Chapter 3 - Proposed changes to reporting framework

3.1 Introduction

Implementation of AASB 17 will change the basis for reporting to APRA on insurers' financial performance and the valuation of insurance contract assets and liabilities. APRA is proposing to align its reporting framework with AASB 17. Insurers will be able to use the AASB 17 accounting policies and principles to report to APRA financial performance, insurance asset and liability items. This will eliminate the need for insurers to maintain two separate accounting reporting systems. Notwithstanding, for life insurance, there are a number of areas where APRA proposes to prescribe reporting requirements that may deviate from AASB 17 given the requirements of the Life Act.

APRA is also proposing to enhance the granularity of its reporting groups to provide improved and more detailed insights on product groups. Further details on the proposed new product groups are listed below.

APRA encourages insurers to make public the different accounting and capital policies adopted each year. This approach will enhance transparency, comparability and market discipline.

3.2 New product groups

APRA indicated the possibility of additional product groups to the industry in 2019. Most insurers understood the need for improved data collection for greater product group transparency and product sustainability. APRA's new reporting groups will look to address concerns that information reported to APRA at existing levels constrains the effectiveness of monitoring sustainability and performance of certain products.

APRA recognises that the new proposed product groups for APRA reporting purposes may impose an additional burden for insurers. However, implementation of AASB 17 provides an opportunity to substantially improve the foundations for future reporting and analysis while insurers are making revisions to their systems and reporting approaches to accommodate the new accounting standard. APRA considers the additional burden of more granular reporting is outweighed by the benefits of improved performance information to support management of insurance risk by insurers, as well as enhanced prudential oversight. APRA also considers standardised ongoing reporting will be less burdensome than ad hoc individual reporting group requests. APRA is therefore eager to improve the granularity of product performance information in conjunction with its integration of AASB 17.

More broadly, APRA is designing new collections to be based on data models that can be used for multiple purposes. Forthcoming collections will move away from form-based returns to concept-dimension models, which allows collections to be changed or extended without needing to be entirely redeveloped. By collecting data at a granular level, APRA aims

to reduce the data burden on the industry, by minimising duplication of collections and reducing the number of ad-hoc data requests in future.

APRA is seeking feedback on the challenges entities may face in the future given the new product groups and classes (including any transitional challenges).

3.2.1 General insurers

From 1 July 2023, APRA is proposing to introduce two new product groups under Prudential Standard GPS 001 Definitions (GPS 001) and Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge (GPS 115):

- Directors and Officers (D&O) insurance: D&O is currently included within the professional indemnity product group. Professional indemnity insurance focuses on claims against financial loss, personal injury or property damage arising from an error or omission in the performance of professional services. D&O insurance focuses on the personal assets of corporate directors and officers, and their spouses, against actual or alleged wrongful acts in managing a company. Given the inherent differences between the intention and performances of these products, it is important to split the two groups in order to provide greater product transparency.

  APRA proposes to define D&O as follows:

  D&O covers directors and officers of a company, and the company itself, for liability in the event of a legal action brought for alleged wrongful acts in their capacity as directors and officers. Cover for legal expense is generally included in this type of policy.

  APRA proposes that the definition of professional indemnity be similarly redefined to no longer include D&O.

- Cyber insurance: The demand and supply of cyber insurance has been growing both globally and locally, as are concerns around cyber-related claims. This new product group will help APRA identify any emerging claims trends and sustainability of the product.

  APRA is currently eliciting views from the industry to help develop the definition of cyber insurance via the National Claims and Policies Database statistics consultation process. Once finalised, APRA will use the same definition in the reporting standard for the product group data collection.[4]

APRA will incorporate feedback from insurers on the definitions of D&O and cyber insurance in the draft prudential standards.

[4] APRA has outlined a proxy definition of cyber insurance in the instruction for insurers to reference for the 2020 Quantitative Impact Study (QIS).

3.2.2 Life insurers

From 1 July 2023, APRA is proposing to introduce two new reporting categories under Reporting Standard LRS 001 Reporting Requirements (LRS 001):

- Participating; and
- Non-participating.

Participating and non-participating products have different risk factors for policyholder and legislative requirements for insurers. Therefore, having two separate reporting categories would provide clarity for APRA and allow greater visibility on profitability and risk profiles. Under each participating and non-participating reporting category, APRA is proposing to introduce the following new product groups:

	New product groups under participating and non-participating
L1.	Conventional
L2.	Annuity with longevity risk
L3.	Individual[5] death – stepped[6] premium **(new)**
L4.	Individual TPD – stepped premium **(new)**
L5.	Individual trauma – stepped premium **(new)**
L6.	Individual DII – stepped premium **(new)**
L7.	Individual death – other **(new)**
L8.	Individual TPD – other **(new)**
L9.	Individual trauma – other **(new)**
L10.	Individual DII – other **(new)**
L11.	Group[7] death **(new)**
L12.	Group TPD **(new)**
L13.	Group trauma **(new)**
L14.	Group DII
L15	Investment linked

[5] See LRF 750.0 paragraph 16 for the definitions of 'Death', 'TPD', 'Trauma' and 'DII'.

[6] Stepped premium policies are the policies where premiums increase each year according to risk factors (i.e. age). Other individual policies are the individual policies that are not stepped premium policies (e.g. level premium policies and hybrid stepped premium policies).

[7] See LRF 750.0 paragraph 13 for the definitions of 'Group' and 'Individual'.

	New product groups under participating and non-participating
L16	Investment with discretionary additions
L17	Other investment policy
L18	Annuity without longevity risk
L19	Other

Currently, insurers report financials of death, TPD and trauma in a single APRA product group called lump sum. APRA proposes to separate these three categories given that death, TPD and trauma have different risk profiles, characteristics and profitability levels. Separating the three would provide APRA with greater visibility on the level of profitability or loss, and allow for early intervention if required.

The majority of life insurance products sold in Australia have been stepped premium products. However, there has recently been a rise in the popularity of level premium products. The two products are different in terms of lapse risk, profitability and capital profile. APRA therefore proposes to separate the two as this would provide APRA with greater visibility on emerging trends, and the impact on profitability and regulatory capital.

3.2.3 Friendly societies

No new product groups are proposed for friendly societies. However, APRA is proposing to ask friendly societies to identify the types of benefit fund. Specifically:

- identify whether a benefit fund is a defined contribution fund or a defined benefit fund; and
- identify whether a defined benefit fund pays surplus to members, to the management fund or neither.

3.2.4 Private health insurers

No new product groups are proposed for PHI, but reflecting APRA's desire to improve understanding of the non-insurance business of insurers, and their potential to generate prudential risks, APRA is proposing that the definition of health-related business is further clarified.

From 1 July 2023, APRA proposes the definition of health related (insurance) business to include provision of overseas visitors cover and overseas student health cover. This includes hospital treatments, general treatment and ambulance. Health related (non-insurance) business should include other medical service businesses operated by insurers (such as dental and optical centres), as well as other non-insurance business (such as medical centres and agency businesses).

Health related (non-insurance) businesses are classified as retail businesses, and therefore do not fall under the remit of AASB 17.

3.3 Product groups allocation principles for all insurers

The industry has flagged that the Groups of Insurance Contracts (GICs) that insurers will determine under AASB 17 will not necessary mirror the APRA product groups. In this context, APRA is proposing insurers allocate the AASB 17 financials to APRA product groups where it is not possible to clearly assign AASB 17 financials by APRA product groups. This position addresses the risk of insurers preparing a separate reporting basis for APRA.

APRA proposes to state a number of principles for insurers to follow when allocating AASB 17 financials to APRA product groups. These principles are to assist APRA in obtaining meaningful data for analysis of profitability by APRA product groups. The allocation principles are as follows:

- Principle 1: Allocation of AASB 17 income statement items should be performed in a way that reflects the underlying profitability of each APRA product group;
- Principle 2: A systematic and rational approach should be applied;
- Principle 3: The approach applied should be consistent over time;
- Principle 4: The aggregate of the allocated numbers across APRA product groups should be consistent with AASB 17 numbers reported on a statutory basis;
- Principle 5: Allocation of CSM – The approach applied should result in reported CSM (or loss component where relevant) and insurance service result amounts that reflect the expected relative profitability of each APRA product group – ie. no offsetting of profit and losses; and
- Principle 6: A single allocation approach need not necessarily be applied. Insurers could apply different allocation approaches across AASB 17 items.

APRA is proposing insurers prepare a document outlining how they have applied the allocation principles. In relation to the insurers that are participating in the 2020 QIS, APRA has requested the participating insurers prepare this document and submit it to APRA as part of the QIS workbook submission.

APRA is seeking feedback from the industry on whether the principles outlined above are adequate and appropriate. APRA is also seeking suggestions from the industry on ways to make the allocation principles more effective.

3.4 Reporting direction for life insurers

For reporting of accounting financials to APRA, APRA proposes that insurers determine valuation of insurance and reinsurance liabilities and assets separately for:

1. each statutory fund;
2. each of the ordinary and superannuation classes within a statutory fund;

3. each of the Australian participating, overseas participating and non-participating categories within a class; and

4. each of the subcategories within a category, where subcategory is defined in the Life Act.

However, for non-participating risk business within a statutory fund, insurers may choose to determine insurance and reinsurance assets and liabilities at a combined level across ordinary and superannuation classes within the statutory fund and apply the allocation principles outlined above to allocate the results for APRA reporting of ordinary and superannuation classes.[8]

APRA has previously considered retaining the existing requirement without any exemption outlined in LPS 001 that a related product group must not extend over subcategories, where a subcategory is defined in the Life Act. This requirement would allow APRA to have visibility over standalone views of insurance and reinsurance assets and liabilities by each subcategory, category, class and statutory fund to support the principles, and effectively administer the requirements, of the Life Act.

However, APRA has received feedback from insurers that there would be circumstances where this requirement would lead to dual preparation of accounts for APRA because AASB 17 may not allow the establishment of separate GICs by the Life Act reporting structure. APRA understands the majority of these circumstances will relate to grouping of insurance and reinsurance contracts across ordinary and superannuation classes. For example, a number of insurers have benefits in a contract that extend across ordinary and superannuation classes and hold outwards (or inwards) reinsurance contracts where the treaties cover benefits across ordinary and superannuation classes. In these circumstances, AASB 17 may not allow insurers to establish separate groups of insurance and reinsurance contracts by ordinary and superannuation classes thereby resulting in dual preparation of accounts for APRA and ASIC if APRA retains the existing LPS 001 grouping requirement.

On that basis, APRA proposes to provide a reporting exemption for non-participating risk businesses, where insurers may choose to determine insurance and reinsurance assets and liabilities at a combined level across ordinary and superannuation classes. APRA understands that this proposal would significantly reduce regulatory burden among insurers for the preparation of reports for APRA, and would not have a material impact on APRA's ability to supervise and understand insurers' financial and risk profiles.

For other cases, APRA proposes that insurers continue to determine insurance and reinsurance assets and liabilities separately in accordance with the Life Act reporting structure (ie. following the requirements 1 to 4 outlined above). For example, for an investment linked benefit with an insurance rider benefit, AASB 17 may not allow disaggregation of the two benefits into separate GICs, whereas under the APRA requirement the two benefits would need to be valued separately given that the two benefits are provided in separate statutory funds as per requirement 1.

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[8] APRA proposes to adopt the LPS 001 definition of risk business.

APRA is seeking feedback on the proposal outlined above and is seeking specific cases where the proposal above would cause significant issues from an AASB 17 implementation perspective. APRA will consider these cases when determining the final reporting position.

3.5 Reporting direction for Life Act participating benefits

APRA anticipates that the majority of Life Act participating benefits, as well as some additional products such as non-participating investment account products, would be valued under the VFA approach. APRA recognises that some departure from AASB 17 may be necessary to accommodate legislative requirements (particularly relevant for the Life Act).

3.5.1 APRA profit reporting

APRA is proposing to align its standard for valuing policy liabilities with AASB 17. In most situations it is expected that this should result in shareholder profit being the same for Life Act reporting and for general purpose financial statements. The policy owner profit would be generated pro-rata from the shareholder profit based on the profit share proportion. APRA's proposal is that total benefit payments to policy owners will be unaffected by the adoption of AASB 17.

To achieve this outcome, insurers would maintain a record of Life Act policy liability and policy owner retained profit (PRP) components that together would comprise the AASB 17 insurance contract liability. Life Act Shareholders' Retained Profits Participating (SRPP) would be excluded from the liability. APRA also proposes that cost of bonus would be determined on a best estimate basis, rather than surrender value, given that the patterns of profit release and bonus declaration are less likely to be consistent under AASB 17. The profit that emerges under AASB 17 will reflect change in coverage units instead of supportable bonus under existing Prudential Standard LPS 340 Valuation of Policy Liabilities (LPS 340).

The proposed approach will likely require a recalibration of Life Act policy liability, PRP and SRPP at transition. The recalibration would reflect the value for AASB 17 insurance contract liability at transition, and changes required to maintain policyholder reasonable benefit expectations. This recalibration will include consideration of CSM, risk adjustment and time value of options and guarantees (TVOG). APRA understands policyholder's benefits will be maintained on transition.

Other considerations are:

- For APRA reporting, assets backing participating business would need to be valued using the fair value through profit and loss approach. Amounts are to be included in profit or loss rather than other comprehensive income.
- Expenses allowed for in the AASB 17 insurance contract liability would need to be consistent with total expenses allocated to the participating business.
- Policy loan and non-forfeiture premium advances: an adjustment would be required for this to arrive at the Life Act policy liability.

Further consideration is currently underway to identify if additional requirements may be necessary for specific circumstances such as if the contract becomes onerous under AASB 17. APRA is continuing to work with key industry stakeholders and welcomes input into this discussion.

3.6 Reporting direction for friendly societies

APRA proposes that friendly societies determine their insurance and reinsurance assets and liabilities separately for each benefit fund for reporting of accounting financials to APRA. Friendly societies would not be able to determine insurance liabilities at a combined level across benefit funds and management fund for reporting of accounting financials to APRA. This is consistent with the principles of the Life Act and the LI Reg. APRA is seeking feedback on this proposal and is seeking specific cases from friendly societies where the proposal would cause significant issues from an AASB 17 implementation perspective.

APRA is currently assessing how AASB 17 would impact financial reporting of friendly societies and whether there are any components of the reporting framework on which APRA should provide further clarification for friendly societies given the existence and operation of benefit funds. Feedback on this matter is welcomed.

3.7 Approach to liability data collection

AASB 17 allows for various accounting interpretations and calculation methods depending on the insurer's business model. APRA anticipates that the key challenges will be as follows:

- AASB 17 profit and loss will be influenced by differences in insurers' business models and accounting policy decisions, so comparisons across the industry are likely to be complex and challenging. AASB 17 allows insurers to determine accounting positions on key AASB 17 valuation constructs including insurance acquisition cash flows, risk adjustment, discount rates and determination of portfolios and groups. Insurers' profit and loss patterns could be substantially different depending on the accounting positions adopted. APRA also understands that AASB 17 transition approaches could significantly influence insurers' profit and loss patterns.

- The comparability of pre-2023 to post-2023 accounting financials will be lost. Depending on the accounting positions adopted under AASB 17, profit and loss patterns could be substantially different compared to the existing accounting standards. AASB 17 also introduces different disclosure requirements and terminologies. APRA expects that the comparability will be even more challenging for life insurers due to their longer contract term view deployed for insurance risk management and the related AASB 17 calculation methods allowing for a shorter contract term.

Given the challenges outlined above, APRA views that additional data are required for APRA to fully understand profitability and risk profiles of insurers and insurance risk components.

APRA notes that the capital calculation requirements and framework will be consistent across insurers within each industry. In this context, APRA is proposing to collect more granular data on the regulatory liabilities (ie. the GPS 340 liabilities and RFEFCF) such that it can perform comparability analysis of profitability and risk profiles across insurers and over

time. The comparability would not be lost because the basis of the capital requirement will be consistent across insurers within each industry.

APRA is seeking feedback on suggestions to improve the liability data collection approach. The liability data collection approach is illustrated in the 2020 QIS workbook.

3.8 Reporting direction for supplementary data collection

Under AASB 17, APRA intends to capture primary financial statement information that is required by the accounting standard. APRA is also proposing to continue the collection of information that is important for APRA's capital assessment. Examples of such items include:

- All insurers: Breakdown of investment assets and data underlying regulatory adjustments and the capital risk charges.
- GI and PHI: Premiums receivable and unearned premium reserve.
- GI: Deferred reinsurance expense, amounts due on reinsurance contracts, non-reinsurance recoveries, gross written premium and transaction-based taxes and levies and claims development data.
- LI: Life Act participating liability components such as policy owners' retained profits and shareholders' retained profits.

The above is not an exhaustive list as APRA is in the process of reviewing its reporting framework, and will provide further details in the draft reporting standards. Some of the above items are reflected in the 2020 QIS workbook. APRA is seeking feedback on any supplementary data collection that insurers deems unnecessary in the AASB 17 environment. APRA will take these into consideration when reviewing the reporting framework.

3.9 APRA Connect

APRA is introducing a new data collection solution, APRA Connect, to progressively replace Direct to APRA (D2A) and facilitate entities meeting other prudential obligations.

APRA Connect will provide greater flexibility for collecting and submitting data, with new functionality and an easy-to-use interface. It will ensure both entities and APRA are well placed to continue to meet evolving regulatory needs. APRA Connect will enable APRA to collect more granular data into the future, strengthening our data-enabled decision-making and enabling enhanced data submission capabilities.

While the APRA Connect project was temporarily suspended for six months in response to the COVID-19 crisis, APRA has begun re-planning, and subject to internal approvals, APRA anticipates recommencing the project in early 2021 for implementation in late 2021. As APRA replaces data collections, they will be introduced on APRA Connect in line with industry consultations.

It is expected that AASB 17, when it commences in 2023, will be collected through APRA Connect. The APRA webpage will be updated as new information on the project becomes available.

Chapter 4 - Proposed LAGIC updates

4.1 Introduction

The introduction of the LAGIC framework in January 2013 fundamentally reshaped the capital framework for life and general insurers. Principally, the objectives of LAGIC were to:

- improve the risk sensitivity and appropriateness of the capital standards in life and general insurance; and
- where appropriate, improve the alignment of capital standards across the different insurance industries.

APRA has considered the ongoing appropriateness of the LAGIC framework, and is of the view that it has achieved, and continues to achieve, these objectives and remains fit for purpose. However, APRA is taking this opportunity to propose updates to the framework in response to past experiences and to address issues that have been identified since its implementation. The proposals set out in this Discussion Paper follow APRA's initial communication on this matter in 2018.[9]

The majority of proposals in this Discussion Paper do not seek to implement any structural change in policy or alter the fundamental operation of LAGIC, but rather seek to clarify existing requirements in the framework. APRA considers that both the fundamental structure and overall calibration of the LAGIC framework is appropriate and does not intend to use this review as an opportunity to increase or reduce capital levels.

4.2 GI and LI – Reviewing the appropriateness of APRA's prudential requirements in a low or negative interest rate environment

Over recent years, Australia has observed a steady fall in market interest rates, now at their lowest level in Australian history, and negative in some parts of the world. At the 99.5 per cent confidence interval used in determining the Prescribed Capital Amount (PCA), APRA views it necessary to allow for the risk of market interest rates becoming negative. APRA is reviewing the results that would be produced if negative market interest rates were applied to the current capital framework, as well as the impact of current low market interest rates on capital.

Low and negative nominal interest rates impact APRA's ARC, in Prudential Standards GPS 114 Capital Adequacy Asset Risk Charge (GPS 114) and Prudential Standard LPS 114 Capital Adequacy Asset Risk Charge (LPS 114). The ARC is the minimum amount of capital to be held against asset risk and is related to the risk of adverse movements in the value of on-balance

[9] See Roadmap for Integration of AASB 17 Insurance Contracts into the Capital and Reporting Frameworks for Insurers.

sheet and off-balance sheet exposures. GPS 114 and LPS 114 set out the method for calculating the ARC for general insurers and life companies respectively.

The ARC is calculated by determining the fall in capital base in seven stress tests. Low and negative interest rates impact the operation of two of these stresses: the real interest rates stress and expected inflation stress. These stresses were designed in an environment where interest rates were at significantly higher levels and negative interest rates were far less likely than they are today. APRA recognises that the requirements in GPS 114 and LPS 114 do not produce robust outcomes in the current low interest rate environment, and will not be appropriate if interest rates in Australia are negative. In those scenarios, the current capital treatment can result in insurers not holding appropriate capital against the risks they are exposed to. APRA proposes to revise GPS 114 and LPS 114 to ensure LAGIC remains fit-for-purpose.

APRA has outlined several proposed changes below to address this matter, and welcomes feedback from industry on these proposals as well as any other potential impacts of low or negative interest rates on the current capital framework.

4.2.1 Real interest rates stress test

Currently, GPS 114 and LPS 114 both apply a relative calculation for the real interest rates stress. The stress adjustment is determined by multiplying nominal risk-free rates by defined values (0.25 for the upward stress or -0.20 for the downward stress). The stress adjustment is then added to nominal risk-free rates.

When nominal risk-free rates are negative, the intended direction of the real interest rate stress is reversed and a shock is produced in the wrong direction. Additionally, where nominal risk-free rates are close to zero, the shock applied will be minimal and not operate as a realistic stressor as the standard intends. APRA proposes to alter the calculation of the stress adjustment required for the real interest rate stress by applying a three per cent floor to the nominal risk-free rate before multiplying by the prescribed factors. The practical effect of applying the floor will be to impose a minimum upward stress of 75 basis points, and a minimum downward stress of 60 basis points, whenever nominal risk-free rates are below three per cent.

4.2.2 Expected inflation stress test

In GPS 114 and LPS 114, the stress adjustments to expected inflation rates are absolute, and are an increase of 125 basis points (upward stress) and a decrease of 100 basis points (downward stress). APRA is proposing to provide some relief from the requirement to assume a 100 basis point decrease in expected inflation rates when nominal risk-free rates are below one percent. Specifically, APRA is considering reducing the downward expected inflation stress to 50 basis points when nominal risk-free interest rates are negative. When nominal risk-free rates are between zero and one per cent, the downward expected inflation stress would be determined as the sum of 50 basis points and half of the nominal risk-free rate. To calculate the required stress adjustment, APRA would expect insurers to assess and apply a different stress at each duration, depending on the nominal yield at that duration.

APRA is also proposing to clarify the intended operation of the expected inflation stress. Currently, APRA requires that stress adjustments for expected inflation rates be added to any

explicit expected inflation rates used in the valuation of assets or liabilities. APRA is aware that, particularly for general insurers, not all methods used to value insurance liabilities adopt explicit inflation rates. Some liability valuation methods project claims and expense inflation implicitly based on past experience. Under a strict reading of the prudential standards, where insurers use implicit inflation projections they are not obliged to apply the expected inflation rate stress to the projected claims and expenses, and could assume that the liability values fall under the upward inflation stress and rise under the downward inflation stress.

APRA is proposing to clarify the intent of this requirement to ensure that all insurers appropriately allow for expected inflation risk and hold appropriate capital against this risk. For many insurers, it is the imbalance between liabilities affected by inflation, and non-inflation linked assets that leads to a substantial expected inflation risk capital requirement. Where insurers with an implicit allowance for inflation in their liabilities avoid allowing for this imbalance in their inflation risk assessment, the capital held can be too low. APRA will clarify that the inflation stress should also be applied to liabilities valued using an implicit inflation assumption.

4.2.3 Removing the floor of zero for nominal interest rates

APRA is proposing to amend paragraphs 40 and 44 of LPS 114, and paragraphs 36 and 40 of GPS 114 to remove the floor on nominal risk-free rates of zero that applies to the downward inflation stress and real interest rate stress. APRA recognises that this floor produces inappropriate results in a negative interest rate environment, and views that removing the floor on nominal rates in the expected inflation stress and real interest rate stress (upward and downwards stress) will more accurately reflect the required level of capital for the relevant risks.

4.3 GI and LI – Reviewing dollar value exposure limits

APRA has defined dollar value limits for certain exposures across several prudential standards for general and life insurers. For example, APRA expresses asset exposure limits in LPS 117 and GPS 117 in dollar value terms.

APRA recognises that these values have remained unchanged for some time, and may now be outdated and no longer appropriate in achieving their intended purpose. APRA is taking this opportunity to review the dollar value exposure limits across general and life insurance capital standards to determine if the limits remain fit for purpose.

In considering this, APRA is proposing to factor in the inflation that has occurred since the values were introduced. APRA is also looking at methods to future proof these values, such as adding an indexing requirement to ensure that limits remain appropriate over time. APRA welcomes feedback on this matter.

4.4 GI and LI – Maintaining alignment in APRA's approach to the measurement of capital instruments for ADIs and insurers

APS 111 sets out detailed criteria for measuring the regulatory capital held by ADIs. APRA has sought to maintain alignment in the measurement of capital instruments for general and

life insurers and ADIs where it is appropriate to do so. In October 2019, APRA released a Discussion Paper on the proposed revisions to APS 111 for consultation.[10]

The revisions proposed in the APS 111 Discussion Paper are the first significant updates to be made to the prudential standard since 2013, and includes further technical information to assist ADIs issuing capital instruments, and codifies other rulings APRA has made over time relating to the determination of capital. APRA is proposing to adopt for LAGIC, the APS 111 proposals that improve the simplicity and transparency of capital instruments, as well as those which clarify expectations and existing requirements relating to capital instruments.

APRA views that the principles underlying the changes made to APS 111 improve clarity, are appropriate across both banking and insurance industries and intends to maintain alignment across industries where it is reasonable to do so. APRA welcomes feedback on this matter, specifically whether this alignment will bring any significant burden to the insurance industry.

4.5 GI – Removal of Internal Capital Models

APRA currently has requirements in place which allow general insurers and ADIs to use Internal Capital Models (ICMs) to determine aspects of regulatory capital. For general insurers, these are set out in Prudential Standard GPS 113 Capital Adequacy: Internal Model-based Method (GPS 113). The use of ICMs was intended to allow regulated entities to have capital requirements that better reflect the nature and extent of risks in the institution's particular business structure and business mix. However, APRA understands there has been limited take up from insurers in using ICMs for regulatory capital purposes.

While the principles underlying the purpose of using ICMs in the calculation of regulatory capital are consistent among general insurers and ADIs, APRA has observed differences in outcomes and the prudential benefits being derived from the use of ICMs between these two industries. The key benefits of ICMs are an improved understanding of risk profile, and risk sensitivity to inform better risk-based decisions, thereby improving prudential outcomes. These benefits must be balanced against the costs of increased complexity and a loss of comparability of outcomes, particularly if there is considerable flexibility in the modelling approach that may be taken.

APRA's prudential framework allows ADIs to use modelling approaches to determine regulatory capital for several risk classes, based on the internationally agreed Basel framework. The use of regulatory capital modelling is a long-established practice among ADIs and other international banks. This has allowed for the Basel framework to be prescriptive in the form of modelling to be used, and to reject modelling (eg. for operational risk) where international practices have not sufficiently converged to ensure appropriate risk sensitivity or prudential outcomes. However, for insurers, there is no established international framework or international approach governing the use of ICMs, and the approach to how general insurers' models operate is less specified. Therefore, the ICMs for insurers do not deliver the same cost-benefit advantage as for ADIs.

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[10] See APRA's consultation package for the review of APS 111 here.

APRA understands that the development of economic capital models to the extent required for approval and ICMs is a resource intensive and complex process for insurers, without necessarily improving prudential outcomes. On this basis, and noting the industry use of ICMs for regulatory capital purposes remains limited, APRA is proposing to remove GPS 113 and instead require all general insurers to adopt APRA's standard method for calculating regulatory capital. In the event that GPS 113 is removed, APRA will work with the entity currently calculating regulatory capital under GPS 113 on an appropriate transitional arrangement.

APRA recognises that economic capital models, more generally, are a useful risk management tool and could play a role in the dialogue between general insurers and APRA. APRA believes that this change will promote the concentration of general insurers' modelling resources on activities which produce greater and more tangible prudential benefits. APRA welcomes feedback on this proposal.

4.6 GI – Default stress

Under GPS 114, general insurers are charged a default stress in relation to unpaid premium, unclosed business and non-reinsurance recoveries. APRA recognises that whole of account quota share arrangements involve a portion of risk being transferred to reinsurers, and that as a result, the risk of default does not sit with the insurer. APRA has considered whether the current capital framework results in double counting in relation to unpaid premium, unclosed business and non-reinsurance recoveries in respect of business ceded under a whole of account quota share arrangement.

APRA's view is that capital should be held against risk of default for non-reinsurance recoveries by the insurer, even where whole of account quota share arrangements are in place. This is because the reinsurer does not hold capital against these risks, and non-reinsurance recoveries will not be an asset for the reinsurer. In practice, APRA observes that reinsurers simply tend to hold smaller gross outstanding claims. While APRA takes this view with respect to non-reinsurance recoveries, APRA accepts that there may be an element of double counting in relation to unpaid premiums and unclosed businesses as reinsurers generally also record this business as unpaid premium and therefore attracting a capital charge.

To overcome this issue, APRA is proposing for the insurer to apply a charge to the net rather than gross of the quota share position, however APRA recognises this may create further complexity to the capital requirements.[11] APRA also views that this may unfavourably influence the level of capital held in Australia, where the whole of account quota share arrangement is placed with a non-APRA authorised reinsurer. APRA welcomes the placement of whole of account quota share arrangements locally with APRA authorised reinsurers, and intends to reflect this by ensuring an appropriate capital treatment within the prudential framework. APRA welcomes feedback on the proposed method and any other methods that may overcome this issue.

[11] APRA is also considering how unpaid premiums and unclosed business should be disclosed.

4.7 GI – Fair value requirement for the measurement of assets

APRA proposes to clarify its prudential requirements to reflect the expectation that general insurers measure all assets at fair value for the capital base determination. Currently under GPS 114, APRA requires that the stress tests informing the asset risk charge should be applied to the fair value of assets. However, this is not explicitly reflected in Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital (GPS 112) which governs the measurement of capital and the characteristics an instrument should have to be included in the capital base. APRA is proposing to explicitly require general insurers to deduct the difference between fair value and the reported value of each asset, for the purpose of determining the capital base. APRA is seeking feedback on whether there are situations where general insurers shouldn't use fair value for capital base determination.

4.8 LI – Specifications of illiquidity premium

LPS 112 specifies a formula for illiquidity premium in Attachment H. The illiquidity premium is included in the discount rate used for valuing the adjusted policy liabilities for certain types of life insurance products. The adjusted policy liabilities determine the capital base.

From 1 December 2013, the RBA ceased publishing the information required by life insurers to calculate illiquidity premium outlined in Attachment H to LPS 112. APRA issued a letter to all insurers in 2014 to specify an alternative method to calculate illiquidity premium.[12] This letter specifies that insurers must use an input on credit spreads from statistical table F3, published monthly by the RBA.

APRA has since become aware that the RBA has changed the publication date of the relevant statistical table. APRA understands that this change may cause difficulties for some insurers. APRA is proposing to continue to allow life insurers to apply an illiquidity premium for certain illiquid liabilities. In APRA's view, allowing an illiquidity premium for certain liabilities where cash flows are sufficiently certain in timing and quantum remains appropriate for prudential purposes. APRA is considering updating the specification of the illiquidity premium in LPS 112, and is looking at alternative calculation methods to address the delay in the publication of the current RBA table F3.

APRA is seeking feedback on the level of illiquidity premium details that should be included in the prudential standard, and methods of future-proofing this requirement.

4.9 Reinsurance

Since the LAGIC framework was introduced, APRA has observed a change in the reinsurance landscape. Reinsurance procedures have gradually formalised, and offerings of reinsurance arrangements have become increasingly diverse over time. APRA is proposing amendments to reflect these changes to more appropriately recognise the risk transfer that takes place across various types of reinsurance. In particular, APRA is looking at whole of account quota

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[12] See APRA's letter to insurers in 2014 here.

share reinsurance arrangements, where a portion of a direct insurer's premium is ceded to reinsurers.

APRA recognises that there may be opportunities to better reflect the risk transfer that takes place under these arrangements. To address this, APRA has reviewed the following items to clarify the regulatory position and proposed improvements. APRA welcomes suggestions on the following matters, and any other matters that may enhance reinsurance arrangements.

4.9.1 GI and LI – Operational risk charge for whole of account quota share arrangements

APRA introduced the Operational Risk Charge (ORC) to account for and reflect the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The ORC is calculated by applying a risk charge to an exposure base that acts as a proxy for exposure to operational risk. The exposure base is calculated as the maximum of gross written premium and net technical provisions. Where an insurer enters into a long term quota share arrangement, both the insurer and reinsurer would be required to hold an ORC for the full amount of premium ceded.

APRA recognises that the double-counting of risk charges is an undesirable outcome for insurers, reinsurers and policyholders. While APRA recognises that requiring both insurers and reinsurers to hold the full capital amount against the ORC is not appropriate, APRA is considering whether there is a heightened level of operational risk associated with whole of account quota share arrangements. This will inform APRA's view on whether the risk charges are appropriate, or instead are excessive and over-compensate for any additional operational risk incurred under these types of arrangements. APRA welcomes suggestions on this matter.

4.9.2 GI – Duration of policies in the calculation of the Insurance Risk Charge

GPS 115 outlines the method for calculating the Insurance Risk Charge (IRC) component of the PCA. APRA requires insurers to take account the duration of policies on risk in determining premiums liabilities used to calculate the IRC. This requires insurers to hold capital for the full duration of reinsurance contracts.

Whole of account quota share reinsurance arrangements involve multi-year contracts running for five to six years with no cancelation clauses in place before the fourth year. In the event a whole of account quota share arrangement is multi-year, GPS 115 requires a participating reinsurer to hold capital based on their inwards reinsurance premium anticipated for the full five years.

APRA recognises that this is an impost which may result in the transaction being undesirable for local APRA authorised reinsurers. It also results in the reinsurer being required to hold substantially more capital than the insurer for the same risks. APRA is considering methods to adjust this standard to more appropriately deal with multi-year reinsurance contracts without creating a relatively blunt instrument. APRA intends to ensure that any proposals put forward will not introduce a risk that a reinsurer enters into other contracts of this nature to be exempt from Bound but not Incepted Business (BBNI) premium requirements. APRA is

evaluating these factors and reviewing whether a suitable proposal can be made. APRA welcomes suggestions for improvement for this matter.

4.9.3 GI – Procedural requirements for contracts

Prudential Standard GPS 230 Reinsurance Management (GPS 230) includes requirements which set out procedural expectations on the documentation of reinsurance arrangements. APRA introduced these requirements to remedy the highly informal processes previously governing reinsurance contracts. Specifically, the 'two and six month' rule was intended to gradually formalise procedures. This rule requires that within six months of inception, an insurer has in place fully signed and stamped reinsurance treaty contract wordings, and within two months of inception the insurer has appropriate placing slips or cover notes in place.

Since these requirements were introduced, APRA has observed significant improvements in the formalisation of procedures and no longer views this requirement as necessary. APRA is proposing to remove this requirement to recognise the improvement, and instead require all formal procedures to be in place by inception date of the reinsurance contract. APRA expects that industry will continue to maintain good practice and the formal procedures which are currently in place, despite this change. An insurer unable to meet this rule will be required to notify APRA upon becoming aware of their inability to meet the requirement, and outline the reasons and actions being taken to remedy this. APRA welcomes feedback on whether this will create significant regulatory burden for the industry.

4.10 Other amendments

APRA also intends to propose other minor drafting changes for the purposes of greater clarity in the draft prudential standards when they are released in late 2021. These changes are not intended to alter existing expectations or the intent of APRA's prudential requirements, but will clarify ambiguities and definitions that have been identified over time. APRA is also taking this opportunity to seek views from industry on any other minor wording change suggestions to provide further clarity in the standards.

Additionally, while it is not APRA's intention to introduce further material change beyond what is outlined in this Discussion Paper, it is possible that additional policy changes will be introduced over the course of the AASB 17 consultation process as industry feedback is provided. In these circumstances, APRA will ensure that industry has an opportunity to comment on any policy proposals in subsequent rounds of consultation.

Chapter 5 - Consultation

5.1 Request for submissions

APRA invites written submissions on the proposals set out in this Discussion Paper.

Written submissions should be sent to Insurance.Policy@apra.gov.au by **5pm AEST, Wednesday, 31 March 2021** and addressed to:

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Please engage with your APRA supervision contact or Insurance.Policy@apra.gov.au if you wish to discuss any of the matters raised in this Discussion Paper or other matters related to the AASB 17 implementation.

5.2 Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

5.3 Request for cost-benefit analysis information

APRA requests that all interested stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any increases or decreases to the compliance costs incurred by businesses as a result of APRA's proposal. Please exclude any compliance costs that businesses would have incurred from the implementation of AASB 17 regardless of the proposals contained in this Discussion Paper.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to

capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: https://rbm.obpr.gov.au/home.aspx.

Respondents are requested to use this methodology to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include any assumptions made and, where relevant, any limitations inherent in their assessment.

Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake regardless of regulatory requirements in their ordinary course of business.

5.4 Public disclosure for prudential purposes

APRA and ASIC encourage insurers to consider the effects of significant judgements made under AASB 17. These judgements include for example, the inputs, assumptions, and measurement approaches applied to material product groups under AASB 17 such as loss making products. APRA emphasizes the importance of these judgements on regulatory capital.

In accordance with the disclosure principles in AASB 17 and the APRA letter of June 2015 on public disclosures for prudential purposes for insurers[13], insurers are expected to provide further information that is representative of their risk exposures during and post transition period. Transparency with such practices will facilitate a better understanding of profitability and ongoing financial sustainability of products and will also promote market discipline.

5.5 Consultation questions

Submissions are welcome on all aspects of the proposals in this Discussion Paper. In addition, specific areas where feedback on the proposed direction would be of assistance to APRA in finalising its proposals are outlined in the below table.

Chapter 2 – Proposed changes to capital framework		
	1.	**(GI, LI and Friendly societies)** Would maintaining the existing GPS 340 requirements and measurement substantially increase regulatory burden?
	2.	**(GI)** Are there any types of expenses that should not be included in the expense basis and its justification?
	3.	**(LI)** Will there be challenges calculating RFEFCF by projecting cash flows and not using account balance for all investment accounting business?
	4.	**(GI and LI)** How would the new four quarters dividend test affect your entity?

[13] https://www.apra.gov.au/sites/default/files/150622-LTI-Public-disclosure-for-prudential-purposes-for-insurers-June-2015.pdf

Chapter 3 – Proposed changes to reporting framework	5.	**(All insurers)** What types of challenges would the new product groups bring to your entity, including any transitional challenges?
	6.	**(GI)** How should APRA define Cyber and Directors & Officers insurance?
	7.	**(All insurers)** Are the allocation principles outlined in this Discussion Paper adequate for reporting of APRA product group data? Are they any ways to make the allocation principles more effective?
	8.	**(LI)** Would the proposal underlying separate valuation of insurance and reinsurance assets and liabilities in accordance with the Life Act reporting structure cause issues despite the proposed reporting exemption for Non-participating risk business? Are there any other specific issues in relation to the proposal?
	9.	**(LI)** How should APRA define reporting components for Participating business given AASB 17 and the Life Act reporting structure?
	10.	**(Friendly societies)** Would the proposal underlying separate valuation of insurance and reinsurance assets and liabilities by benefit funds cause issues? Are there any specific issues in relation to the proposal?
	11.	**(Friendly societies)** Are there any reporting components that APRA should clarify for friendly societies given the existence and operation of benefit funds?
	12.	**(GI and LI)** Would the liability data collection approach outlined in the QIS workbook cause significant issues? How can APRA improve its collection of the liability data items to better understand profitability profiles by APRA product groups?
	13.	**(All insurers)** Are there any supplementary data collections that insurers deems unnecessary in the AASB 17 environment?
Chapter 4 – LAGIC updates	14.	**(All insurers)** Are there any other potential impacts of low or negative interest rates, not already mentioned in this Discussion Paper, on the current capital framework?
	15.	**(All insurers)** Will the expected inflation stress to 50 basis points when nominal risk-free interest rates are negative cause any unintended consequences?
	16.	**(All insurers)** Will removing the floor on nominal risk-free rates of zero that applies to the downward inflation stress cause any unintended consequences?
	17.	**(All insurers)** Will the clarification on the usage of the inflation stress cause any unintended consequences?
	18.	**(GI and LI)** What should the new dollar value limit be? Will indexing future-proof the value?
	19.	**(GI and LI)** Will the alignment in APS 111 for insurers and ADIs bring any significant burden to the insurance industry?
	20.	**(GI)** What are industry views on the proposal to cease allowing the use of ICMs in the calculation of regulatory capital?
	21.	**(GI)** Will applying a charge to the net rather than gross of the quota share position realign the risk to the insurer rather than the

reinsurer? Are there any other methods that may achieve the same goal?

22. (GI) Are there situations where general insurers shouldn't use fair value for capital base determination?

23. (LI) How can APRA best future-proof the requirement of illiquidity premium if written into the prudential standard?

24. (All insurers) APRA is seeking improvement suggestions on the current double counting risk charge under quota share reinsurance arrangements.

25. (All insurers) APRA is seeking improvement suggestions on solving the mismatch between IRC and the duration of quota share reinsurance policies.

26. (All insurers) Would a requirement of inception date of having all procedural documentation of reinsurance arrangements formalised be a significate burden on the industry?

27. (All insurers) Are there any additional LAGIC updates, not already mentioned, that would be beneficial to APRA and the industry?

5.6 Quantitative impact study (QIS)

To assess the impact of the proposals in this Discussion Paper, particularly for assessing the implications for meeting APRA's objectives for the implementation of AASB 17, APRA is undertaking multiple QISs.

5.6.1 Targeted QIS - 2020

A number of respondents to APRA's 2019 letter suggested that APRA bring forward its timeframe for the QIS from 2021 to 2020. Taking on-board the feedback, APRA has decided to conduct a targeted QIS in 2020 alongside this Discussion Paper. Insurers selected to participate in the targeted QIS have been individually notified by APRA. Instruction on how to complete and submit the targeted QIS will be provided to those selected insurers. Insurers that have not been selected to participate in the targeted QIS are not expected to complete the workbooks.

For the benefit of all insurers in the industry, APRA has made public the workbooks that will be used in the targeted QIS. Insurers may use this information to assist in planning for the 2021 full QIS. The workbooks are available for download on the APRA website.

For the targeted QIS, APRA is aiming to:

- assess the impact of AASB 17 on insurers' financials (compared with company historical and across industry);
- test whether APRA's proposed position will deliver the target prudential outcome through practical implementation on industry portfolios including potential identification of any unexpected issues or unique circumstances;
- understand insurers' AASB 17 accounting policies and choices;
- assess the level of regulatory burden for insurers; and

- obtain feedback that can direct future policy development and application for the full QIS in 2021.

It is important to note the 2020 targeted QIS will not provide definitive quantitative proposals or represent the final set of reporting forms. Further quantitative analysis needs to be undertaken by APRA to inform the final calibration of the revised capital and reporting frameworks. The information contained in the targeted QIS should therefore be regarded as indicative only. Based on feedback from this Discussion Paper, as well as the results of the targeted QIS, APRA may refine its requirements further.

5.6.2 Full QIS - 2021

All life insurers, general insurers, Level 2 insurance groups and private health insurers will be invited to complete the full QIS in 2021. It is in all insurers' interests to accelerate their implementation of AASB 17 in order to participate as the data collected in the full QIS will be used to adjust the final prudential standards.

APRA intends to evaluate its capital proposals by assessing the results of the full QIS in which all insurers will be invited to participate. The full QIS is expected to be issued in Q4 2021, and insurers will be provided with three months to complete the study.

APRA