31 March 2021

General Manager,
Policy Development,
Policy and Advice Division,
Australia Prudential Regulation Authority
1 Martin Place (Level 12)
Sydney
NSW
2000

By email: insurance.policy@apra.gov.au

Dear General Manager, Policy Development and Policy and Advice Division at APRA,

Re: Comments on APRA's discussion paper: Integrating AASB 17 into the capital and reporting frameworks for insurers and updates to the LAGIC framework.

We are writing on behalf of Insurance Australia Group Limited (IAG) to provide comments on the discussion paper, issued to the industry by APRA on 25 November 2020 ('discussion paper'), regarding its intentions on how AASB 17 will be integrated into the capital and reporting frameworks for insurers and other updates to the LAGIC framework.

IAG as a member of the Insurance Council of Australia (ICA), has also contributed to the discussions supporting the comment letter that will be submitted by the ICA on behalf of its members. The points raised in this letter provide due prominence to those areas of greatest significance to IAG.

We appreciate the efforts made to date by APRA in providing details on the direction and potential changes it is considering for the integration of AASB 17 into its capital and reporting frameworks and we welcome this opportunity to provide feedback on the proposal set out in your discussion paper to insurers. We have also been encouraged by APRA's proactive industry outreach and its engagement on material issues through various forums across both the actuarial and accounting professions.

As part of APRA's future plans, we would encourage APRA to consider undertaking a post-implementation review subsequent to the integration of AASB 17 into the capital and reporting framework and to seek industry feedback at that future date. This would help facilitate the assessment of any further refinements and the remediation of any unintended consequences not identified at this stage.

As set out in our response, we would encourage APRA to continue to allow the appropriate capital relief for the protection that whole-of-account quota share reinsurance arrangements provide and we are supportive of any refinement to the capital standards to address other related inefficiencies or double counting that currently exists at an industry level.

In general terms, we agree with APRA's overarching approach of not making fundamental changes to the current capital (LAGIC) framework and aligning, where possible, the reporting requirements under the prudential framework with the accounting standards. This approach provides for more clarity and consistency across the industry and for stakeholders more broadly. As we have previously highlighted, the implementation of AASB 17, in itself, does not change the fundamental economics of our business and, consequently, should not materially impact the level of regulatory capital required to be held.

There are, however, a number of areas that we believe require further consideration. These are primarily in relation to those areas that may be considered more complex, instances of potential unintended consequences, and where unnecessary departures from the accounting standards may exist. These include:

- the regulatory adjustment mechanism;
- adjustment to the expense base to be included in the GPS 340 liabilities;
- amendments to GPS 112 in respect of the requirement for all assets to be included at fair value;
- the date at which procedural documentation is required to be in place in respect of reinsurance contracts; and
- the proposed inclusion of requirements of APS 111 into the capital framework for general insurers.

We would encourage APRA to confirm its position on the key matters in a timely manner to ensure that these changes can be appropriately reflected in our ongoing program of work.

In this regard, we believe it would be beneficial if APRA could prioritise the release for consultation of any of the amended capital standards that either have an implication on regulatory capital or valuations, in particular GPS 340. In respect of the reporting standards, the priority would be to provide those that either are a deviation from the accounting standards, require substantially more granular levels of data and/or may require system or process changes, for example the final proposal for the liabilities form.

Further, we appreciate that APRA has adopted a commencement date for reporting and determining regulatory capital requirements on an AASB 17 basis from 1 July 2023. At this stage, IAG does not intend to early adopt AASB 17 and so this approach will help to mitigate the impact of dual reporting under the two accounting standard bases, being AASB 1023 and AASB 17.

In addition to the points noted above, we have attached an appendix to this letter which includes our detailed response to each of the consultation questions posed by APRA in its discussion paper to the industry.

If you wish to discuss further any of the contents of this letter, please contact us.

Yours faithfully,

[redacted]

[redacted]

Chief Financial Officer, Australia

[redacted]

[redacted]

Chief Actuary

Appendix 1: Response to APRA's consultative questions[1]

	Consultative question	APRA Letter Ref	IAG's Response
1	**Would maintaining the existing regulatory capital and measurement substantially increase regulatory burden?**	2.2	**Summary** In general terms, we support APRA's overarching approach of retaining the regulatory capital requirements under the LAGIC framework, wherever possible. The implementation of AASB 17 does not change the fundamental economics of our business and, consequently, should not materially impact the level of regulatory capital required to be held. Under the current frameworks, both regulatory capital and accounting (AASB 1023), there is a level of dual reporting required to be maintained with existing systems and process infrastructure having been designed with this in mind. For general insurers, AASB 17 will require new liability measurement 'infrastructure' to be assembled. In our view, this predominately pertains to: • de-coupling of gross insurance contracts from reinsurance contracts; • risk adjustment; • contracts requiring the application of the General Measurement Model; and • identification and valuation of losses for onerous portfolios. AASB 17 requires some additional liability calculations to be performed and these will be additive to the overall workload of actuarial teams. IAG acknowledges that AASB 17 also has an enhanced focus on measurement approaches that may result in a different timing of profit/(loss) recognition, which may have potentially less utility in a solvency assessment context. The existing infrastructure that produces the GPS 340 liabilities would need to be retained under APRA's proposals. **Regulatory adjustments** Overall, we agree with the proposal to continue to determine the capital base using GPS 340 liabilities via an appropriate adjustment, resulting in capital neutrality. The mechanism proposed by APRA provides a relatively straightforward approach to

[1] Note: Responses to questions 3, 8, 9, 10, 11 and 23 have been excluded as are not relevant for IAG.

	Consultative question	APRA Letter Ref	IAG's Response
			determine the primary adjustment i.e. the difference between the GPS 340 liabilities and the aggregate of AASB 17 insurance and reinsurance liabilities. Where this approach becomes more complex is in the process of determining the other elements of the proposed adjustment. Whilst we understand APRA's intention of requesting the constituent parts of both premiums receivable and reinsurance premiums payable (e.g. premiums invoiced but not received), we believe this level of detail is not required and would create an undue burden to determine. We would appreciate a further explanation from APRA as to why this level of detail is required. We encourage APRA to aggregate these various elements to the existing required level i.e. total premiums receivable and total reinsurance premium payable. Under IFRS 17, these control accounts will continue to be maintained and will be more readily available than the level of granularity proposed. To achieve capital neutrality, there are also additional adjustments APRA would need to consider incorporating into the regulatory adjustment. All receivable and payable balances that relate to insurance/reinsurance contract cash flows (i.e. implicitly contained within the AASB 17 liability for remaining coverage and liability for incurred claims) would be required to be adjusted for. In addition to the balances APRA have identified, this would include such balances as reinsurance recoveries, non-reinsurance recoveries, commissions payable, indirect taxes payable/receivable and so on. In order to facilitate a further understanding of this point, we have provided a simple example in Appendix 2. In addition, for any cash flows within the GPS 340 liabilities that are also represented as unearned amounts on balance sheet (e.g. received in advance), the regulatory adjustment would need to include the difference between the unearned portion and the respective payable/receivable balance. This scenario is potentially less probable but would be a necessary step to ensure overall capital neutrality. Whilst APRA's recommended approach provides for a plausible solution, it is potentially more complex than is currently articulated and APRA would need to consider carefully how any final proposal is constructed as it may prove challenging to provide an exhaustive list of all potential adjustments. Therefore, we suggest that potentially a more principles-based approach be considered. **Expense basis** Please refer to question 2 below for further detail. **Risk margin requirements**

	Consultative question	APRA Letter Ref	IAG's Response
			IAG acknowledges APRA's desire to maintain risk margins on a probability of sufficiency basis at 75% to which capital figures are applied. As the probability of sufficiency needs to be reported under AASB 17, then this same infrastructure, with some adjustment, can also produce the required risk margins. On balance, this approach should not present a significant burden to IAG. To ensure consistency across the industry, we would like APRA to consider whether it is appropriate for them to provide the specific factors to be applied to net central estimate cash flows in order to determine the desired probability of sufficiency for capital purposes. This approach would have some merit, particularly given that the common starting point under both AASB 17 and the capital framework is the net central estimate cash flows and this would go some way to alleviating the requirement to maintain multiple risk margin/adjustment models. We note that even if insurers decide to align their risk adjustment to equate to the 75th percentile APRA risk margins, if there are contracts valued under the General Measurement Model then net risk margins will not necessarily equate to the risk adjustment. We also suspect at this stage that once insurers evaluate a true 75th percentile risk adjustment on a gross basis and determine the potential for an increased incidence of onerous portfolios, this may result in insurers reconsidering adopting methods such as cost of capital risk adjustments. In these instances, the 'excess technical provisions' adjustment is likely to be negative. This is not viewed as an issue. **Projection period** IAG supports the maintenance of the existing approach to projecting GPS 340 liabilities, particularly in the context of our existing systems and processes. **Discount rate** We request that APRA reconsider its current position of not allowing for an illiquidity premium within discounting general insurance liabilities under GPS 340 as required under AASB 17. We strongly urge that alignment be achieved on this issue for the following reasons: • Increased time absorbed with discounting to net central estimates on two bases, checking and reconciliation, preparation of results and tables, plus potential stakeholder confusion. Particularly given our current aim to streamline processes for faster reporting for all stakeholders. • An illiquidity premium does not, in our view, violate the 'risk free' principle. We believe it is fair for policyholders to expect that

	Consultative question	APRA Letter Ref	IAG's Response
			the investment income assumptions built into the pricing of their premiums reflects the illiquid nature of accessing their claim payments. They would reasonably expect to receive funds after an insurance event and assessment of that event has occurred. Although policyholders do not participate in market return risks, they are still subject to illiquidity constraints. • Given the relatively short-tail nature of many general insurance products, it is likely that the overall impact from an illiquidity adjustment will be immaterial, so harmonising the approach taken under IFRS 17 and LAGIC should not make a material change to general insurance liabilities, but would result in a significant saving in operational effort and complexity. • We also note that in the case of Life Insurance, LPS 112 prescribes the inclusion of illiquidity premium in the discount rate used for valuing the adjusted policy liabilities for certain types of life insurance products. There is an opportunity for APRA to adopt a consistent approach across industries on this matter. **Removal of reinsurance default risk** We support APRA's suggestion that the AASB 17 adjustment in the best estimate cashflows for 'expected reinsurance default' not be allowed for within the value of reinsurance liabilities, for the following reasons: • In the absence of significant market events, and given the credit ratings across our panel of reinsurers, any provision is anticipated to be largely immaterial; and • For consistency, there is currently no provision for expected policyholder deficit in the gross liability calculation. We agree that there is no utility in incorporating such complexities in the projected central estimate cashflows in lieu of consistent capital charges to allow for the risk in other parts of the LAGIC framework. Nevertheless, depending on emerging practice under AASB 17, should a (minor) allowance for expected cost of reinsurance default be made in the calculation of reinsurance recoveries, we would like to retain the flexibility to conservatively adopt these reinsurance net central estimates for APRA purposes and accept the double count. This will maintain simplicity and efficiency, similar to our proposal with respect to discounting. **Unclosed business** IAG supports continuing to include unclosed business in the GPS 340 liabilities calculation.

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			Capital risk charges In principle, IAG supports maintaining the overall approach and requirements of capital risk charges (subject to the LAGIC updates outlined in the Discussion Paper). As the current framework is well embedded in the general insurance industry, appropriately captures relevant risk factors and provides for clarity and consistency for key stakeholders.
2	**Are there any types of expenses that should not be included in the expense basis and its justification?**	2.2	IAG supports the approach of releasing expenses from policy liabilities as the service they relate to is supplied, be that upon acquisition, during the policy exposure period or during claim fulfilment. For general insurance products, a reasonable proportion of total expenses relates to services performed leading into acquisition or renewal of a product such as distribution and product & underwriting and should be appropriately excluded from GPS 340 liabilities. Hence the principle of there being just policy maintenance and claim handling expenses within premium liabilities is justifiable. This approach is also more closely aligned to the requirements of AASB 17, with 'directly attributable' expenses included in measurement of insurance liabilities. We also note that referencing prior year expenses as a starting point for determining those for inclusion in the GPS 340 liabilities does not provide a forward-looking view to take into account appropriate changes in the business. We, therefore, encourage APRA to reconsider this approach. In respect of one-off expenses, such as redundancy or remediation costs, provisions would likely be recognised and so IAG supports the view that these expenses should also be excluded from GPS 340 liabilities. There are also other expenses that are either variable or discretionary in nature which should also be excluded. IAG encourages APRA to review any changes in the context of expenses by service type, this should ensure a rigorous allocation and understanding of the nature of services that are required to be provided for the duration of policy maintenance and claim fulfilment. This is potentially a simpler approach than starting with total expenses and determining what to exclude. Depending on the approach taken by APRA, any required expense adjustment to GPS 340 liabilities could have a consequential impact of increasing the capital requirement for entities. This potential outcome would appear contradictory to APRA's approach of not materially impacting the level of regulatory capital required to be held.
4	**How would the new four quarters**	2.6	For IAG, AASB 9 *Financial Instruments* became effective for periods beginning on 1 July 2018. Under this Standard, IAG adopted the option to value all of its investment portfolio, and other financial assets, at fair value through profit or loss. IAG does not

	Consultative question	APRA Letter Ref	IAG's Response
	test affect your entity?		anticipate this accounting policy choice to change on adoption of AASB 17 and expects to continue to present all finance income/expense in the profit or loss. This position is further supported when considering the incremental complexity associated with implementing the policy option of Fair Value through Other Comprehensive Income (FVOCI). On this basis, IAG does not consider that this proposal will have any material impact and are supportive of the proposal as an appropriate mechanism. However, IAG questions whether both the gains/(losses) should be included in the adjustment and not just when the outcome is negative.
5	**What types of challenges would the new product groups bring to your entity including any transitional challenges?**	3.2	Overall, we support APRA's proposal to align its reporting framework with AASB 17. This approach helps us limit operational complexity with regards to maintaining dual reporting. On APRA's proposal to enhance the granularity of its reporting groups, whilst we appreciate what APRA is looking to achieve with the proposal, we believe the existing class of business reporting requirement for general insurers provides an appropriate level of granularity for the purposes of prudential oversight. As a result, we would have concerns around the cost / benefit implications of a change in this area particularly given that all our existing systems and processes are designed with the current taxonomy in mind. This proposal creates a number of additional challenges, over and above the requirement to update systems and process, including: • Creating and defining additional actuarial reserving classes; • Additional data requirements from source systems; • Remapping of reporting structure hierarchies; and • If not separately identifiable at the group of insurance contract level, an appropriate allocation methodology to APRA class.
6	**How should APRA define Cyber and Directors & Officers insurance?**	3.2.1	**Directors and Officers (D&O) insurance** In respect of D&O insurance, IAG supports APRA's proposed definition, being: *"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."* **Cyber insurance**

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			As APRA will be aware, IAG is currently engaged as part of the ICA APRA working group with regards to consultation on the collection of cyber insurance and management liability data in the National Claims and Policies Database (NCPD consultation) and AASB 17. IAG will work with the ICA, and ICA members, in providing APRA with a response.
7	**Are the allocation principles outlined in this discussion paper adequate for reporting of APRA product group data? Are there any ways to make the allocation principles more effective?**	3.3	We fully support APRA endorsing methodologies, such as adopting allocation approaches, where it limits the operational impost on insurers by not requiring, where possible, a separate reporting basis for APRA. We believe it is best for APRA to provide a principles based approach, as this allows insurers to adopt the allocation methodology that is most appropriate to their particular circumstances (for example, based on how their products are structured as well as their data, systems and processes). Some of the key challenges to note with regards to allocation, particularly where a group of insurance contracts cover a number of APRA classes, are as follows: • The challenge of ensuring the consistent allocation of both related balance sheet and profit or loss elements over time; • Identifying the most appropriate driver to adopt for the allocation of each component; • It may drive the requirement for additional systems/process changes to ensure the appropriate granularity of component data is available; and • The level of complexity with regards to allocation of whole-of-account quota shares treaties, which by their nature are singular contracts that span all classes, will be heavily dependent on the level of granularity at which the various calculations are maintained, in particular with regards to the Contractual Service Margin (CSM). As required by APRA, we will be providing a document outlining the allocation principles we have applied as part of our QIS submission.
12	**Would the liability data collection approach outlined in the QIS workbook cause significant issues?**	3.7	Whilst IAG can support the granularity desired by APRA in terms of reporting liabilities produced under GPS 340, but to do so would be additive to the overall workload of actuarial teams. Currently, IAG's liability valuation portfolios are at a level of granularity that can support APRA's expansion of data collection requirements, with the exception relating to APRA's proposal to enhance the granularity of its reporting groups. We would appreciate if APRA could provide further clarity as to why they believe the benefit from receiving the additional liability data, as set out in the liability forms, outweighs the incremental cost for the industry. Note: With respect to the "LY/LY" rollforward liability data requested, we understand APRA's intention was for this to reflect the

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			rollforward of the opening outstanding claims liability (in respect of prior accident years) by allowing for the impact of discount unwind and actual payments made. We would like to highlight that the further clarification included in the QIS instructions (cited below) contradicts/confuses APRA's intention and may be computationally onerous to estimate. *"For example, insurers would report LY/LY liabilities reflecting current case estimates and actual payments that have occurred in the reporting year but applying the previous year's economic and non-economic assumptions."*
	How can APRA improve its collection of liability data items to better understand profitability profiles by APRA product groups?		On balance, we believe that the proposed level of information requested via the liabilities form would provide APRA with sufficient visibility of the profitability profiles by APRA product groups.
13	**Are there any supplementary data collections that insurers deems unnecessary in the AASB 17 environment?**	3.8	There are a number of supplementary reporting forms in the current APRA returns that reference items using AASB 1023 terminology. We suggest that a full review of these forms is undertaken to ensure all are relevant for use under AASB 17. A number of examples of required amendments (or potential removal) are as follows: • 114_4 – we question whether the split of investments between Policyholder and Shareholder funds is still required. Whilst the separate portfolios will likely be maintained for operational purposes, this presentation is not a requirement of AASB 17; • 300 forms – require alignment to AASB 17 terminology; and • 400 forms – potentially look to combine all relevant information into the proposed liabilities form to ensure there is no duplication.
14	**Are there any other potential impacts of low or**	4.2.1	To date, as part of our AASB 17 implementation program, we have not identified any other potential impacts not mentioned in the Discussion Paper. In principle, we support APRA's indicated direction of ensuring that the capital framework remains appropriate in a low or negative interest rate environment. We believe the proposed approach maintains an appropriate level of consistency with

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	negative interest rates, not already mentioned in this discussion paper, on the current capital framework?		the current LAGIC stress tests.
15	**Will the expected inflation stress to 50 basis points when the nominal risk-free rates are negative cause any unintended consequences?**	4.2.2	For IAG, this change is unlikely to have any material impact. Given the composition of our technical reserve (policyholder funds) investment portfolio (i.e. fixed interest) and our policy of matching its (nominal interest rate) duration to our insurance liabilities, there would be very few circumstances, if any, where we would be in a net long position in relation to our exposure to inflation. Consequently, in most cases we would be holding capital in respect of the outcome of the up-stress scenario. As a result, we do not anticipate any unintended consequences as a result of this proposed change.
16	**Will removing the floor on nominal risk-free rates of zero that applies to the downward inflation stress cause any unintended consequences?**	4.2.3	Upon investigation, we do not anticipate any unintended consequences as a result of this proposed change.
17	**Will the clarification on the usage of the inflation stress cause any unintended consequences?**		We support APRA's proposal. For IAG, we do not expect this clarifying point to have any impact to our minimum capital requirements. Under the inflation stress adjustment, we currently recognise the full impact of the imbalance between our liabilities affected by inflation and our non-inflation linked fixed interest portfolio.

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18	**What should the new dollar value limit be? Will indexing future-proof the value?**	4.3	Given the size and scale of IAG's insurance operations, this change is not considered to have any material impact. However, in principle it seems reasonable to adopt an indexation approach to the minimum dollar limit.
19	**Will the alignment in APS 111 for insurers and ADIs bring any significant burden to the insurance industry?**	4.4	IAG supports APRA's review of the capital framework and acknowledges APRA's intention to increase alignment across industries. We note however, that in comparison to General Insurance companies ADI's are more highly leveraged and dependent of debt funding to support their ongoing operations. This is different for general insurers where premiums are payable in advance to support claims and debt financing is generally used relatively sparingly as a source of capital and liquidity. Whilst at this stage we do not consider most of the proposed changes material, we would encourage APRA, as was undertaken with ADIs when these changes were proposed, to run a consultation process with insurers to ensure the industry as a whole has an opportunity to provide more detailed and considered feedback.
20	**What are industry views on the proposal to cease allowing the use of ICMs in the calculation of regulatory capital?**	4.5	IAG is agnostic towards the decision to remove the option for insurers to utilise an approved internal capital model (ICM) to determine minimum requirements. However, IAG remains committed to maintaining a 'best in class' economic model to support strategic decision making as is currently the case under ICAAP. We believe key stakeholders, including investors and consumers, obtain utility from an objective and consistent measure of minimum capital requirements across different insurers. We have questioned the overall value of a potentially lower regulatory minimum that may arise from the utilisation of ICMs. Although increased flexibility arises from a lower minimum regulatory requirement, particularly in times of stress, this would not necessarily lead to lower overall capitalisation levels. Apart from the minimum requirement, other factors play a role in capitalisation such as: • Fulfillment of Board risk appetite requirements; • Industry practice and benchmarking; • Rating agency assessments; and • Risk of capital depletion / expected policyholder deficit. When the cost and resource required to achieve, and maintain, model approval is taken into consideration, both for APRA and IAG

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			and maintained for both IAG and APRA, then we are ambivalent about the overall value of such an endeavour and support APRA in removing the option.
21	**Will applying a charge to the net rather than gross of quota share position realign the risk to the insurer rather than the reinsurer?**	4.6	In our view, where there is a long term whole of account quota share treaty in place between an Australian regulated insurer and reinsurer, the operation of certain risk charges required under Prudential Standards GPS 114 (Capital Adequacy: Asset Risk Charge) and GPS 118 (Capital Adequacy: Operational Risk Charge) lead to a double-counting of these risk charges at the industry level. This leads to an undesirable outcome for the industry as a whole and for individual insurers and reinsurers. It potentially creates a financial disincentive to enter long term quota share arrangements which may be of benefit to policyholders. These contracts are typically written on a 'follow-the-fortunes' basis which means that the reinsurer shares in the underlying experience of the portfolio, and so many of the risks covered by the APRA risk charges have been transferred to the reinsurer in part or in full. On this basis, we support APRA's proposal to address the double counting and encourage APRA to consider providing the relief for insurers who enter into whole-of-account quota share arrangements. However, as noted above, we concede that it may be more appropriate to provide relief in circumstances where the reinsurance counterparty is an Australian regulated entity, but would also encourage that partial relief be considered in a scenario where the reinsurance counterparty is non-APRA authorised. **Prudential Standard GPS 114 (Capital Adequacy: Asset Risk Charge)** In our view, the default stress risk charge in relation to unpaid premium, unclosed business and non-reinsurance recoveries represents a double count across the industry in respect of premium ceded under the long-term quota share arrangements. The reinsurers are proportionately exposed to the defaults risk associated with each of these assets. The whole-of-account quota share contracts that IAG has entered into require cash settlement in relation to premium and recoveries received, so any premium or recoveries not received are, in turn, not payable to the reinsurer. Thus, the consequences of counterparty default are shared proportionately. On this basis, we would support the proposal to provide relief to the insurer from the default stress risk charge in relation to unpaid premium and unclosed business in respect of the business ceded under long-term quota share agreements. However, we would also strongly urge APRA to reconsider its position on non-reinsurance recoveries and look to also provide the appropriate capital relief in respect of these balances. In summary, the double-counting of risk charges is an undesirable outcome both at an industry level, and for impacted individual insurers and reinsurers, because it does not faithfully reflect the commercial reality of long-term whole of account quota share agreements, in particular. These transactions are ultimately beneficial for policyholders, in that they diversify capital sources and

	Consultative question	APRA Letter Ref	IAG's Response
			generally provide uncapped protection in relation to the reference portfolio.
	Are there any other methods that may achieve the same goal?		At this stage, we believe the proposed mechanism (i.e. net position) would best achieve the intended outcome.
22	**Are there situations where general insurers shouldn't use fair value for capital base determination?**	4.7	In principle we support the proposal to include the fair value of each asset for the purpose of determining the capital base. In respect of all our financial assets, these are all held at fair value on our balance sheet, with other asset carrying values being a close approximation of their fair value, and, hence, in the determination of our capital base. The overarching principle should be not deviate from the requirements under the relevant accounting standards, where possible, not to introduce undue distortions or volatility in regulatory capital and reduce comparability across the industry. There are a number of assets that we believe should be given careful consideration under this proposal, for example: • Investment in subsidiaries (relevant for Level 1) and associates; • Assets 'held for sale', as determined under AASB 5; • Right-of-use assets, as defined under AASB 16; and • Property, plant and equipment, as defined under AASB 116.
24	**APRA is seeking improvement suggestions on the current double counting risk charge under quota share reinsurance arrangements.**	4.9.1	**Prudential Standard GPS 118 (Capital Adequacy: Operational Risk Charge)** The Operational Risk Charge is calculated by applying a risk charge to an exposure base that acts as a proxy for exposure to operational risks. Under long-term quota share reinsurance arrangements, both the insurer and the reinsurer would be required to hold an operational risk charge for the full amount of premium ceded at the respective rates. In the case of long-term quota share arrangements where the reinsurer 'follows the fortunes' of the insurer, many of the operational risks inherent in the business and covered by the risk charge are passed proportionally to the reinsurer. In our view this means that there is a double count at the industry level. While we accept that the quota share arrangement leads to some additional operational risk, we believe this should be neutralised across the industry. We recognise that there is no single approach for determining how to moderate and share the overall industry operational risk charge between the insurer and reinsurer. However, below we suggest a possible mechanism for adjusting this charge in respect of the direct insurer. We have considered an alternative method to calculate the exposure base whereby the operational risk charge percentage is

	Consultative question	APRA Letter Ref	IAG's Response
			applied to the average of 'Gross Written Premium (GWP) and Net Technical Provisions'. Our reasoning for this is as follows: • For a large diversified insurer such as IAG, both GWP and Net Technical Provisions exposure measures tend to be broadly equally weighted (in the absence of whole-of-account quota shares). • Whole-of-Account quota shares proportionally reduce the net cost to IAG of all operational risks related to the underwriting of insurance contracts (such as mishandling of claims, failure of controls/reporting systems leading to poor underwriting decisions and any associated regulatory imposts). As noted above, these contracts are written on a 'follow the fortunes' basis. • Therefore, a more suitable proxy for IAG's net exposure to operational risk would be an average of GWP and Net Technical Provisions, assuming these risks are broadly equally weighted. • This is predicated on the assumption that IAG remains a large diversified insurance company. If there were any material change to business mix or risk management practices, there would need to be a suitable mechanism to amend this approach. An alternative approach would be to calculate the operational risk for business that is covered by a quota share arrangement using the net written premium amount. This is on the basis that: • A quota share contract passes insurance and investment risk from the direct insurer (reinsured) to the reinsurer, though the reinsured may retain some volatility of earnings exposure depending on the terms of the individual contract (for example, profit shares). • The negative consequences (cost) of the manifestation of an operational risk (e.g. paying claims not intended, refund of premium for mis-sold policies etc.) will fall upon some combination of the reinsured and reinsurer. • Therefore, the overall industry operational risk in relation to the busines concerned has not materially changed, aside from some operational risk in relation to the operation of the quota share contract.
25	**APRA is seeking improvement suggestions on solving the mismatch between**	4.9.2	**Prudential Standard GPS 115 (Capital Adequacy: Insurance Risk Charge)** Within the context of the Australian market, IAG supports APRA's proposal to consider a mechanism to adjust the method of calculating premium exposure in respect of quota share arrangements, such that the capital inefficiency is minimised. Given the complexity in determining an appropriate adjustment mechanism, APRA may consider allowing for exemptions on a

	Consultative question	APRA Letter Ref	IAG's Response
	IRC and the duration of quota share reinsurance policies.		case-by-case basis.
26	**Would a requirement of inception date of having all procedural documentation of reinsurance arrangements formalised be a significate burden on the industry?**	4.9.3	Whilst we understand the intent of what APRA is trying to achieve with this proposal, APRA should be aware of the operational complexities before pursuing this approach. In our view, having all procedural documentation in place by the inception of our reinsurance treaties would be incredibly challenging. Negotiations for renewal are frequently continuing up to the renewal deadline. The duration of negotiations is also often influenced by the current market conditions i.e. the severity of recent global catastrophes. In our view, to conclude the negotiation and sign the contract by the renewal date is not a realistic expectation in most circumstances. Indeed, it may put Australian insurers at a competitive disadvantage in negotiating contracts with multi-national reinsurers. One proposal we have is to remove the 6-month rule and implement a 2-month rule for all procedural documentation to be in place. We believe this is a more reasonable expectation to place on insurers and reinsurers and would mitigate the risk that Australian insurers are placed at a competitive disadvantage in a global context.
27	**Are there any additional LAGIC updates, not already mentioned that would be beneficial to APRA and the industry?**		We are aware of various international proposals and procedures to the calculation of operational risk charges for both ADI's and insurers. We would suggest that should APRA consider changing the current pragmatic approach to a more complicated system, that the industry be given ample warning. Changes would likely come with a significant implementation cost.

Appendix 2: Regulatory Adjustment Example

Cash flows	Yr 1	Yr 2	Total
Premiums	2500	2500	5000
Claims	-2000	-2250	-4250
Non-RI	200	200	400
commissions	-250	-250	-500
	450	200	650

Assumptions
- Single 2-year contract
- CSM run-off passage of time
- Claims incurred in Yr 1 not settled until Yr 2
- Premium received 50:50
- Commissions incurred upfront but paid 50:50
- Non-RI recoveries received as claims paid
- Assume PoA for OCL at 75th percentile
- Ignore discounting

AASB 1023	Yr 1
Cash	2250
Premium receivable	2500
Non-RI receivable	200
DAC	250
OCL	-2000
UPR	-2500
Commissions payable	-250
Net Assets	**450**

AASB 17	Yr 1
Cash	2250
Insurance contract liabilities	-1925
Net Assets	**325**

GPS 340 Liabilities	
OCL	-2000
Premium liability	-2050
GPS 340 Liabilities	**-4050**

	PVFCFs	CSM	Total
Opening balance	650	-650	0
Net Cash Flows	-2250		-2250
Current service		325	325
Closing balance	-1600	-325	-1925

XS Technical Provisions	
UPR less DAC (AASB 1023)	-2250
Premium liability surplus	-2050
OCL	0
Total	**200**

	LRC	LIC	Total
Insurance revenue	2325		2325
Insurance expenses		-2000	-2000
Net Cash Flows	-2250		-2250
Total	75	-2000	-1925

Capital Balance Sheet	Yr 1
Net Assets	450
OCL surplus	0
Premium liability surplus	200
Regulatory capital base	**650**

Capital Balance Sheet	Yr 1
Cash	2250
GPS 340 Liabilities	-4050
add back Premium receivable	2500
add back Non-RI receivable	200
add back Commissions payable	-250
Regulatory capital base	**650**