



Response to Submissions

Refinements to the General Insurance Prudential Framework

19 December 2007

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Preamble

The purpose of this paper is to initiate further consultation on proposals contained in APRA's discussion paper, *Refinements to the General Insurance Prudential Framework* released on 31 July 2007. In that paper, APRA proposed modifications and clarifications to its prudential framework to give effect to the Government's announcement in relation to Direct Offshore Foreign Insurers (DOFIs) and, more generally, to recognise different categories of insurer based on risk profiles.

The Government has enacted its 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* (Insurance Act). This general position is subject to limited exemptions. The extent and nature of these exemptions is the subject of a separate consultation process by the Treasury.

The changes to the Insurance Act are set out in the *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007* (DMF & DOFI Act), which was given Royal Assent on 24 September 2007.

In addition to the refinement proposals in the discussion paper, APRA is also consulting on the changes to the prudential standards that were previously foreshadowed in:

- the *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007* (SRR Act). The most significant change relates to the removal of the requirement for APRA to approve auditors and actuaries. These are minor procedural amendments and do not have any substantial impact on authorised insurers; and
 - APRA's discussion paper, *Capital adequacy for authorised deposit-taking institutions and general insurers* released on 2 July 2007. This mainly affects the treatment of certain capital instruments and APRA's supervisory discretion over an insurer's capital base.
- APRA is also taking the opportunity to make minor changes to existing prudential standards to clarify their intent. The main one is that the current *Prudential Standard GPS 110 Capital Adequacy* (GPS 110) has been divided into a number of separate standards covering distinct elements of capital adequacy.
- APRA's 31 July 2007 discussion paper invited submissions on the proposals set out in that paper. Many submissions were received and industry's comments have been useful. This paper summarises APRA's responses to submissions received. The proposals themselves, including any modifications based on industry feedback, are incorporated within draft prudential standards and draft prudential practice guides that are now available on the APRA website.
- Each of the policy proposals made in this paper is cross-referenced to the relevant sections of the drafts; the substantive changes are also highlighted within these drafts.
- Insurers affected by these proposals and by changes to the Insurance Act more generally are:
- all existing APRA-authorised insurers;
 - DOFIs that intend to become APRA-authorised insurers;
 - Australian-owned sole parent captive insurers that are not APRA-authorised; and
 - Australian-owned association captive insurers that are not APRA-authorised.

Preamble

Next steps

Written submissions on APRA's proposals should be forwarded by 22 February 2008 via e-mail to Keith Chapman at GIRFPF@apra.gov.au. APRA requests that submissions include relevant cost-benefit analysis of the proposals (see Attachment 3 for further details).

Important

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified. APRA will determine FOIA requests, if any, in accordance with the provisions of the FOIA.

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Glossary

AASB	Australian Accounting Standards Board
ADI	Authorised deposit-taking institution as defined under the <i>Banking Act 1959</i>
APRA	Australian Prudential Regulation Authority
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
BAC	Board audit committee referred to in GPS 510
Business plan	Business plan referred to in GPS 220
Corporations Act	<i>Corporations Act 2001</i>
DMF	Discretionary mutual fund as defined under DMF & DOFI 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 as defined under <i>Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 Explanatory Memorandum</i>
FCR	Financial Condition Report referred to under GPS 310
Foreign branch	Foreign general insurer as defined under the Insurance Act
FSCODA	<i>Financial Sector (Collection of Data) Act 2001</i>
GPG	General insurance prudential practice guide
GPG 110	Prudential Practice Guide GPG 110 Capital Adequacy: Capital Management (Draft – November 2007)
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 (Draft)</i>
GPS 110	<i>Prudential Standard GPS 110 Capital Adequacy</i>
GPS 112	<i>Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital (Draft)</i>
GPS 113	<i>Prudential Standard GPS 113 Capital Adequacy: Internal Model Based Method (Draft)</i>
GPS 114	<i>Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Charge (Draft)</i>
GPS 115	<i>Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Capital Charge (Draft)</i>
GPS 116	<i>Prudential Standard GPS 116 Capital Adequacy: Concentration Risk Capital Charge (Draft)</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>
IAAust	Institute of Actuaries of Australia
IBNER claims	Claims that are incurred but not enough reported
IBNR claims	Claims that are incurred but not reported
ILVR	Insurance Liability Valuation Report referred to in GPS 310
Insurance Act	<i>Insurance Act 1973</i>
Insurer or general insurer	General insurer as defined under the Insurance Act
MCR	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
PPG	Prudential practice guide
ReMS	Reinsurance management strategy referred to under GPS 230
Reviewing actuary	Reviewing actuary as defined in GPS 310
Risk management declaration	Risk management declaration referred to in GPS 220
RMS	Risk management strategy referred to under GPS 220
SRR Act	<i>Financial Sector Amendment (Simplifying Regulation and Review) Act 2007</i>

Summary of proposals

The following tables summarise proposals discussed in this paper, with references to the sections. The first table covers proposals that have been modified from those set out in the July discussion paper.

Proposal	Description
Reinsurance recoverables (ref. 2.1)	<p>Capital requirements:</p> <ul style="list-style-type: none"> Reinsurance recoverables from non-APRA-authorized reinsurers on outstanding claims provisions which are not supported by suitable security arrangements in Australia to be subject to 100 per cent capital factor one year after the end of the financial year in which the claims giving rise to the recoverables occur. Any guarantees or letters of credit provided as security arrangements in Australia to be provided by an authorised deposit-taking institution (ADI). <p>Transitional arrangements:</p> <ul style="list-style-type: none"> For reinsurance contracts entered into before 30 June 2008, no additional capital charges to apply until 30 June 2012 with the full 100 per cent capital factor not applying until 30 June 2013.
Reinsurance contracts (ref. 2.1)	<p>Reinsurance contractual requirements for arrangements entered into on or after 30 June 2008:</p> <ul style="list-style-type: none"> Reinsurance contracts to be subject to Australian law with any disputes to be heard in an Australian court. Reinsurance recoverables to be payable to the insurer in Australia and no other payment mechanism to be substituted for convenience. <p>These requirements would not apply to contracts entered into before 30 June 2008.</p>
Investment capital factors on reinsurance assets (ref. 2.2)	<ul style="list-style-type: none"> The existing investment risk capital factors applying to reinsurance assets to be increased by 50 per cent for reinsurance assets from non-APRA-authorized reinsurers (e.g. apply 3 per cent instead of 2 per cent for grade 1 & 2 reinsurers).
Intra-group reinsurance (ref. 2.3)	<ul style="list-style-type: none"> With the imminent implementation of insurance group supervision, the current temporary concessions on intra-group reinsurance exposures to be discontinued from 30 June 2008. Transitional arrangements to be considered for the insurance groups affected on a case-by-case basis.
Categories of insurer (ref. 3.1)	<ul style="list-style-type: none"> The definition of each category of insurer to be incorporated in a new definitional standard (GPS 001). A captive reinsurer of an insurance group to be recognised as a Category E insurer. Definition of a category B insurer to include certain non-wholly owned subsidiaries (e.g. controlled entities).

Proposal	Description
Run-off plan (ref. 3.6)	<ul style="list-style-type: none"> • A run-off plan for a run-off insurer to replace the business plan and financial condition report (FCR). • Run-off plan to be prepared by the insurer on a rolling three-year basis. • An appointed actuary to review the run-off plan and make comments where necessary. • A run-off plan and the role of the actuary in respect of the run-off plan to address the matters specified.
Assets in Australia (ref. 3.13)	<ul style="list-style-type: none"> • Co-signatory requirements for assets held by a custodian to allow an agent to delegate authority to an authorised person resident in Australia. • Where co-signatory arrangements are in place with a foreign insurer, the agent in Australia (or an authorised delegate who is resident in Australia) to maintain authority to issue final instructions to the custodian.
Capital buffer (ref. 3.18 & 3.21)	<ul style="list-style-type: none"> • The capital buffer for category D and category E insurers to be 1.5 times their minimum capital requirements. The buffer for all other insurers generally expected to be 1.2 times their minimum capital requirements.
Harmonised capital adequacy (ref. Chapter 4)	<ul style="list-style-type: none"> • The eligibility criteria applied to capital instruments clarified. • APRA's supervisory discretion over the composition of an insurer's capital base modified (and varied from the original proposal).
Investment capital factors for equity and real property (ref. Chapter 5)	<ul style="list-style-type: none"> • Insurers to apply investment capital factors of 25 per cent for listed equity instruments and units in listed trusts. • Insurers to apply investment capital factors of 30 per cent for unlisted equity instruments and units in unlisted trusts. • Insurers to apply investment capital factors of 30 per cent for direct holdings of real estate property investments. • 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 to apply to net exposures after allowing for equity derivatives.
Kangaroo bonds (ref. 6.2)	<ul style="list-style-type: none"> • APRA to recognise kangaroo bonds as assets in Australia subject to certain criteria.
APRA reporting requirements (ref. 3.2)	<ul style="list-style-type: none"> • Claims development table to be more consistent with AASB requirements. • Investment income to be allocated between shareholders and policyholders. • Data on bound but not incepted business, unearned premium provisions and deferred reinsurance expense to be supplied.

A number of proposals remain unchanged from the proposals put forward in the July discussion paper. They are outlined in the following table.

Proposal	Description
Sub-custodian arrangements (ref. 3.3)	<ul style="list-style-type: none"> Investments held by foreign sub-custodians not to be recognised as assets in Australia.
Small insurers – actuarial requirements (ref. 3.7)	<ul style="list-style-type: none"> Transition to full actuarial requirements for small insurers that grow in size to be progressive.
Small insurers – APRA reporting (ref. 3.8)	<ul style="list-style-type: none"> Small insurers to be able to use accounting data as approximations for APRA reporting purposes.
Cession limits – (ref. 3.9, 3.19, 3.20 & 3.24)	<ul style="list-style-type: none"> Cession limits to be 90 per cent for captive insurers and 60 per cent for other categories. Insurance group captives to cede up to 90 per cent, as they will be Category E insurers. APRA authorised subsidiaries should not cede more than 60 per cent to the group captive.
International group actuaries (ref. 3.10 & 3.15)	<ul style="list-style-type: none"> International group actuary who is not an Australian resident can be appointed.
Group business plans (ref. 3.11 and 3.16)	<ul style="list-style-type: none"> Group business plans can be used in place of local entity business plans.
Corporate Agents (ref. 3.14)	<ul style="list-style-type: none"> Corporate agents to have at least three directors on their boards.
Outsourcing to related parties – Category D insurers (ref. 3.19)	<ul style="list-style-type: none"> Outsourcing arrangements to related parties of association captives to be formalised.
Loans back to parents – Category E insurers (ref. 3.22)	<ul style="list-style-type: none"> Loans to parents of sole parent captive insurers to be available up to 100 per cent of capital base.
Governance – Category E insurers (ref. 3.23)	<ul style="list-style-type: none"> Alternative governance arrangements to be available for sole parent captive insurers by exempting them from the requirement for a majority of independent directors.
SRR Act (ref. 6.1)	<ul style="list-style-type: none"> Minor consequential amendments to be made flowing from SRR Act. Most significant is the removal of the requirement for APRA's approval of auditors and actuaries. These procedural amendments have no real impact on prudential requirements.

Chapter 1 – Background

DOFIs that wish to carry on insurance business in Australia are required to become subject to prudential regulation from 1 July 2008 as a result of the DMF & DOFI Act. Amendments to the Insurance Act will extend the definition of 'insurance business'. This will affect DOFIs that carry on insurance business in Australia, either directly or through the actions of an intermediary. Under the DMF & DOFI Act, APRA is also provided with additional powers to enforce the amended provisions of the Insurance Act.

APRA released a discussion paper titled *Refinements to the General Insurance Prudential Framework* (the refinements paper), on 31 July 2007. That paper began APRA's formal consultation process on refinements to the prudential framework to give effect to the Government's announcement in relation to the prudential regulation of DOFIs. APRA received 52 submissions from APRA-authorized insurers, insurance brokers, reinsurance brokers and other interested parties.

The changes to the Insurance Act will not change the position of foreign reinsurers that are not APRA-authorized. They will continue to be able to accept business from APRA-authorized insurers.

The refinements paper proposed the creation of categories of insurer and refinements to prudential requirements, some of which would apply to all insurers and others only to particular categories of insurer. For all insurers, there were proposals to:

- encourage non-APRA-authorized reinsurers to lodge security in Australia for reinsurance recoverables of APRA-authorized insurers;
- enhance insurer reporting to APRA;
- clarify that assets held via foreign sub-custodians are not assets in Australia;
- allow small insurers to make a transition progressively to full actuarial requirements as they grow in size;
- clarify that small insurers can use accounting data as approximations for some APRA reporting requirements; and
- allow run-off insurers to substitute a run-off plan for an annual Financial Condition Report.

For Category A insurers (locally incorporated insurers), APRA wishes to emphasise that a prudent cession limit would be 60 per cent.

For Category B insurers (wholly-owned subsidiaries of local or foreign insurers), there were proposals to:

- allow an international actuary to be appointed to the Australian subsidiary of an international group;
- allow group business plans to replace individual business plans; and
- emphasise that a prudent cession limit would be 60 per cent.

For Category C insurers (foreign insurers operating as foreign branches), there were proposals to:

- review and amend the 'assets in Australia' requirements;
- provide minimum governance standards for corporate agents;
- allow an international actuary to be appointed to the Australian subsidiary of an international group;
- allow group business plans to replace branch business plans; and
- emphasise that a prudent cession limit would be 60 per cent.

For Category D insurers (association captives), there were proposals to:

- reduce the floor of the minimum capital requirement from \$5 million to \$2 million while increasing the expected capital buffer from 1.2 times to 1.5 times when the insurer's minimum capital requirement is less than \$5 million;
- require outsourcing to related parties to be formalised; and
- emphasise that a prudent cession limit would be 90 per cent.

For Category E insurers (sole parent captives) there were proposals to:

- reduce the floor of the minimum capital requirement from \$5 million to \$2 million while increasing the expected capital buffer from 1.2 times to 1.5 times when the insurer's minimum capital requirement is less than \$5 million;

- permit sole parent captives to operate their boards without a majority of independent directors under certain conditions (this arrangement already applies to existing sole parent captives); and
- emphasise that a prudent cession limit would be 90 per cent.

Other changes

Other modifications foreshadowed in the refinements paper and incorporated in this second round of consultation are:

- amendments to GPS 110 arising from APRA's discussion paper, *Capital adequacy for authorised deposit-taking institutions and general insurers*, released on 2 July 2007; and
- changes to the investment capital factors under GPS 110 in relation to property and equity investments, following a reassessment of the volatility of these asset classes.

Miscellaneous changes also dealt with in this paper include:

- recognition of kangaroo bonds for the assets in Australia test;
- consequential amendments that result from the *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007*; and
- removal of concessions on intra-group reinsurance.

The background to these changes is set out below.

Changes to treatment of capital instruments

APRA's paper, *Capital adequacy for authorised deposit-taking institutions and general insurers*, contained proposals relating to the treatment of capital instruments and APRA's supervisory discretion on the composition of an insurer's capital base. Chapter 3 of this paper sets out the changes involved which are being introduced to bring APRA's approach to capital adequacy in line with the implementation of the Basel II Framework (Basel II), in Australia from 1 January 2008. Consequential amendments are appropriate for general insurers in order to maintain a consistent treatment of capital in both industries.

The proposals in the capital adequacy paper also related to finalisation of APRA's approach to conglomerate groups containing one or more locally incorporated ADIs, which was released in the form of draft conglomerate standards in 2002. For general insurers, corresponding amendments will be incorporated into a separate discussion paper on consolidated supervision of general insurance groups, which is expected to be released in early 2008.

APRA is currently reviewing *Prudential Standard GPS 113 Internal Models* (GPS 113). Draft GPS 113 included in this package does not contain amendments flowing from this review. The changes flowing from APRA's review of the requirements for internal models will be subject to separate consultation in 2008.

Investment capital factors

APRA is proposing to increase the investment capital factors on net exposures to equities (25 per cent for listed equities and 30 per cent for unlisted equities) and property (30 per cent). Equity exposures will be assessed net of the effects of any equity derivatives. APRA is also implementing a look-through approach to unit trust investments where practical.

These changes are being made to correct clear and widely recognised anomalies in APRA's current capital requirements. Details are contained in Chapter 5.

APRA is planning to review the adequacy of other capital factors that make up the prescribed method of calculating the MCR and intends to consult on any resultant amendments to the capital factors in 2008.

Governance

APRA's paper, *Governance for APRA-regulated institutions*, issued in September 2007, proposed minor amendments to APRA's governance standards which have been the subject of separate consultation. The amendments follow changes to the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*. These proposed amendments do not impose any new requirements on insurers and mirror those already released for ADIs and life insurers, which become effective from 1 January 2008. The amendments are incorporated in draft GPS 510.

Miscellaneous changes

The miscellaneous changes proposed in this paper fall into three areas:

- consequential amendments flowing from the SRR Act, the most significant of which relate to removal of the requirement for APRA approval of the auditor and actuary. The SRR Act addresses some of the recommendations from the Government's 2006 review aimed at streamlining prudential regulation;
- kangaroo bonds on which APRA has been in preliminary consultation with the industry. APRA is now proposing to recognise certain kangaroo bonds as assets in Australia. This paper provides an opportunity for wider public consultation on the proposal; and

- other minor changes aimed at clarifying APRA's intent where it has become evident, through practical application of the standards, that such clarification is required.

Draft standards

The table below lists the draft prudential standards and draft prudential practice guides covering capital adequacy and shows the corresponding current prudential standards and prudential practice guides. All other prudential standards and prudential practice guides will retain their current numbering.

Draft PSs and PPGs	Corresponding Current PSs and PPGs
GPS 001 Definitions	Definitions dispersed through the current standards
GPS 110 Capital Adequacy	GPS 110 Capital Adequacy excluding the attachments
GPG 110 Capital Adequacy: Capital Management	No equivalent PPG but some material on capital management has been taken from GPG 200 Risk Management
GPS 112 Capital Adequacy: Measurement of Capital	GPS 110 Capital Adequacy – Attachment A
GPS 113 Capital Adequacy: Internal Model Based Method	GPS 110 Capital Adequacy – Attachment B
GPS 114 Capital Adequacy: Investment Risk Capital Charge	GPS 110 Capital Adequacy – Attachment D
GPS 115 Capital Adequacy: Insurance Risk Capital Charge	GPS 110 Capital Adequacy – Attachment C
GPS 116 Capital Adequacy: Concentration Risk Capital Charge	GPS 110 Capital Adequacy – Attachment E and F
GPS 110 Capital Adequacy paragraphs 36 to 42	GPS 110 Capital Adequacy – Attachment G
GPS 112 Capital Adequacy paragraphs 34 to 37	GPS 110 Capital Adequacy – Attachment H

Chapter 2 – Reinsurance Proposals

2.1 Security of reinsurance recoverables

Original proposal

The refinements paper proposed that, where there has been a period of longer than 12 months since the date of accident, reinsurance recoverables would only be recognised as part of an insurer's capital base if they are from an APRA-authorized reinsurer, or are otherwise supported by assets in Australia that are guaranteed to be available to the insurer when required.

The basis of this proposal is that APRA's prudential framework should respond to the greater risk associated with settlement of reinsurance recoverables from non-APRA-authorized reinsurers by ensuring greater security of these recoverables. This greater risk has a number of sources, including:

- in the event of the insolvency of a non-APRA-authorized reinsurer, parties located in its home domicile are likely to receive favourable treatment in a liquidation;
- in the event of the insolvency of an Australian insurer, there may be circumstances where the recoverables from its reinsurers are not readily accessible in Australia, owing to legal impediments to the repatriation of the recoveries to the insurer's Australian liquidator;
- it is more difficult for APRA to monitor the status of non-APRA-authorized reinsurers than local reinsurers and APRA has no jurisdiction, on behalf of policyholders and claimants, over non-authorized reinsurers; and
- there are additional costs and risks in enforcing contracts against reinsurers that have no legal representation in the Australian jurisdiction.

In general, these risks are associated with insolvency laws rather than prudential regulation of insurers and reinsurers, and also with the willingness as much as the ability of reinsurers to honour their obligations in Australia. These risks are most likely to manifest themselves in times of stress.

The principle underlying this proposal on reinsurance recoverables is that, in the interests of policyholder protection, it should be the gross liabilities of APRA-authorized insurers that are secured in Australia rather than their net liabilities, which is the case at present.

Reinsurance is effectively a substitute for insurer capital. APRA is proposing that, in situations where non-APRA-authorized reinsurers do not lodge security in Australia for amounts recoverable from them by ceding companies, those ceding companies should be required, after a period of grace, to be subject to capital charges that match the unsecured recoverables.

The proposal would also correct an anomaly that has existed since the current prudential framework was introduced in 2002. This framework requires the full scope of APRA's prudential standards to be applied by APRA-authorized insurers and reinsurers, while at the same time giving full recognition for capital purposes to all reinsurance recoverables and placing no requirements on non-APRA-authorized insurers and reinsurers.

The new legislative requirement that DOFIs be authorized in future rectifies the part of this anomaly that relates to direct insurers. However, it potentially exacerbates the anomaly in respect of reinsurers because an alternative for non-APRA-authorized insurers wishing to operate in Australia in future will be to do so as reinsurers (via "fronting" arrangements). Hence, APRA has an enhanced interest in the level of security for reinsurance recoverables.

Industry submissions

Many of the submissions received on the refinements paper were directed at this proposal on reinsurance recoverables. Most of these submissions covered one or more of four different aspects of the proposal:

- *the principle*. There was disagreement with the underlying proposition and the counter-argument was put in several ways, that recoveries from non-APRA-authorized reinsurers should be treated similarly for capital purposes to recoveries from APRA-authorized reinsurers;

- *transition*. Concern was expressed that APRA would apply the proposal to all existing reinsurance recoverables, which would be tantamount to applying the proposal retrospectively;
- *administration*. Concern was expressed that the proposal would be difficult and costly to apply; and
- *security*. Questions were raised on what forms of security or funding APRA had in mind as suitable to support reinsurance recoverables.

Other submissions contended that the proposal is counter to international initiatives for wider recognition of foreign reinsurance.

APRA prudential approach

After full consideration of all of the submissions received and associated discussions, and in the light of the amended Insurance Act, APRA continues to believe that the underlying rationale for the proposal is consistent with and appropriate to APRA's prudential framework for general insurers.

Recognising also the merits of many of the submissions relating to transition, administration and security, APRA proposes in relation to:

- *the principle*: to proceed with the substance of the original proposal, for the reasons set out above;
- *transition*: in respect of reinsurance arrangements entered into before 30 June 2008, not to apply the principle for four years from 30 June 2008;
- *administration*: to modify the proposal as expressed below; and
- *security*: to treat as suitable security a guarantee or letter of credit from an ADI, collateral in the form of a trust fund or a deposit with the insurer.

APRA is also proposing to introduce some threshold contract requirements for all reinsurance arrangements entered into on and after 30 June 2008.

APRA is mindful of concerns relating to the possible retrospective imposition of the new requirements and has designed the transitional arrangements accordingly.

The intention of the proposal is to encourage non-APRA-authorized reinsurers to put in place security arrangements that will enhance the protection of Australian policyholders. This proposal is not intended to increase capital requirements or industry capital, as some observers have suggested. More precisely, given that APRA does not authorise foreign reinsurers and has no jurisdiction over them, as clarified in the DMF & DOFI Act, APRA wishes to enhance policyholder protection by encouraging foreign reinsurers to lodge security in Australia in respect of their liabilities here (and, as a corollary, to be satisfied that the reinsurers are holding adequate reserves). If these reinsurers choose instead to continue to hold their reserves for these liabilities offshore, APRA proposes to impose on the ceding company, after a grace period, a capital charge based on its actuary's assessment of these reinsurance recoverables.

APRA understands that there would need to be some adjustment in industry practice to deal with the proposal. It is to be expected that many non-APRA-authorized reinsurers would make available security arrangements in Australia and would continue to operate in the Australian market.

APRA is proposing to implement the proposal by modifying the minimum capital requirement. The assets in Australia requirement, including s116A of the Insurance Act which deems certain reinsurance recoveries to be assets in Australia, is independent of the proposal.

International steps towards mutual recognition of reinsurance are currently limited by the difficulties entailed in meeting the conditions that would satisfy all parties involved. For example, the APRA proposal is not inconsistent with recent US indications of potential reductions in levels of collateralisation for well-rated reinsurers, as some submissions have suggested. The APRA requirements will not be as stringent and will require much less security than is required in the United States for non-US authorised reinsurers. The United States is some distance from reducing its heavy collateralisation requirements and any reductions, if and when they eventually occur, will be highly conditional.

Although a number of submissions disagreed in principle with APRA's proposal, there were several submissions which supported or accepted its validity. No submission contested APRA's proposition that the proposal would increase the protection of Australian policyholders.

Modified proposal

The modified proposal is that, subject to the transitional arrangements (see below), **the reinsurance recoverables charge will be calculated using a 100 per cent capital factor on and after the second balance date after the date of loss unless the recoverables are from APRA-authorized reinsurers or are otherwise supported by suitable security arrangements in Australia.**

The additional capital charge would be included in GPS 114 (see paragraphs 8, 9 and 10) and thereby nominally classified as another component of investment risk.

The proposal would become operative on balance dates on and after 30 June 2010 in respect of recoverables under reinsurance arrangements entered into on and after 30 June 2008 (see paragraphs 4 and 5 of Attachment A of draft GPS 114). The transition arrangements would apply to reinsurance arrangements entered into before 30 June 2008.

There is a period of grace inherent in the proposal, being the time between the date of occurrence of a claim and the date at which the 100 per cent capital factor might apply to reinsurance recoverables associated with the claim. The grace period will be between 12 and 24 months for new treaties entered into on and after 30 June 2008, and much longer for treaties entered into before 30 June 2008.

Transitional arrangements

Under this proposed transition, there would be no effect on MCR until 30 June 2012 and then only if no security arrangements are entered into in the intervening four years. For contracts entered into before 30 June 2008, in the absence of security a reinsurance recoverables capital factor of 50 per cent would apply from the first balance date on or after 30 June 2012 and a factor of 100 per cent would then apply from the first balance date on or after 30 June 2013 (see Table 2 of Attachment A of draft GPS 114). Prior to 2012, the standard investment capital factors based on the rating of the non-APRA-authorized reinsurer (as set out in section 2.2 below) will apply.

By 2012, it is expected that the level of reinsurance recoverables from pre-30 June 2008 contracts will not be significant except perhaps in respect of some particular long-tail classes such as asbestos claims and some long-term medical indemnity claims. Thus the transitional arrangements would allow insurers four years to plan for some combination of security arrangements and additional capital.

APRA would expect each insurer to be capable of applying this proposal by reference to the ILVR prepared by its appointed actuary. The actuary is already required to identify reinsurance recoverables by class of business and generally segments them by accident year. Under the proposal, from the first balance date on or after 30 June 2010 the actuary would need to identify the estimated reinsurance recoverables by layer and allocate them between APRA-authorized and non-APRA-authorized reinsurers. Estimates relating to disputes and other uncertainties in recoverables are part of the ILVR process.

APRA acknowledges that the proposal would involve some cost to insurers or reinsurers. Security arrangements would have a cost, albeit a very small cost relative to reinsurance recoverables, and there would be some additional actuarial work. In APRA's view, the extra costs are more than offset by the benefits of the additional policyholder protection involved.

Scope of proposal

The proposal would apply to all reinsurance recoverables recognised in an insurer's gross claims liabilities for claims outstanding, including IBNR and IBNER claims. It would apply to:

- all classes of insurance, including statutory classes such as CTP and workers' compensation;
- intra-group reinsurance arrangements which occur between an APRA-authorized insurer or reinsurer and another company in the same corporate group which is not located in Australia; and
- retrocession recoverables, in the same way that it would apply to other reinsurance recoverables.

Recoverables from property catastrophe treaties following large events will often go beyond 12 months to settlement. This possibility is acknowledged as an integral part of the proposal. To protect themselves against technical insolvency in the event of a large catastrophe claim, insurers would need to negotiate security arrangements at the time of catastrophe treaty renewal.

Security arrangements in Australia

Where a guarantee is used to provide security in Australia, the following minimum standards would apply (see paragraphs 23 to 26 of draft GPS 114):

- the guarantee to be provided by an ADI in Australia including a foreign branch ADI. A guarantee from another insurer would not be sufficient¹ (see paragraph 24(a) of draft GPS 114);
- the guarantee to cover the expected timeframe for payment of claims under the reinsurance contract or, if this is impractical, the guarantee to extend for at least two years but be renegotiable each year to allow time to identify alternative arrangements if the guarantee cannot be renegotiated (see paragraph 26 of draft GPS 114); and

- the guarantee to be specifically linked to performance of the reinsurance contract or contracts with the authorised insurer (see paragraph 24(c) of draft GPS 114).

Letters of credit would be subject to similar requirements to guarantees.

Security arrangements that would serve as alternatives to guarantees or letters of credit may include (see paragraph 11 of draft GPG 245):

- collateral in the form of assets held in a trust fund (see paragraph 23(a) of draft GPS 114); or
- deposits held by the insurer (see paragraph 23(b) of draft GPS 114).

Guidance on appropriate trust fund arrangements is contained in paragraph 11 of draft GPG 245.

During the grace period, the investment capital factors to be applied by insurers to reinsurance recoverables where there are no contractually agreed security arrangements would be as set out in section 2.2. Where security arrangements are contractually agreed, however, the investment capital factor to be applied to the reinsurance recoverables would be that applying to the security arrangement (paragraph 24 of draft GPS 114). For instance, if the recoverables were supported by an AA-rated bank, the investment capital factor that applies would be two per cent.

If a trust fund were to be created, the capital factor applicable to the underlying assets of the trust would be applied. If reinsurance premiums were withheld by the insurer, the investment capital factor would be that applying to the assets supporting the deposit.

¹ Under the Corporations Act, insurance creditors have preference on liquidation of an insurer. It is arguable whether the insurer in whose favour the guarantee is written would be an 'insurance creditor' because the debt did not arise under a contract of insurance.

Contractual arrangements with reinsurers

APRA proposes to amend the reinsurance management prudential standard (see paragraph 32 of draft GPS 230) to include contractual requirements to mitigate some of the legal and operational risks associated with foreign reinsurance contracts. It is 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 (e.g., a non-APRA-authorized reinsurer could not establish a course of dealings where it paid recoverables to a foreign subsidiary of the authorised insurer or to a broker account that is not in Australia).

There are some additional contractual terms that an insurer may consider when entering into reinsurance arrangements with non-APRA-authorized reinsurers in order to minimise any risks associated with recoverables. They are described in paragraph 9 of GPG 245.

2.2 Investment capital factor for credit risk from non-APRA-authorized reinsurers²

Original proposal

The refinements paper proposed a higher investment capital factor on reinsurance recoverables from non-APRA-authorized reinsurers during the grace period for the reinsurance recoverables capital factor.

Where an insurer has reinsurance recoverables from both APRA-authorized and non-APRA-authorized reinsurers with the same credit rating, it was proposed that recoverables from non-APRA-authorized reinsurers attract a higher investment capital factor than those from APRA-authorized reinsurers.

The proposal was that the capital factor, which ranges from two per cent to eight per cent of recoverables, be increased by two per cent.

Industry response

There were two sets of responses to this proposal:

- Those which argued against the proposal, and
- Those that accepted the proposal but argued for a loading different from the two per cent proposed by APRA.

APRA prudential approach

There is good reason, in principle, for reinsurance recoverables from non-APRA-authorized reinsurers to carry a higher investment capital charge than the equivalent recoverables from APRA-authorized reinsurers.

The majority of responses agreed in principle, although support was not unanimous.

However, as far as the loading was concerned, most respondents argued against APRA's proposal for a flat two per cent increase for recoverables from non-APRA-authorized reinsurers. They argued that such a proposal might encourage a preference for lower rated APRA-authorized reinsurers compared to non-APRA-authorized insurers with a higher rating.

APRA has reconsidered the loadings and, instead of the two per cent loading for all grades of reinsurers, proposes increasing each existing factor by 50 per cent (e.g. two per cent becomes three per cent and eight per cent becomes 12 per cent). The effect of this revised proposal is shown in the table below and is incorporated within Table 1 of Attachment A of draft GPS 114.

² Investment capital factors are applied to assets to determine the investment capital charge. The investment capital charge is a component of APRA's prescribed MCR. It applies to all assets of an insurer and covers multiple risks, including credit risk. See Chapter 4 for proposed new terminology 'asset capital charge'.

Grade	Standard & Poor's	Moody's	AM Best	Fitch	Capital factor: APRA- authorised reinsurer	Capital factor: on-APRA- authorised reinsurer
1	AAA	Aaa	A++	AAA	2%	3%
2	AA+, AA, AA-	Aa1, Aa2, Aa3	A+	AA+, AA, AA-		
3	A+, A, A-	A1, A2, A3	A, A-	A+, A, A-	4%	6%
4	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	B++, B+	BBB+, BBB, BBB-	6%	9%
5	BB+ or below	Ba1 or below	B or below	BB+ or below	8%	12%

2.3 Intra-group reinsurance

Background

This issue was last addressed in APRA's May 2005 paper dealing with supervision of conglomerate groups involving general insurers. As APRA is now dealing with a number of issues relating to reinsurance, it is also appropriate to finalise APRA's approach to intra-group reinsurance.

Under the current GPS 110³, APRA may determine that the investment capital factor for a reinsurance recovery is zero where the reinsurer is a related party and is authorised by APRA. Concessions have been granted, on a temporary basis one year at a time, to APRA-authorized insurers within some groups since the current capital framework was introduced in 2002. However, the concessions are not uniformly applied to all entities within these groups due to differences in their business arrangements. This position was always intended to be a temporary measure until a final policy position was reached as part of APRA's approach to conglomerate supervision.

Currently, the general position where concessions have been granted for intra-group reinsurance is that the entities in the group have not had to apply any capital charges, as if the entities were a single entity. This arrangement has been put into effect as follows:

- for the reinsurer –
 - a zero investment capital factor on premiums receivable from other insurers within the group;
 - the business is treated as direct business for the group reinsurer (the insurance capital factors are lower on direct business); and
- for the ceding company –
 - a zero investment capital factor on reinsurance recoveries and other reinsurance assets due from the reinsurer(s) within the group.

APRA has reviewed its policy in the context of the practices of insurance regulators overseas and of its own regulation of ADIs, noting that:

- APRA is not aware that any of the leading overseas regulators offering concessions on intra-group reinsurance arrangements;

³ Paragraphs 6 and 7 of Attachment D of GPS 110, to become GPS 114

- overseas regulators focus on the requirement to regulate individual legal entities. The same obligations exist for APRA under the Insurance Act; and
- the focus of ADI supervision is on individual legal entities and intra-group transactions are not treated in a concessional manner. The only concession to intra-group exposures applies to aggregate large exposure limits, where an ADI is restricted to an exposure of 150 per cent of its capital base with regard to related ADIs but only 25 per cent for a group of unrelated counterparties. Conversely, related unregulated entity exposures are limited to 15 per cent of the capital base in the aggregate. No concessions are given with regard to capital adequacy ratio calculations.

In summary, concessions of the kind currently granted temporarily by APRA are out of line with the approach taken by other regulators and by APRA in relation to ADIs. They are also out of line with APRA's obligations in supervising individual authorised entities.

APRA prudential approach

APRA is proposing that the current temporary concessions on intra-group reinsurance exposures, which essentially ignore legal structures within a corporate group, be discontinued. The principles on which this position is based are, firstly, that APRA needs to protect the interests of policyholders of each individual entity and, secondly, that group structures cannot be treated for prudential purposes as if they did not exist.

Discontinuance of the concessions will be handled as a matter of supervision policy, without any amendment to prudential standards. The existing ability for APRA to provide these temporary concessions (e.g. during restructures) has been maintained in paragraphs 13 and 14 of draft GPS 114.

Each insurance group currently having the benefit of an existing temporary concession will be affected differently by cessation of the concession. Some may choose to restructure their businesses and others may choose simply to accept additional capital requirements. APRA will consider individual transitional arrangements for each group affected, with a view to completing the transition process by 30 June 2010.

Chapter 3 – Refinements to Other Proposals

3.1 Categories of Insurer

Original proposal

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

- 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.

Industry response

On the whole, industry supported APRA's proposal to modify the prudential standards to recognise the differing risk profiles of insurers. A few respondents suggested APRA consider creating greater differences for reinsurers, smaller branch insurers, run-off insurers, captive insurers, insurance group captives, international subsidiaries of an Australian insurance group and Lloyds.

One of the submissions also argued that APRA should consider creating differences based on the risk profile of the insurer determined by size, complexity and the regulatory regime of the parent insurer, rather than based on the insurer's legal structure in Australia.

APRA prudential approach

APRA proposes to proceed with the proposed categorisation of insurers, subject to two modifications:

- APRA agrees that an insurance group captive should be treated similarly to a Category E captive. Accordingly, APRA has amended the definitions of Category B and Category E to clarify that an insurance group captive would be a Category E insurer (refer to draft GPS 001, Paragraph 6); and

- certain non-wholly owned subsidiaries are consolidated as part of the insurance group for accounting purposes. APRA believes that such subsidiaries should also be treated as Category B insurers. The definition of a Category B insurer has been amended accordingly (refer to draft GPS 001, Paragraph 6).

The suggestions for greater differences to be created for certain types of insurers (e.g. smaller branches) did not nominate those aspects of the existing requirements that APRA should modify. APRA does not intend to modify the proposals further as there is sufficient flexibility within the existing standards to allow APRA to exercise its discretion, if need be, based on individual circumstances.

The suggested changes relating to group arrangements (such as risk management, reinsurance management, outsourcing and governance) are already available within the existing framework. No further modifications are required in respect of these proposals.

Some proposals regarding retrocessions suggested that APRA should consider treating insurers and reinsurers differently. There is no fundamental difference, in the economic structure of insurers and reinsurers.

There appears to be some confusion within the industry regarding APRA's treatment of Lloyds underwriters, since there were some suggestions that a separate category should be created for Lloyds. In essence, Lloyds already has its own category, with its own specific regulatory framework within Part VII of the Insurance Act. APRA's prudential standards do not apply to Lloyds but its operations in Australia are nevertheless subject to APRA supervision.

With regard to the proposal to create differences in the prudential framework based on the size, complexity and regulatory risks of the insurer, APRA's current risk-based supervisory framework (e.g. PAIRS and SOARS) already addresses these matters and applies a supervisory approach specific to each insurer.

3.2 APRA reporting requirements

Original proposal

APRA proposed to:

- simplify the current claims development table including reducing the period of claims development from 10 years to five years;
- require investment income to be allocated between assets supporting insurance liabilities and other assets; and
- require premiums for bound but not incepted business to be identified as a separate item.

Industry response

Industry responded positively to aligning the APRA reporting framework more clearly with the statutory reporting framework established by the Australian Accounting Standards Board (AASB). On specific matters:

Claims development table. Although supportive of the proposal, a few respondents noted that under AASB 1023 (General Insurance Contracts) the claims development disclosure is required for a period of 10 years but with a transition from an initial five year period under AIFRS (Australian equivalent to International Financial Reporting Standards);

Investment income allocation. There were some requests for guidance on the allocation of investment income; and

Other. There were a few proposals for profit and loss and balance sheet data collected by APRA to align fully with AASB reporting requirements.

APRA prudential approach

Claims development table. APRA will maintain the five year minimum for the claims development table with a transition to 10 years to correspond with the AASB transitional provisions (refer to draft GRF 440 Form and Instructions).

Investment income allocation. The proposed instructions to the reporting forms provide guidance on investment allocation methods. For example, where an insurer divides its investments into sub-portfolios for insurance liabilities and other liabilities, the investment income earned from those sub-portfolios should be allocated according to that division. Where an insurer does not use investment sub-portfolios to support its insurance liabilities or does not otherwise allocate specific assets to support its insurance liabilities, a proportional allocation method would be acceptable (refer to page 12 of draft GRF 310.3 Instructions).

Bound but not incepted business (BBNI). Upon further consideration, APRA intends to make some additional changes to enable APRA to assess the insurer's financial performance and to validate the data being submitted. In addition to the data on premium liabilities for BBNI, APRA intends to capture AASB 1023-based figures for unearned premium and deferred reinsurance expenses (refer to draft GRF 310.1 Form and Instructions).

These additional data items would normally be prepared for the company's own accounts and, as such, could be readily supplied to APRA.

Other. APRA intends to review the possibility of further alignment of its general insurance reporting framework with AASB reporting requirements as a separate project in 2008. Detailed suggestions already received in submissions will be considered as part of that project.

3.3 Assets in Australia – Sub-custodian arrangements

Original proposal

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

Industry response

Industry responded positively to this proposal.

APRA prudential approach

Paragraph 15(i) of draft GPS 120 incorporates this proposal.

3.4 IAAust Professional Standard 300 revisions

Original proposal

The refinements paper indicated that APRA would modify GPS 310 as a result of the finalisation of the revised *Professional Standard 300 – Valuation of General Insurance Liabilities* (PS 300) by the Institute of Actuaries of Australia (IAAust).

Industry response

Submissions on this proposal were limited but supportive of APRA's proposal to align the liability valuation requirements outlined in GPS 310 with the requirements of the IAAust's professional standard. However, the respondents opposed the suggestion to remove the liability valuation requirements set out in GPS 310 and rely exclusively on PS 300. These respondents argued that a professional body should not be in charge of determining prudential requirements. Instead, the principles should be set by APRA and maintained in GPS 310 with the process for applying the principles to be specified in PS 300 and determined by IAAust.

APRA prudential approach

APRA does not believe that there are any fundamental inconsistencies between GPS 310 and PS 300. As such, APRA does not propose any amendments to GPS 310 relating to valuation of insurance liabilities (see paragraph, 79 to 84 of draft GPS 310 and attachment A of draft GPS 310).

3.5 Capital buffer

APRA has been informally applying to most insurers a capital buffer of 20 per cent above the MCR and has required some insurers to hold a higher capital buffer.

The expected capital buffer of 20 per cent of MCR will now be specified in a prudential practice guide (paragraph 6 of draft GPG 110). This will aid transparency for foreign insurers wishing to become authorised in Australia and will align with the specification of the higher capital buffer for Category D and E insurers (see 3.18 and 3.21 below).

Specific proposal applying to run-off insurers

3.6 Run-off plan

Original proposal

For run-off insurers, APRA proposed that a run-off plan replace an annual Financial Condition Report (FCR).

Industry response

Overall, the industry supported APRA's proposal with some queries regarding details to be included in a run-off plan and the role of the actuary in respect of the run-off plan.

APRA prudential approach

APRA will require the run-off plan to be prepared by the run-off insurer. A run-off insurer is defined under paragraph 7 of draft GPS 001 as an insurer that is closed to new business and has not written renewal business for a period of at least 12 months.

APRA will retain discretion to require an FCR and a business plan under certain circumstances (paragraph 59 of draft GPS 310). For example, a large run-off insurer whose liabilities have been unstable over the past 12 months may be required to have an FCR prepared.

The run-off plan removes the requirement for a run-off insurer to prepare a business plan and an FCR (paragraph 16 of draft GPS 220). The run-off plan is to be prepared on a rolling three-year basis (paragraph 23 of draft GPS 220).

The appointed actuary will be required to review the run-off plan and make comments where necessary (refer to paragraph 33(a) and 35 of draft GPS 310). The following table outlines the matters to be addressed in a run-off plan and the role of the appointed actuary in respect of the plan.

Matters addressed in run-off plan (to be prepared by run-off insurer)	Review by appointed actuary
(a) Business overview.	Comment on any material anomalies.
(b) The expected claims experience on a rolling three-year basis, expected run-off period and the approach the insurer has adopted to manage the discharge of its liabilities.	Comment on whether the run-off plan is achievable and appropriate.
(c) Assessment of the insurer's recent experience and profitability, including at least the experience during the year ending on the valuation date.	Assess the experience relative to the ILVR assumptions and valuation results including the adequacy of past estimates for insurance liabilities (where appropriate, this may include references to past ILVRs).
(d) Assessment of asset and liability management, including the insurer's investment strategy.	Comment on the appropriateness of the investment strategy with regard to the insurance liabilities.
(e) Assessment of current and future capital adequacy and a discussion of the insurer's approach to capital management.	Comment on the reasonableness of the assumptions used for stress testing.
(f) Assessment of the suitability and adequacy of reinsurance arrangements, including recoverability of reinsurance arrangements, documentation of reinsurance arrangements and the existence and impact of any limited risk transfer arrangements.	Comment on any matters judged to be material to APRA.
(g) Summary of the risk management framework.	Assess the suitability and adequacy of the risk management framework.

Specific proposals applying to small insurers

3.7 Transition to full actuarial requirements

Original proposal

When an insurer ceases to meet the definition of a small insurer because of growth, APRA proposes that its supervisors apply a progressive transition to full actuarial requirements.

At present, a number of small insurers are in run-off. With the advent of authorisation of foreign insurers, it is likely that more insurers will become authorised when small and then outgrow APRA's definition of small insurer.

Industry response

Although limited, submissions on this proposal were supportive.

APRA prudential approach

Paragraph 18 of draft GPS 310 incorporates this proposal.

3.8 Accounting data used as proxy for APRA reporting

Original proposal

Small insurers can, under certain circumstances, use accounting data as approximations to certain data items required for APRA reporting purposes.

Industry response

Although limited, submissions on this proposal were supportive.

APRA prudential approach

APRA's reporting requirements will be updated to implement the proposals contained in this paper. When that occurs, APRA will ensure that the instructions to the reporting forms clearly indicate that small insurers, which by definition do not have an actuary, can provide the following items in their quarterly returns based on accounting data:

- Premium Liabilities – AASB 1023 Unearned Premium Provision less Deferred Acquisition Costs and
- Expected Reinsurance Recoveries on Premiums Liabilities – AASB 1023 Deferred Reinsurance Expense.

APRA intends to review the possibility of further aligning its general insurance reporting framework with AASB reporting requirements as a separate project in 2008. Suggestions already received in submissions will be considered as part of that project.

Specific proposal applying to Category A: Locally incorporated insurers

3.9 Cession limit

Original proposal

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

Industry response

A majority of the submissions supported APRA's proposal with a preference to incorporate this expectation within a prudential practice guide.

APRA prudential approach

This proposal is essentially a restatement of existing APRA policy but additional guidance has now been prepared. Paragraph 5 of draft GPG 245 incorporates the proposal.

Specific proposals applying to Category B: Subsidiary of a local or foreign Insurer

3.10 Group Actuary

Original proposal

APRA proposed that Australian subsidiaries of foreign insurance groups be allowed to use a group actuary who is not an Australian resident.

Industry response

Responses on this proposal were supportive. One of the respondents proposed that, where an Australian actuary produces an insurance liability valuation report, a suitable international actuary should be allowed to undertake the peer review.

APRA prudential approach

APRA would generally expect (without limiting the intent of the standard) that the group actuary would be employed within the insurance group. APRA is satisfied to proceed with the proposal, given the assurance provided by the need for the reviewing actuary ordinarily to reside in Australia and thereby to be familiar with Australian requirements. APRA is not prepared to accept that a non-resident group actuary, who may not be familiar with Australian requirements, can be presumed to offer peer review.

Paragraph 28 of draft GPS 520 incorporates APRA's proposal to allow group actuaries to be appointed for Category B and Category C insurers.

3.11 Group business plan

Original proposal

APRA proposed to accept business plans prepared on an insurance group basis (as it already does for the risk management framework) provided there is adequate detail about each APRA-authorized insurer in the group.

Industry response

Responses to this proposal were supportive.

APRA prudential approach

Paragraphs 19 and 20 of draft GPS 220 incorporate this proposal.

3.12 Cession limit

Original proposal

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

Industry response

A majority of submissions supported APRA's proposal with a preference to incorporate this expectation within prudential practice guide. A few proposals suggested that insurance group captives should be allowed to cede up to 90 per cent like other captives.

APRA prudential approach

This proposal is essentially a restatement of existing APRA policy but additional guidance has now been prepared. Paragraph 5 of draft GPG 245 incorporates this proposal.

APRA has decided to classify insurance group captives as Category E insurers (sole parent captive insurer). As a result, Category E insurers would be expected to cede up to 90 per cent. APRA-authorized subsidiary insurers would be expected not to cede more than 60 per cent to the insurance group captive.

Specific proposals applying to Category C: Foreign insurer operating as a foreign branch

3.13 Assets in Australia

Original proposal

APRA proposed to review and amend its assets in Australia requirements for foreign branches to recognise that a trust structure for the agent to hold assets in Australia may prove impractical for some forms of assets.

Industry response

There was general support for APRA's proposals. Specific comments are outlined below:

Premium receivables outstanding for more than six months. A few respondents objected to this suggestion, arguing that the risk of collectability for a company is the same as for a branch. Some suggested that, because the normal commercial terms allow for 90 days, the premium receivable should be disallowed when the receivable is over 90 days due from the date of inception.

Withdrawals from bank account to be authorised by agent. Submissions suggested that the agent should be allowed to delegate to an Australian resident who would meet APRA's fit and proper requirements.

Co-signatory arrangements for assets held by custodian. A few submissions suggested that day-to-day dealings should be allowed to be delegated to another person (e.g. accountant) up to a certain limit. One respondent stated that the custodian will not be in a position to administer the co-signatory requirements due to electronic instructions being issued. The suggestion was that the insurer should be responsible for administering co-signatory and delegated arrangements.

APRA prudential approach

Premium receivables outstanding for more than six months. Since branches are not separate legal entities, additional controls will be required over assets in Australia. The changes regarding receivables to be held by an agent on trust or by a custodian, where these assets can now be held in the name of the foreign insurer, reflect the need for these controls (refer to paragraph 24(b) of draft GPS 120).

Withdrawals from bank account to be authorised by agent. Where bank accounts are held in the name of the foreign insurer, not only the agent but also an 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 (refer to paragraph 24(c) of draft GPS 120).

Co-signatory requirements for assets held by custodian. APRA's proposal is to allow but not to require co-signatory arrangements. An agent may delegate authority to an authorised person who is a resident in Australia (refer to paragraph 22 to 23 and 25 of draft GPS 120). Where co-signatory arrangements are in place with the foreign insurer, the agent in Australia (or an authorised delegate of the agent who is resident in Australia) must maintain authority to issue final instructions to the custodian (refer to paragraph 23 of draft GPS 120). APRA expects the agent in Australia to be responsible for administering compliance with the co-signatory arrangements.

Remove requirement for real estate in Australia to be held by an agent or custodian. Paragraph 24(a) of draft GPS 120 incorporates this proposal.

3.14 Corporate agent

Original proposal

The Insurance Act has been amended to allow corporate agents in Australia. As a result, APRA is proposing that its fit and proper requirements be applied to corporate agents.

Industry response

Limited responses were received regarding this proposal but they were all supportive. One suggestion was that the corporate agent board should consist of two directors rather than three as proposed by APRA.

APRA prudential approach

APRA will proceed with the original proposal, including a requirement for at least three directors. Normally a casting vote by the chairman is sufficient in the case of a split vote where there is an even number of directors but that is not appropriate. Where there are only two directors, paragraph 25 of draft GPS 510 incorporates this proposal.

3.15 Group Actuary

Original proposal

Use of a group actuary who is not an Australian resident will be allowed.

Industry response

Responses on this proposal were favourable.

APRA prudential approach

Refer to paragraph 28 of draft GPS 520 for the amendment to the standard that incorporates APRA's proposal to allow group actuaries to be appointed for Category B and Category C insurers.

3.16 Group business plan

Original proposal

APRA proposed to accept business plans prepared on an insurance group basis (as it already does for the risk management framework) provided there was adequate detail about each APRA-authorized insurer in the group.

Industry response

Responses on this proposal were supportive. One respondent argued that it is impractical for group business plans to include the appropriate level of detail on individual branches.

APRA prudential approach

An insurer will have the option of using a group business plan or preparing a specific business plan for its operations. Paragraphs 19 and 20 of draft GPS 220 incorporate this proposal.

3.17 Cession limit

Original proposal

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

Industry response

A majority of submissions supported APRA's proposal with a preference to incorporate this expectation within a prudential practice guide.

APRA prudential approach

This proposal is essentially a restatement of existing APRA policy but additional guidance has now been prepared. Paragraph 5 of draft GPG 245 incorporates this proposal.

Specific proposals applying to Category D: Association captive insurer

3.18 Lower capital floor of \$2 million

Original proposal

APRA proposes to lower the floor for the calculated risk-based minimum capital requirement from \$5 million to \$2 million. APRA's expected buffer over the minimum capital requirement would increase from 20 per cent to 50 per cent when the insurer's minimum capital requirement was less than \$5 million.

Industry response

Although limited in number, submissions on this proposal were supportive. One suggested that the capital buffer should be in the prudential practice guide rather than specified in the prudential standard to allow insurers a transition from the requirements that apply when actual capital held is between \$4 million and \$5 million.

APRA prudential approach

The prudential standard has been varied so that the minimum capital requirement for Category D and Category E insurers can be as low as \$2 million (paragraph 16(b) of draft GPS 110), with the buffer specified in the prudential practice guide (draft GPG 110).

3.19 Outsourcing to related parties

Original proposal

APRA proposes that outsourcing of material business activities to related parties be required to be documented in written contracts.

Industry response

Although limited in number, submissions on this proposal were supportive.

APRA prudential approach

Paragraph 21(a) of draft GPS 231 incorporates this proposal.

3.20 Cession limit

Original proposal

APRA proposed to emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 90 per cent of gross written premium.

Industry response

Submissions on this proposal were supportive.

APRA prudential approach

This proposal is essentially a restatement of existing APRA policy but additional guidance has now been prepared. Paragraph 5 of draft GPG 245 incorporates this proposal.

Specific proposals applying to Category E: Sole parent captive insurer

3.21 Lower capital floor of \$2 million

Original proposal

APRA proposes to lower the floor for the calculated risk-based minimum capital requirement from \$5 million to \$2 million. APRA's expected buffer over the minimum capital requirement would increase from 20 per cent to 50 per cent when the insurer's minimum capital requirement is less than \$5 million.

Industry response

Although limited in number, submissions on this proposal were supportive. One respondent suggested that the capital buffer should be in the prudential practice guide rather than specified in the prudential standard to allow insurers a transition from the requirements that apply when actual capital held is between \$4 million and \$5 million.

APRA prudential approach

The prudential standard has been varied so that the minimum capital requirement for Category D and Category E insurers can be as low as \$2 million (paragraph 16(b) of draft GPS 110) with the buffer specified in the prudential practice guide (draft GPG 110).

3.22 Loan back to parent

Original proposal

APRA proposed to allow up to 100 per cent of the capital base of the sole parent captive to be lent back to the parent group on commercial terms.

Industry response

Submissions on this proposal were supportive.

APRA prudential approach

Paragraph 31 of draft GPS 114 incorporates this proposal.

3.23 Governance

Original proposal

APRA has agreed to board composition exemptions for current sole parent captives where there is no majority of independent directors, and proposed to apply this approach to all sole parent captives.

Industry response

A majority of the submissions supported APRA's proposal. There were some queries regarding the conditions attaching to the exemptions.

APRA prudential approach

An insurer can write to APRA to seek an adjustment to or exclusion from the current board composition requirements under paragraph 65 of GPS 510. The draft prudential practice guide (GPG 510) outlines the various conditions that may be attached to an adjustment or exclusion to allow use of an alternative board arrangement. In exercising its discretion, APRA may vary those conditions if they are not applicable to individual insurers. Refer to paragraphs 3 and 4 of draft GPG 510.

3.24 Cession limit

Original proposal

APRA proposed to emphasise that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 90 per cent of gross written premium.

Industry response

Submissions on this proposal were supportive.

APRA prudential approach

This proposal is essentially a restatement of existing APRA policy but additional guidance has now been prepared. Paragraph 5 of draft GPG 245 incorporates this proposal.

Chapter 4 – Harmonised Capital Adequacy

4.1 Previous paper

APRA released a discussion paper on *Capital adequacy for authorised deposit-taking institutions and general insurers* on 2 July 2007. That discussion paper set out details of proposed changes to the treatment of certain capital instruments and APRA's supervisory discretion over an insurer's capital base. Attachment C to that discussion paper set out the changes applicable to general insurers.

As explained in that discussion paper, APRA has taken the view, consistent with a number of overseas supervisors, that there are benefits in maintaining a broadly consistent approach to the definition of capital for ADIs and general insurers. Accordingly, APRA intended that a number of the proposed changes to capital adequacy for ADIs flow into amendments to prudential standards for general insurers, particularly the capital standards.

Industry response

Submissions received from insurers in response to the discussion paper were high-level comments only, since some insurers wished to see how the proposals would translate into the general insurance capital standards before providing more detailed comments. There were no adverse comments about the approach of harmonising capital adequacy for insurers at Level 1⁴ with that for ADIs at Level 1.

Many of the high-level comments focused on Level 2 aspects of the proposals. While they are not relevant for this round of changes to the capital standards, which focus on capital adequacy at Level 1, APRA will consider the submissions when preparing the prudential standards to be released as part of its proposals for consolidated supervision.

APRA prudential approach

The changes have now been incorporated in the following draft prudential standards as part of this consultation package:

- draft GPS 110 Capital Adequacy; and
- draft GPS 112 Capital Adequacy: Measurement of Capital.

Industry will now be in a better position to comment on the capital changes in the general insurance context. The table at Attachment 1 sets out further detail on these changes. Where there are departures from any of the proposals in the discussion paper, they are specifically indicated in that table.

4.2 Departures from ADI capital changes

While APRA's aim is to harmonise the approach to capital adequacy for ADIs and general insurers, there are a number of areas where this is not possible at present. In many cases, this is due either to inherent differences between the ADI and general insurance industries or to the implementation of Basel II on matters that are specific to ADIs. Further alignment in some areas may be possible when Level 2 capital requirements are implemented for general insurance groups as part of consolidated supervision.

Areas of departure from the ADI capital standards include the following:

- the clearly defined Pillar 1⁵, Pillar 2⁶ and Pillar 3⁷ approach to supervision of ADIs has not yet been adopted in the supervision of insurers;
- there is currently no concept for insurers of an Internal Capital Adequacy Assessment Process (ICAAP), as set out in APS 110;

⁴ Level 1 refers to individual APRA-authorised entities. Level 2 refers to consolidated groups.

⁵ Pillar 1 essentially consists of minimum capital requirements including specific capital charges for operational risks.

⁶ Pillar 2 consists of the institution's own assessment of their capital adequacy and enhanced supervision of capital management.

⁷ Pillar 3 consists of disclosure requirements.

- insurers do not have to recognise operational risk unless they have an internal model. There is no standardised approach;
- general insurance capital standards currently make no mention of Level 3 assessment while ADI standards do;
- the proposals for deductions at Level 1 that are meant to reinforce Level 2 deductions will not be implemented at this stage but will be deferred to the next consultation package on consolidated supervision; and
- the proposal for clarification of the treatment of non-equity support (item 2.8 in the discussion paper) will not be incorporated in the capital adequacy standards for general insurers. While it is desirable for an ADI not to have significant exposures to equities, equities are a legitimate part of an insurer's balance sheet. Therefore, the restrictive limits on investments in equities by ADIs have not been adopted for insurers. The rules relating to capital support have been included in the ADI standards because capital support can be used as an alternative to equity investment and such capital support is therefore also restricted. There are very specific rules about an ADI investing in other ADIs that are aimed at addressing the contagion risk in the industry. That contagion risk issue is not as prominent for insurers.

Chapter 5 – Investment capital factors for equities and real property

APRA proposes to increase the investment capital factors applying to equities and real property from eight per cent to 25 per cent for listed equities and listed property trusts, and from 10 per cent to 30 per cent for unlisted equities and direct property investments. At the same time, APRA will recognise that a 'look through' approach should apply to unit trust investments where it is administratively practical to do so.

In conjunction with the revised investment capital factor applicable to equities, APRA will recognise the risk-reducing effect of derivative hedge positions for equity portfolios when calculating the investment capital charge using the prescribed method.

APRA has consulted informally with the insurance industry on these changes. The industry is concerned with the quantum of change to the investment capital factors and with transitional arrangements. Nevertheless, the limited feedback provided so far indicates that there is general recognition that the existing factors are too low.

Principle

Overall, APRA's target for the MCR is a 99.5 per cent probability of sufficiency over a one-year time period. APRA's capital framework for general insurers has been in place since 2002 and it is now appropriate for APRA to review whether its framework is achieving the stated target level of sufficiency. Initial work has shown that the investment capital factors currently applying to property and equities are well below levels that are consistent with the desired target level of sufficiency.

Current position

The relevant current investment capital factors for the prescribed approach to calculating the MCR are:

- eight per cent for listed equity instruments and units in listed trusts, and
- 10 per cent for direct holdings of real estate, unlisted equity instruments and units in unlisted trusts.

Unit trusts are classified simply as listed or unlisted, without regard to the underlying investments.

Investment capital factors are applied to physical positions and there is no recognition of the economic benefits of hedging. For example, the capital factor for listed equities is applied to the physical position and a charge for counterparty risk of derivatives is added for any derivative position that is put in place to hedge the risk of the physical equity position. The result is that the hedged equity position requires more capital to be held than the physical position without the hedge in place.

Basis of analysis

Investment capital factors are based on the volatility of returns and realisable values of different type of assets. The greater the volatility, the greater the likelihood of a significant downward revaluation and hence impact on the capital position of an insurer.

Two approaches have been used to assess the investment risk capital factors:

- primary research about volatility of relevant markets; and
- comparisons with overseas regulators and other regulated industries.

Primary research conducted on both the Australian equity market and global equity markets indicates that the 0.5 percentile annual volatility for shares varies between about 30 per cent and 50 per cent, depending on the period and market chosen. These figures are much greater than the eight per cent investment capital factor currently applied to listed equity instruments. However, there are arguments for using smaller factors than suggested by this primary research.

The investment capital factors are intended to reflect the extreme losses that can occur. Share market volatility varies over time. The five-year rolling volatility of the Australian share market has been lower since 1990 than previously. For world markets, volatility has not exhibited any trend, instead going through cycles or periods of low and high volatility. The nature of investment markets, however, is that periods of high volatility can commence very suddenly, often in response to a system shock.

Diversification of investment risk occurs at two levels: diversification between investments in different asset classes ('inter-asset-class diversification') and diversification between investment risk as a whole and the remainder of an insurer's risk ('inter-risk diversification'). APRA believes it is appropriate to give some recognition to diversification and is proposing to do so by selecting factors that are at the lower end of the ranges of non-diversified risk as indicated by primary research.

There is a lack of reliable data about the volatility of property prices. The only data sets of a reasonable size are for listed property trusts. Using similar techniques to those applied above to shares, the volatility of one-year returns for individual listed property trusts at the 0.5 percentile was estimated to be around 40 per cent. This figure may be overstated somewhat by distortions caused by income distributions. The volatility of returns on the ASX Listed Property Trust (LPT) index at the 0.5 percentile was estimated to be around 20 per cent. An investment across the ASX LPT index has a high level of diversification across properties. On the other hand, an insurer holding a property directly will generally have low liquidity and a high degree of concentration of investment risk.

The Basel II capital adequacy requirements for ADIs will include a 300 per cent risk-weighting for listed equities and a 400 per cent risk-weighting for unlisted equities. With a minimum capital adequacy ratio of eight per cent, these weightings correspond to a 24 per cent investment capital factor for listed equities and 32 per cent for unlisted equities. In Europe, in the recent third quantitative impact study for the implementation of Solvency II, the factor applied to listed equities before diversification benefits was 32 per cent.

APRA prudential approach

APRA proposes a 25 per cent investment capital factor for listed equity instruments (see draft GPS 114 Attachment A) and units in listed trusts where a look through approach is not practical. This figure is lower than that indicated by primary research into share market volatility over the last 100 years, and hence gives some implicit credit for the mitigating effects of diversification.

APRA is also proposing that units in listed property trusts have an investment capital factor of 25 per cent (see draft GPS 114 Attachment A). This accords with primary research and is consistent with the treatment of units in other listed trusts.

Unlisted equity instruments are generally more uncertain as to liquidity and realisable value than listed equity instruments; and hence, APRA proposes an investment capital factor of 30 per cent. Similarly, it is proposed that direct holdings of real estate by an insurer attract the same investment capital factor of 30 per cent. For both changes, see draft GPS 114 Attachment A.

APRA proposes to allow insurers to treat investments in unit trusts on a 'look-through' basis (see draft GPS 114 Attachment A), whereby the capital factors for investments in a trust will be determined based on the underlying assets of the trust where it is administratively practical to do so. Where this is not administratively practical for unlisted trusts, the investment capital factor will be 30 per cent.

Currently, the capital charge for derivatives under the prescribed method only covers counterparty default risk. APRA recognises that derivatives can be used to reduce the equity risk position of an insurer that holds both physical positions in equities and derivatives to hedge those positions. The risk-reducing role that derivatives may play in an insurer's investment strategy clearly warrants recognition now that APRA is proposing that the investment risk capital factor on equities be increased to a level that is significantly higher than the current factor.

APRA proposes that the investment capital factor apply to the effective net exposure after allowing for the hedging effect of equity and commodity derivatives (see draft GPS 114 paragraphs 44 to 47). To achieve this, draft GPS 114 includes a charge on the market risk of derivatives. This charge can be negative, thereby offsetting the charge on the physical portfolio. The capital charges arising would be in addition to the counterparty credit risk charge for derivatives.

Terminology

The terms 'investment capital charge' and 'investment capital factor' will be replaced in the final prudential standards with the terms 'asset capital charge' and 'asset capital factor'. The use of 'asset' more clearly reflects that the capital charges apply to reinsurance recoverables and other assets of an insurer, not just its investments.

Chapter 6 – Miscellaneous

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

The SRR Act received Royal Assent on 24 September 2007. The Act implemented initiatives announced in the discussion paper, *Streamlining Prudential Regulation: Response to 'Rethinking Regulation'*,⁹ released by the Government on 4 December 2006. It includes a number of changes to the Insurance Act. While many changes were effective upon Royal Assent, other changes are effective from 1 January 2008.

The SRR Act includes amendments to the Insurance Act that:

- 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.

As a result of these amendments, a number of amendments are required to APRA's prudential standards, particularly to GPS 310 and GPS 520, to reconcile these prudential standards with the revised provisions of the Insurance Act.

APRA will amend all references to "Approved Auditor" and "Approved Actuary" to "Appointed Auditor" and "Appointed Actuary", respectively, in the prudential standards to reflect the fact that APRA will no longer approve auditors and actuaries appointed by insurers. (This change occurs throughout any standard where such references occur, particularly GPS 310 and GPS 520). The requirement for an insurer to appoint an auditor and actuary remains. Insurers must apply eligibility criteria when considering the appointment of an auditor and actuary (draft GPS 520, paragraphs 24 to 25). These are consistent with the eligibility criteria for appointment of auditors and actuaries by life companies authorised under the *Life Insurance Act 1995*.

APRA will make other amendments to the prudential standards, where necessary, to ensure consistency with the streamlined exemption regime (particularly paragraphs 9 and 15 to 20 of draft GPS 310 relating to exemption from the requirement for an insurer to appoint an actuary) and new whistleblower protection provisions (draft GPS 510, footnote 16 and draft GPS 520, footnote 19 and 20).

These proposals do not represent a substantial change to the requirements imposed upon insurers under the prudential standards.

6.2 Kangaroo bonds

APRA proposes to amend GPS 120 so that kangaroo bonds would not be excluded from being assets in Australia in cases where all of the following criteria are satisfied (draft GPS 120, paragraph 11):

- (a) the underlying bonds are owned by Austraclear's nominee and are registered on Austraclear;
- (b) the 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 solely payable 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.

Section 28 of the Insurance Act requires a general insurer to hold assets in Australia (net of any goodwill and other assets excluded under the prudential standards) of a value equal to or greater than its liabilities in Australia. APRA has taken the approach of excluding certain assets under the existing GPS 120 where the assets are not considered assets with 'prudential value' or where there is doubt as to whether the assets would be considered assets in Australia by a court of law in the winding up of an insurer.

⁹ <http://www.treasury.gov.au/contentitem.asp?NavId=27&ContentID=1199>

Debt assets not satisfying certain criteria specified in GPS 120 are currently excluded from being assets in Australia under GPS 120. The usual structure of kangaroo bonds means that they may not satisfy all the criteria and such bonds are therefore excluded from being assets in Australia. APRA's position has been that assets such as kangaroo bonds should not be treated as assets in Australia because the law is far from certain on whether such bonds are assets in Australia.

In the past year, there has been considerable industry interest in the issue of whether kangaroo bonds should be excluded from being assets in Australia. APRA has engaged in consultations with certain segments of the industry to understand their views and concerns. APRA recognises that kangaroo bonds may be a source of high quality assets for insurers but remains mindful of the possibility that not all kangaroo bonds may amount to assets in Australia, depending on how they are structured.

Following this informal consultation, APRA proposes not to exclude kangaroo bonds from being assets in Australia under GPS 120 if the five new criteria in draft GPS 120 are satisfied. These criteria are intended to create important points of connection with Australia that will minimise the likelihood of a court concluding that the bonds are not assets in Australia. Inclusion of this proposal in this paper provides an opportunity for wider public consultation.

6.3 Other minor amendments

Since determination of most of the existing suite of prudential standards in 2006, some issues of interpretation have arisen. APRA is taking the opportunity to make minor changes to existing standards to clarify their intent and facilitate their practical application.

A significant structural change is the separation from GPS 110 of its numerous attachments, and their re-labelling as separate prudential standards to a comprehensive suite of standards on capital adequacy. They are as follows:

Draft Prudential Standards and Draft Prudential Practice Guides	Equivalent Current Prudential Standards and Prudential Practice Guides
GPS 110 Capital Adequacy	GPS 110 Capital Adequacy excluding the attachments
GPG 110 Capital Adequacy: Capital Management	No equivalent PPG but some material on capital management has been taken from GPG 200 Risk Management
GPS 112 Capital Adequacy: Measurement of Capital	GPS 110 Capital Adequacy Attachment A
GPS 113 Capital Adequacy: Internal Model Based Method	GPS 110 Capital Adequacy Attachment B
GPS 114 Capital Adequacy: Investment Risk Capital Charge	GPS 110 Capital Adequacy Attachment D
GPS 115 Capital Adequacy: Insurance Risk Capital Charge	GPS 110 Capital Adequacy Attachment C
GPS 116 Capital Adequacy: Concentration Risk Capital Charge	GPS 110 Capital Adequacy Attachment E and F
GPS 110 Capital Adequacy paragraphs 36 to 42	GPS 110 Capital Adequacy Attachment G
GPS 112 Capital Adequacy paragraphs 34 to 37	GPS 110 Capital Adequacy Attachment H

As a result of this change, many cross-referencing amendments have been made to the standards.

The other significant structural change is the introduction of GPS 001. GPS 001 will serve as a glossary of common terms used across all the prudential standards and will include a number of definitions; it also ensures consistency of interpretation of these common terms. As a result, existing definitions of common terms in prudential standards have been moved to GPS 001.

APRA will make minor amendments to clarify the intent of certain requirements in prudential standards. The more significant ones are set out in the table in Attachment 2.

Many other amendments consequential to the SRR Act and minor amendments to clarify APRA's intent relate only to technical drafting changes, and have not been identified in this paper. These minor amendments are incorporated in the draft prudential standards.

Attachment 1 – Table of capital adequacy changes

Chapter reference in 2 July 2007 discussion paper	Description of change as set out in 2 July 2007 paper	Whether applicable to general insurers	Paragraph of draft GPS 110 or draft GPS 112 where change made
2.1	Level 1 and Level 2	Applicable. Level 1 definition – propose to change GPS 110 Level 2 – issue to be considered as part of consolidated supervision.	No change necessary
2.2	Supervisory discretions	Applicable – propose to change GPS 110 (contrary to what is stated in 2 July 2007 discussion paper). APRA believes it is equally important, for ADIs and insurers, to be able to set minimum requirements on the quality and quantum of capital. It is therefore proposed that there be alignment between the ADI and general insurance standards whereby APRA may require a regulated institution to hold a greater level of Tier 1 capital than the regulatory minima and APRA may set higher minimum requirements on the components of capital (e.g. Fundamental Tier 1 capital) where it believes there are sound prudential reasons to do so.	Draft GPS 112, paragraph 33
2.3	Quality of capital Form and substance issue Accounting adjustments	Applicable – propose to change GPS 110	Draft GPS 112, paragraph 10-12 and 14
	Capital upgrading Intra-group capital transactions and guarantees	Applicable – issues to be considered as part of consolidated supervision.	n/a
2.4	Deduction from Tier 1 and Tier 2 capital	Applicable – issue to be considered as part of consolidated supervision.	n/a
2.5	Treatment of undercapitalised subsidiaries	Applicable – issue to be considered as part of consolidated supervision.	n/a
2.6	Treatment of investments in associates and subsidiaries	Applicable – issue to be considered as part of consolidated supervision.	n/a

Chapter reference in 2 July 2007 discussion paper	Description of change as set out in 2 July 2007 paper	Whether applicable to general insurers	Paragraph of draft GPS 110 or draft GPS 112 where change made
2.7	Treatment of equity investments in excess of limits and treatment of underwriting exposures for limit purposes	Not applicable.	n/a
2.8	Clarification of the treatment of non-equity support	Not applicable (contrary to what is stated in 2 July 2007 discussion paper, see discussion on this point in Chapter 3.2 of this Response Paper)	n/a
2.9	General Reserve for Credit Losses included in capital	Not applicable.	n/a
3.1	Interest eligible to be paid on Lower Tier 2 capital instruments	Applicable – propose to change GPS 110	Draft GPS 112, Attachment B, paragraph 10(c)
3.2	Claims in liquidation	Applicable – propose to change GPS 110	Draft GPS 112, Attachment B, paragraphs 9(c)(iii) and 10 (j)
3.3	Dividend stoppers	Applicable – propose to change GPS 110	Draft GPS 112, Attachment B, paragraph 8(d)
3.4	Tap stock	Applicable – propose to change GPS 110	Draft GPS 112, Attachment A, paragraph 1(f) and Attachment B paragraphs 5(c) and 13(a)
3.5	Application of cross-default clauses	Applicable – propose to change GPS 110	Draft GPS 112, Attachment A, paragraph 1(h) and Attachment B, paragraphs 5(l) and 10(m)
3.6	Applicable forms of default	Applicable – propose to change GPS 110	Draft GPS 112, Attachment A, paragraph 1(e)(iv) and Attachment B, paragraph 5(f)(iv)
3.7	Compound instruments containing embedded derivatives	No action at this time	n/a
3.8	Transition arrangements	Applicable – propose to change GPS 110	Draft GPS 112, paragraph 37

Attachment 2 – Table of minor amendments

Description of amendment	Paragraph reference in standard
To clarify that, for Category C insurers, the calculation of net assets in Australia includes excess technical provisions	Draft GPS 110, paragraph 11
To align the provisions for deduction of goodwill with those under the ADI capital standards	Draft GPS 112, paragraph 25(a)
To exclude assets under a fixed or floating charge from being assets in Australia in order to be consistent with the position under the reporting framework	Draft GPS 120, paragraph 22
To clarify what amounts to an operationally independent review of a risk management framework	Draft GPS 220, paragraph 12
To clarify that, while APRA's prior agreement is not required for an insurer to rely on group material (risk management strategies, risk management declarations, reinsurance management strategies, reinsurance arrangements statements and FCRs), APRA reserves the right to require versions of these documents for each individually licenced branch or subsidiary after group documents are submitted.	Draft GPS 220 paragraph 4, draft GPS 230, paragraph 4 and draft GPS 310, paragraph 5 (existing requirement for APRA's prior agreement has been deleted)
To clarify who should sign the Reinsurance Declaration if the CEO of an insurer is also the Reinsurance Manager and who should sign the Financial Information Declaration if the CEO of an insurer is also the CFO.	Draft GPS 220, paragraph 42, draft GPS 230, paragraph 34
To clarify that only Limited Risk Transfer Arrangements approved by APRA as reinsurance arrangements may be treated as reinsurance for the purpose of calculating MER	Draft GPS 230, paragraph 13
To clarify that service level agreements recommended for outsourcing arrangements with related entities are not required to meet minimum requirements specified in the standard for outsourcing agreements	Draft GPS 231, footnote 3
To consolidate all eligibility criteria for Reviewing Actuaries in GPS 520 (as some currently sit in GPS 310).	Existing draft GPS 310 paragraph 67, draft GPS 520 paragraph 26 to 28
To allow for an insurer to apply for exemption from the peer review requirement where its circumstances warrant the exemption. APRA emphasises the importance of the general rule for all insurers to be subject to the peer review requirement but recognises that flexibility may be required for insurers in certain extenuating circumstances	Draft GPS 310, paragraph 89
To clarify the treatment of premium liabilities relating to insurance and reinsurance contracts written on a long-term (or continuous) basis	Draft GPS 310, paragraph 78
To clarify that 'APRA statutory reporting requirements' is not restricted to financial reporting requirements	Draft GPS 510, footnote 6
To clarify scope of the restriction on the Appointed Auditor and Appointed Actuary being from the same firm	Draft GPS 510, paragraph 15, draft GPS 520, paragraph 27

Attachment 3 – Cost-benefit analysis

Entities affected by these proposals

There are currently 132 authorised insurers in Australia. The proposals in this paper will affect all existing authorised insurers to varying degrees.

Assessing the costs

As part of developing prudential requirements, APRA undertakes an assessment of costs and benefits to stakeholders likely to be affected by any proposals. If significant costs are likely to be incurred by stakeholders, APRA may be required to prepare a Regulation Impact Statement (RIS).

APRA expects that the majority of its proposals will be captured within the RIS prepared for the introduction of the DMF & DOFI Act. However, the proposals relating to reinsurance recoverables from non-APRA-authorised reinsurers and the investment capital factors for equities and real property would require a separate RIS to be prepared by APRA.

In keeping with *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (the Banks report), APRA is further enhancing its approach to cost-benefit analysis. These enhancements will generally focus on obtaining more granular cost data from the affected stakeholders, in particular the affected industry. The Business Cost Calculator (BCC) is the preferred tool of the Commonwealth Government in calculating business compliance costs. The BCC can be accessed at: <http://online.industry.gov.au/costingmodel>.

If insurers prefer they may wish to provide information on the costs of the proposals separately along with the assumptions underlying the estimate of costs.

The outcomes of the analysis of costs will be used, where adequately robust, in preparing a RIS for the introduction of the proposals relating to reinsurance recoverable from non-APRA-authorised reinsurers and investment capital factors for equities and real property.

Assessing the benefits

Most of the proposals described in this paper are intended to reduce the cost of compliance while maintaining or enhancing the level of protection to Australian policyholders. APRA is interested in any information insurers in those categories would be able to provide about the reduction in cost of compliance. These are the benefits of the proposals to insurers.

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

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

Submissions regarding benefits identified, where the analysis is suitably robust, will be used in formulating the RIS for the introduction of the proposals relating to reinsurance recoverables from non-APRA-authorised reinsurers and investment capital factors for equities and real property.



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