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MEMBER

14 March 2012

To all CEOs (or equivalent) of general insurers and Level 2 insurance groups

The horizontal requirement of the Insurance Concentration Risk Charge (ICRC)

Background

As you know, APRA is reviewing and updating its capital standards for general insurers and life insurers. The aims of the review include improving the risk sensitivity of the standards and achieving better alignment across APRA-regulated industries. APRA has been consulting with industry on these proposals, including the proposed approach to determining the ICRC, since May 2010.

During 2011, in response to the quantitative impact study results and submissions, APRA released two response papers that refined and provided clarity on the capital proposals, including the ICRC. The December 2011 response paper was accompanied by draft prudential standards.

Submissions on the December 2011 package closed on 24 February 2012. APRA is currently considering the issues raised by industry in this latest round of consultation. APRA intends to release final versions of the capital standards in May 2012 and the draft Prudential Practice Guide on the ICRC in September 2012. The revised prudential standards will be effective from 1 January 2013.

Horizontal requirement of the ICRC

As set out in the December 2011 response paper, an insurer's capital position can be adversely affected over a year by the occurrence of a succession of smaller-sized loss events, including the cost of purchasing additional reinstatements of reinsurance cover. As a result, APRA considers it appropriate for the capital framework to include a component that considers the net impact to an insurer of a series of losses of varying size and frequency over a one-year time horizon. This is known as the 'horizontal requirement'. The December 2011 response paper also set out further detail in respect of the calibration and calculation of the horizontal requirement.

Written submissions received by APRA have expressed concerns in relation to the timing proposed for the implementation of the horizontal requirement. Issues raised in submissions include:

- the need for insurers to have additional time to determine and implement an appropriate strategy, such as increased reinsurance protection or increased capital and to increase premium rates if necessary in response to the chosen strategy;
- the availability and cost of certain reinsurance covers in the current reinsurance market; and
- the need for further clarity on certain aspects of the calculation of the horizontal requirement.

Submissions requested that APRA provide an industry wide transition period for the horizontal requirement of the ICRC.

APRA has considered the issues raised by industry in relation to the potential implementation issues for this aspect of the ICRC. As a result, **APRA is proposing to defer the effective date of the horizontal requirement of the ICRC until 1 January 2014. This deferral is for both insurers and Level 2 insurance groups.**

The deferral in the start date of the horizontal requirement will allow insurers to:

- further develop, where needed, their understanding of the operation of the horizontal requirement as detailed in *Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge* (GPS 116); and
- finalise and implement any strategies for managing the horizontal requirement.

This would mean that, from 1 January 2013 to 31 December 2013, insurers will calculate and report their prescribed capital amount based on the revised capital framework in relation to asset risk, asset concentration risk, insurance risk, ICRC, operational risk and aggregation benefit. The calculation of ICRC, however, will be based only on the vertical requirement as outlined in paragraphs 8(a) and 8(c) of the draft of GPS 116 and the lenders mortgage insurer concentration risk charge under paragraph 8(d) of the draft of GPS 116 (if applicable). The horizontal requirement would not be included in the calculation of the ICRC under paragraph 8 of draft GPS 116 until 1 January 2014.

APRA will require each insurer to calculate the quantum of the horizontal requirement from 1 January 2013 and include this in its Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP will need to set out how the horizontal requirement impacts its target and trigger capital levels and will need to specifically address planned capital, reinsurance or other management actions that will ensure that the insurer can fully meet the horizontal requirement by no later than 1 January 2014. Insurers should be in a position to provide this information to APRA by no later than 1 January 2013.

Should you have any queries in relation to this letter, please contact Kate Bible (02 9210 3502) or email (InsuranceCapital@apra.gov.au).

Yours sincerely



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