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Hannover Re makes this submission in response to APRA's proposals to integrate AASB 17 into the capital and reporting frameworks for insurers and update some aspects of the LAGIC framework.

APRA has invited written submissions on the proposals.

Hannover Re makes this submission regarding duration of policies in the calculation of the Insurance Risk Charge and procedural requirements for contracts.

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 reinsurers to hold capital for the full duration of reinsurance contracts.

Whole of account quota share reinsurance arrangements may 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. Hannover Re supports APRA adjusting this standard to more appropriately deal with multi-year reinsurance contracts.

Whilst Hannover Re supports APRA's requirement that an insurer hold capital at the inception of assuming a risk, the amount should be aligned with the capital benefit acquired by the reinsured and the overall risk. As insurers typically are not bound to assume risk, the benefit acquired by the reinsured at inception of the contract is limited which results in a disproportionate burden on an APRA authorised reinsurer under the current method.

The options are to either apply some arbitrary limitation on the time period to be used for the calculation of Bound but not Incepted Business (BBNI) in a multi year contract, reduce the risk charge percentage applied to the BBNI or include the risk in some other component of the PCA.

APRA currently requires reinsurers to hold an insurance risk charge against BBNI because there is uncertainty regarding the claims outcomes. It is contended this uncertainty is provided for in the insurance risk charges when the business is ceded by the insurer and assumed by the reinsurer. In addition, there are surcharges for reinsurers by way of higher risk charges e.g. Category A Class Of Business Premium Liability Risk direct insurance 13.5%, reinsurance 15 to 18%.

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The current approach fails to encourage the participation of authorised insurers at the expense of non-authorised entities thereby diluting APRA's supervision of the general insurance industry as a whole. As such, the method should not result in more capital to reach the same outcome from a regulatory perspective.

AASB 17 and treatment of Multi Year Contracts

AASB 17 considers contract boundaries; i.e. only cash flows within the contract boundary are subject of the Liability for Remaining Coverage (LRC) measurement.

If the non-cancellable bound multi-year contract does not have a repricing clause that fulfills the requirements of AASB 17.34 during the contract period, the contract boundary will be as at the end of the contract period and at balance date, EPI until the end of the contract period would have to be considered in the LRC.

As the Total LRC represents the net amount of discounted cash outflows (future incurred claims/expenses) and cash inflows (future premiums: EPI) the Total LRC at balance dates during the multi year period should be close to zero in all contract boundary scenarios assuming that the contract has a linear risk distribution over time and there is no single upfront premium for the full 5 year period and the contract is not onerous.

The introduction of AASB 17 will address the current issue in some ways since it allows for the unbooked premium to be reflected in the calculation. That being said, Hannover Re would encourage APRA to apply the appropriate risk charge on the Total (net) LRC and not the 2 individual components.

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.

Hannover Re supports APRA's proposal to remove this requirement and require all formal procedures to be in place by inception date of the reinsurance contract.