost of capital and reinsurance strategy. Insurers have suggested that non-APRA-authorized insurers may increase premium rates to cover the increased cost of reinsurance. However, no precise details have been provided. Insurers have also voiced concerns that the cost of security arrangements of non-APRA-authorized reinsurers will be passed on in higher premium rates. Estimates vary considerably but it would appear a reasonable estimate based on both submissions and other information obtained by APRA that costs to reinsurers might increase by one per cent to two per cent. It is not certain that reinsurers will pass this cost on to insurers.

Table 2 – Increased MCR based on the survey completed by 26 insurers

Proposal	Increase in MCR across 26 insurers	Industry MCR	Total increase in industry MCR
Investment capital factors for equity and real property – increase occurring 1 July 2008	7.0%	\$11.5 billion	\$800 million
Reinsurance from non-APRA-authorized reinsurers – increase occurring 1 July 2008	0.9%	\$11.5 billion	\$100 million
Reinsurance from non-	4.6%	\$11.5 billion	\$530 million

APRA-authorised reinsurers – increase occurring 1 January 2011			
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As of 30 June 2007, the capital of the insurance industry is \$23.7 billion. As general insurers, on average, have capital 2.06 times MCR as at 30 June 2007, only a small minority of insurers would have any potential need to raise additional capital. The majority of insurers could simply reduce their MCR coverage. Alternatively, insurers could change investment or reinsurance strategies to reduce the impact of the changes on their MCR. In other words, insurers could reduce the risks inherent in their business which would then be reflected in a lower MCR.

While this leads to the conclusion that only a minority of insurers will need to raise additional capital as a result of the increased MCR, insurers may face the following costs from an increase in MCR:

- diminished reputation: MCR coverage (i.e. capital base divided by MCR) is used as a benchmark for financial strength in the industry as insurers aim to maintain a certain MCR coverage ratio. A reduced MCR coverage ratio may result in diminished reputation which may have a variety of outcomes including possibly downward pressure on the value of an insurer's shares;
- costs associated with modifying business practices (i.e. reducing risks) to reduce the MCR: These costs are likely to be in the form of transaction costs due to modifying investment portfolios and possibly slightly higher reinsurance premiums. In relation to transactions costs, these are one-off costs and would typically be immaterial to the value of an investment portfolio. Examples of transaction costs would be trading fees and stamp duties on sale of shares and agent fees on the sale of property; and
- costs of raising and maintaining additional capital to meet MCR with a reasonable buffer: In the usual course of business, APRA expects insurers to maintain a capital buffer over MCR. Due to the first point above, insurers often target a higher MCR coverage ratio than APRA either requires or expects. If insurers need to raise capital either to meet APRA's expectations or market expectations, there are initial transaction costs in raising the additional capital and ongoing maintenance costs for that capital, in the form of dividends or interest. These ongoing maintenance costs will depend on the insurer's own cost of capital.

There may be additional administrative complexity in distinguishing between APRA-authorised and non-APRA-authorised reinsurance recoverables. However, the industry has indicated that this added complexity is not significant. In fact, existing APRA reporting requirements provide for the identification of the total of non-APRA-authorised reinsurance recoverables. Additional classification by credit rating is unlikely to be a significant burden and, indeed, the introduction of this additional classification requirement has been after industry requests for it.

With the requirement for greater focus on the collection of reinsurance recoverables from past reinsurance arrangements, there may be additional compliance costs from additional management time, actuarial work and audit work. This will be part of a much larger body of work so it is difficult to determine an estimated cost as much of the work needed for the additional certifications may be already performed or, where it is not already performed, additional benefits may be gained from performing the work. No estimates were provided by industry as to how much additional work is involved.

The requirement for Australian law to be applicable to reinsurance contracts is likely to come at very little cost to insurers. There will be a new compliance requirement but one likely to be monitored with negligible cost.

5.4. Option 2 – maintaining status quo

5.4.1. APRA

Benefits

Under this option, APRA would not incur the costs associated with modifying the prudential standards.

Costs

APRA would have to maintain two sets of precedent decisions with regard to capital instruments and would need to maintain different internal knowledge and skills with regard to the definition of capital for ADIs and general insurers.

The investment capital factors currently applying to property and equities are well below levels that are consistent with the APRA's target for the MCR to be at 99.5 per cent probability of sufficiency over a one-year time period. The insensitivity of the prescribed MCR calculation to investment risks may result in a lesser focus on risks by both insurers and APRA supervisors, lessening the quality of APRA supervision of general insurers.

When the prescribed MCR does not reach its target probability of sufficiency, the result is a lack of parity between the prescribed method of calculating MCR and the internal model-based method of calculating MCR. This may lead to a disincentive for insurers to apply to use an internal model for calculating MCR. As internal models are expected to lead to better risk management by complex insurers, this disincentive may ultimately lead to suboptimal supervision of certain complex general insurers.

APRA would need to implement other supervision measures to ensure there is an appropriate focus on the risks of reinsurance from non-APRA-authorized reinsurers. This would involve training costs and development of internal procedures. It is not likely that the costs here would be significantly different from the benefit, which is the avoidance of costs associated with modifying the prudential standards.

5.4.2. Policyholders

Benefits

The only benefit compared with option 1 is that the costs faced by insurers would be lower, than under option 1 so premiums may be lower assuming insurers pass all regulatory costs on to policyholders.

Costs

There may be opportunity costs from the improved policyholder protection foregone. This opportunity cost is difficult to quantify.

With regard to the MCR calculation in respect of insurers' investments in equity and property, it is sufficient to say that APRA's current prescribed MCR calculation does not address the specific risks of non-APRA-authorized reinsurance so there is a possibility that APRA's stated objective of 99.5 per cent sufficiency over a one-year period for the MCR may not be achieved.

5.4.3. Insurers

Benefits

Under this option, the definition of an insurer's capital base would not be affected but this will benefit very few insurers. As explained under 'costs' in section 5.3.3, only those insurers who seek to exploit weaknesses in the current definition of capital base would benefit from no change in requirements. It is likely that they would incur offsetting costs due to alternative APRA supervisory action (see 5.4.1 above).

Insurers would not have to hold any more capital than they currently do which is a benefit compared to Option 1. The benefit would be the avoidance of costs set out in 5.3.3 above.

Costs

Insurers that are part of conglomerate groups would face greater compliance costs as they would have to maintain knowledge of separate definitions of capital base for both ADIs and general insurers within the groups.

Without the clarifications included within the package, general insurers would face increased compliance costs from developing capital instruments that do not ultimately meet the requirements of the prudential standards.

Insurers will continue to have a higher MCR relating to hedged equity positions than the physical position without the hedge in place. For investments in unit trusts, insurers will continue to need to hold the same amount of capital as with investments in equities without regard to the underlying assets of those trusts. The result will be the MCR against these investments may not reflect the inherent risks of the investments. Where MCR calculation does not reflect underlying risks, there is a disincentive to implement appropriate risk management practices.

For similar reasons stated above, the greater risks of reinsurance recoveries from non-APRA-authorized reinsurers may not be as clearly recognised or accounted for by insurers in their risk management strategies.

6 Consultation

On 2 July 2007, APRA released a discussion paper, *Capital adequacy for Authorised Deposit-taking Institutions and General Insurers*. The focus of the discussion paper was to align the ADI capital adequacy framework with the Basel II framework. General insurers were included in the discussion paper to ensure consistency in APRA's approach to capital between the two industries.

On 31 July 2007, APRA issued a discussion paper, *Refinements to the General Insurance Prudential Framework*. The discussion paper proposed modifications and clarification to the prudential framework to give effect to the government's announcement in relation to DOFIs and to recognise different categories of insurers based on risk profiles. In addition to the refinement proposals, APRA also consulted on the further refinements to the general insurance prudential framework, ranging from miscellaneous changes to the substantial changes discussed in this RIS. This discussion paper contained the following items relevant to this RIS:

- further detail on how the proposals in the 2 July 2007 paper would be implemented for general insurers;
- a statement that APRA was considering the capital factors on equity and real property which would be released in detail in the next round of consultation;
- a proposal to increase the investment capital factor on all reinsurance assets due from non-APRA-authorized reinsurers by adding an additional 2 per cent to existing factors; and
- a proposal that after a grace period of one year from an event giving rise to an unsecured reinsurance recoverable from a non-APRA-authorized reinsurer, the unsecured reinsurance recoverable would not be admissible but APRA left it open as to how that would be implemented – i.e. by a deduction from capital or increasing the MCR.

APRA received 52 submissions to the 31 July 2007 discussion paper from APRA-authorized insurers, insurance brokers, reinsurance brokers, and other interested parties. A range of views were expressed ranging from

- agreement with the proposals; to
- agreement with the principles underlying the proposals but not the detail of APRA's proposals; to
- disagreement with the underlying principles of APRA's proposals.

The submissions were taken into account in a second consultation package released on 19 December 2007.

Leading up to the 31 July 2007 paper and following its release, APRA met with industry representatives in multiple fora in order to discuss the proposals. These fora included meetings with representatives from many insurers, one-on-one meetings with individual insurers and meetings with auditors, actuaries and reinsurance brokers.

The 19 December 2007 consultation package comprised a discussion paper providing a response to submissions on 31 July 2007 paper, along with draft prudential standards and draft prudential practice guides incorporating the proposed amendments. The draft prudential standards and draft prudential practice guides gave the industry the detail of APRA's intended implementation.

APRA altered its proposed approach based on examination of the submissions received and provided greater detail about its intended proposals. The aspects of the 19 December 2007 consultation package relevant to this RIS are:

- APRA provided the detailed implementation of the changes to the definition of capital base in draft prudential standards. Responses on these issues were limited and APRA does not propose to revise the proposals in substantial ways;
- APRA detailed its intention to increase the investment capital factors for listed equities from eight per cent to 25 per cent and for unlisted equity and real property from 10 per cent to 30 per cent. At the same time the recognition of derivative hedging and the 'look through' to the underlying assets of unit trusts were proposed. The recognition of derivative hedging was directly the result of feedback received from the industry in informal consultations prior to the release of the consultation package;
- APRA proposed there would be a 100 per cent capital factor applying to unsecured reinsurance recoverables after a grace period ending on the second balance date after events giving rise to the recoverables occurred. The industry had expressed opposition to this proposal but had not provided cogent arguments against the principle underlying the proposal. APRA responded to practical aspects of the implementation of the proposal in a number of ways:
 - confirming the MCR would be increased as opposed to a deduction from capital;
 - the identification of relevant reinsurance recoverables would be based on the annual Insurance Liability Valuation Report of the Appointed Actuary;
 - the grace period would be linked to reporting periods rather than the need to monitor the effluxion of time from each event; and
 - APRA also proposed a five-year transition period for existing reinsurance arrangements;
- APRA adjusted its proposal regarding the investment capital factors applying to other reinsurance assets due from non-APRA-authorized reinsurers so that the factors would be 1.5 times the factors applying to reinsurance assets due from APRA-authorized reinsurers. This adjustment was based on responses received from the industry; and

- APRA also proposed that reinsurance arrangements must specify that Australian law will apply to the contract and that any disputes heard in a court must be heard in an Australian court.

In addition to the submissions as detailed in section 5.1 above, APRA requested responses to a survey to determine the quantitative impact of the proposals and received 26 responses. APRA also surveyed five major reinsurance brokers regarding the reinsurance proposals and received four responses.

APRA again consulted with the industry on an informal basis through a number of meetings. The early feedback gained in these meetings resulted in APRA adjusting its proposals as detailed below.

The submissions received in response to the 19 December 2007 proposal indicated that the industry was sensitive to the large increases in MCR they saw as resulting from the proposals. The main issues were the large step-up in investment capital factors for equity and property investments and the 100 per cent capital factor applying after the grace period to reinsurance recoverables from non-APRA-authorized reinsurers. While there was opposition to both proposals in isolation there was also concern about the effect of both proposals in combination.

In recognition of the industry feedback, APRA modified its proposals and announced the following changes on 2 April 2008:

- investment capital factors applying to listed equities would increase from eight per cent to 16 per cent (instead of 25 per cent) and the factors applying to unlisted equities and property would increase from 10 per cent to 20 per cent (instead of 30 per cent) on 1 July 2008. APRA stated that the factors would be increased to a level required to meet the 99.5 per cent sufficiency test in two stages – this initial increase and then further adjustments, as appropriate, based on consideration of future work examining all other aspects of the MCR calculation; and
- the capital factors applicable to unsecured reinsurance recoverables from non-APRA-authorized reinsurers would be made more risk-based; instead of a flat 100 per cent capital factor applying to all recoverables, factors ranging from 20 per cent to 100 per cent would apply depending on the credit rating of the reinsurer (as detailed in section 4.1.3.). These new capital factors will not be applied to existing reinsurance arrangements; that is, those existing reinsurance arrangements will be grandfathered.

On 22 April 2008, APRA released extracts of the prudential standards incorporating changes to the investment capital factors applying to equity and property investments as well as the modified reinsurance recoverables proposal. These extracts were subject to two weeks of consultation with the industry.

7 Conclusion and recommended option

7.1. Harmonised definition of capital base

Option 1 is the preferred option as it meets the stated objective of maintaining alignment between the definition of capital base for both ADIs and general insurers. In addition, there are benefits for both APRA and the industry. The costs to industry will not be borne by most general insurers. The costs will only be incurred by those who undertake the development of capital instruments that do not meet the substance of APRA's requirements or where a general insurer engages in activity that is sufficiently risky to justify the use of APRA's supervisory discretion. It is not expected that either situation will occur very frequently and it will only affect a minority of insurers. Therefore, the potential cost to policyholders is insignificant and is outweighed by the increased prudential benefits derived from the proposals in those situations where there is an impact.

Option 2 falls short of meeting APRA's stated objectives. There will be costs to the insurance industry and APRA from maintaining knowledge of different definitions of capital base for both ADIs and general insurers. In addition, there may be instances where policyholder protection is compromised because APRA does not have the ability to enforce the definition of capital instruments in substance or because APRA does not have the supervisory discretion to alter the minimum requirements for the components of a general insurer's capital base.

7.2. Investment capital factors for equity and real property

Option 1 is the preferred option as it best meets the stated objective. There are clear net benefits to APRA and policyholders. Costs will only be incurred by those insurers that have higher risk investment portfolios and that need to raise additional capital as a result of the MCR. On the other hand, proposals relating to derivatives and unit trust investments will benefit insurers that manage the risks of their equity portfolios using derivatives and use lower risk managed investment products. On balance, the cost to the industry does not seem significant compared to the benefits derived by other stakeholders.

Option 2 does not meet the stated objective as the current requirements have been demonstrated to fall short of the objective. There would be costs to APRA and policyholders. Insurers managing their investment risk with derivatives or investing in low risk unit trusts would also incur greater costs. On balance, these costs outweigh the benefits to certain insurers which have higher risk investment portfolios.

7.3. Reinsurance from non-APRA-authorized reinsurers

Option 1 is the preferred option as it best meets the stated objective of enhancing policyholder protection by requiring insurers to recognise reinsurance assets due from non-APRA-authorized reinsurers as being of higher risk than reinsurance assets due from APRA-authorized reinsurers. There are clear net benefits to APRA and policyholders. Costs will only be incurred by those insurers that have higher risks due to the use of non-APRA-authorized reinsurers.

Option 2 falls short of meeting APRA's stated objectives as the more risky reinsurance recoverables due from non-APRA-authorized reinsurers are not given any different treatment in the prescribed MCR calculation. The net benefits to insurers are outweighed by the costs to APRA and policyholders.

8 Implementation and review

8.1. Harmonise capital adequacy

APRA proposes to implement the new requirements on 1 July 2008.

8.2. Investment capital factors for equity and real property

APRA proposes to implement the new requirements on 1 July 2008.

8.3. Reinsurance from non-APRA-authorised reinsurers

APRA proposes to delay until 1 January 2009 implementation of the requirements of the MCR calculation related to non-APRA-authorised reinsurance. This will allow insurers more time to make changes, if required, to their reinsurance strategies. This delay was based on feedback received during consultation.

8.4. Review

The standards will be scheduled for review in three years.