Insurance Council of Australia

6 December 2022

[redacted]
General Manager Policy
Australian Prudential and Regulatory Authority
SYDNEY NSW 2000
By email: [redacted]

Dear [redacted]

Consultation on draft guidance for financial contingency and resolution planning

The Insurance Council of Australia[1] (ICA) welcomes the opportunity to provide a submission for the *consultation on draft guidance for financial contingency and resolution planning*.

Overview

Implementation should be in two stages because insurance differs from banking

The ICA is of the view that contingency, recovery and resolution planning arrangements can be simpler for insurers than arrangements required for the banks because the business of insurance is very different from the business of banking.

Banking that typically has a combination of medium to long-duration assets, leverage and at call deposits, can experience liquidity crises that require immediate recovery or resolution. In contrast, insurance typically has a closer duration match between assets and liabilities, and in addition claims are contingent on contract terms.

In the rare cases insurers fail, they tend to fail slowly. Unless a catastrophe-event is of sufficient scale to clearly leave an insurer insolvent, it is likely to be weeks, months or potentially years until the ultimate claims cost and therefore the insurer's financial position is known with precision.

As a result, recovery or resolution planning for insurance should be very different to banking. For example, prepositioning planning for insurers would anticipate that short term obligations would still be met, and recovery or resolution would only occur over months and years in which recapitalisation or sale of a business could take place. In our view the most urgent concern for the community in a general insurance resolution scenario is ensuring access to insurance cover because the company in question is no longer viable and unable to honour unexpired exposure / underwrite future business. Given the significant differences between banking and insurance, implementation should be undertaken through a staged process that commences with banks, followed by insurers. This would be consistent with the approach being taken in other jurisdictions.

Contingency and Resolution planning should not place pressure on affordability

The ICA believes the proposed standards should be viewed in context of APRA's existing prudential regulation, including capital buffer requirements. In this respect, there is a need to balance the

[1] The Insurance Council is the representative body of the general insurance industry in Australia and represents approximately 89% of private sector general insurers. As a foundational component of the Australian economy the general insurance industry employs approximately 60,000 people, generates gross written premium of $59.2 billion per annum and on average pays out $148.7 million in claims each working day ($38.8 billion per year).

potentially material upfront and ongoing costs of resolution planning and pre-positioning (e.g. organisational or legal structure changes), that will ultimately be borne by policyholders through higher premiums, with the benefits that will only be realised in the very remote (given the stated 99.5 per cent confidence level of APRA's capital standards and the significant capital buffers regulated entities hold above this) circumstances where a regulated entity fails and needs to be resolved. Accordingly, APRA should ensure these proposed standards are proportionate to the residual risk of an insurers' failure.

It would be a mistake to impose requirements that duplicate existing prudential regulation for example where loss absorbing capacity results in a separate and additional capital requirement.

APRA consider a principles-based approach to contingency and recovery planning

The ICA is of the view that it is impractical for contingency and recovery plans to include detailed step by step instructions for the multiple scenarios that exist within these plans and to be able to pre-emptively capture the recovery impacts under all of these scenarios.

Attempting to capture such a large amount of information would result in an excessively lengthy contingency/recovery plan which would present significant challenges in terms of imbedding the plan into the business. Therefore, as a more effective and efficient alternative, the ICA request APRA consider moving towards a more principles-based approach to contingency and resolution planning rather than a proscriptive and operational approach which allows for contingency/recovery plans to focus on more high level financial, strategic and interdependency considerations. This principles-based approach would also appear to be in line with APRA's proposed plan to modernise their prudential architecture by reducing the number and complexity of standalone documents.

APRA response to stakeholder views

We note that APRA is still considering stakeholder views on 900 and intends to provide a response that may also involve amendments to these draft documents. We note that APRA released final Prudential Standard CPS 190 Recovery and Exit Planning (CPS 190) on 1 December 2022, however the practice guide is still under consultation. In this context our members have identified the following areas of concern.

Specific provisions

Clarity of ownership and responsibility and Board responsibility

In relation to both CPS 190 and CPS 900 the ICA requests there be greater clarity in relation to the role of the Board.

In relation to CPS 190, paragraph 10 of the PPG states that 'the Board must oversee the execution of contingency actions in stress'. We request APRA provide clarity on what is meant by 'oversee' and their expectations in relation this.

We request APRA provide additional clarity on the ownership and responsibilities for the development of resolution plans. In particular, does ownership and responsibility of the resolution plan sit with APRA or the regulatory entity/group. What roles do APRA and the regulated entity/group play in the development of the different resolution options?

Board responsibility to ensure that an entity is resolvable: paragraph 17 of CPS 900 states that the Board of an APRA-regulated entity is ultimately responsible for ensuring the entity is resolvable. Given the extent to which the ability of a company to be subject to orderly winding up or exit from a regulated business is dependent on a range of factors, many of which are outside the Board's control (including the manner in which APRA exercises its powers) – this is a very high standard and duty to impose on the Board. It would be fairer and more pragmatic to express this as a reasonable steps obligation.

We request that APRA provide guidance and clarity on its expectations.

CPS 190 – Trigger Framework

The draft CPG 190 places significant emphasis on the role and use of the trigger framework within financial contingency plan. While a trigger framework plays an important role, insurers day-to-day business operational and management processes play a similarly critical role in identifying issues and escalating them when necessary. Therefore, we request APRA provide acknowledgment that prescriptive triggers are an additional enhancement on existing management and operational processes, and that a trigger framework is not the sole source of identification of issues that can be implemented uniformly.

For example, with many qualitative triggers (which is a main source of escalation in emerging uncertain events), it is not realistic to have cascading triggers. It is also impractical to set triggers anticipating a certain recovery option.

CPS 190 – Testing and Review of Contingency plan (CPS 190 paragraph 28)

Paragraph 28 of CPS 190 requires that contingency plans be reviewed and updated on an annual basis, with comprehensive review and testing every three years. We also note the importance and need to incorporate stress scenarios into assessment and testing.

Insurers propose that there be provision for stress testing of different categories to occur over multiple years and for the results of this testing carried over given these results would remain relevant on a relative basis for many years. This would allow for more efficient process.

Being able to perform these tests periodically to ensure frameworks, actions and recovery capacity remain effective while being able to balance with other testing requirements (such as CPG 229) would also help manage compliance costs of meeting the multiple stress testing requirements across different APRA standards.

CPS 190 – Operational Testing (CPG 190 paragraph 43)

Paragraph 43 of CPG 190 outlines the critical role of operational testing in assessing a contingency plan. It would assist insurers if APRA could distinguish operational testing from stress and scenario testing as follows:

- Operational testing should focus on roles and responsibilities of recovery committee members and escalation processes.
- Stress and scenario testing involve devising a more detailed response which may involve more time as part of a comprehensive stress test.

This distinction would keep operational testing realistic for executive management and the Board, allowing them to focus on the results and implications of each stress test over a broader risk continuum.

CPS 900 – Pre-positioning Actions

Pre-positioning actions could have significant financial and operational impacts and so the expectations around these actions need to be proportionate.

Paragraph 22 of CPS 900 states:

> “APRA may require an APRA-regulated entity to develop and implement a pre-positioning plan to remove barriers to the execution of resolution options and mitigate execution risks.”

These plans may have very significant implications for any organisation, especially, for example the need for structural changes.

CPG 900 also states:

> "APRA expects that these plans would set out clear timeframes and accountabilities for the completion of pre-positioning actions."

We request that APRA provide further guidance on the likely timeframe for completing the pre-positioning plans and guidance on the point at which an entity is deemed in compliance following the initiation by APRA of resolution planning.

CPS 900 - Additional loss-absorbing capacity

In most cases the mitigation strategy would be to raise additional capital, so is it APRA's intention that additional capital will be required?

Paragraph 28 of CPS 900 states

> "APRA may require an APRA-regulated entity that is not an RSE licensee to maintain an amount of loss-absorbing capacity to support the resolution plan."

CPG 900 provides further clarification and states:

> "In determining a resolution plan, APRA may require an entity…to hold an amount of loss-absorbing capacity to support the execution of a resolution option. This is more likely to occur under a recapitalisation strategy and could be necessary for the execution of other resolution options. In requiring entities to maintain loss-absorbing capacity, APRA's objective is to ensure that, in the event of failure, an entity could be resolved using private rather than public funds."

If additional loss-absorbing capacity (LAC) is required, other than to support a recapitalisation, even though the existing regulatory capital requirements are on a "1 in 200 year" basis, there would be overlap between existing capital requirements and additional Loss Absorbing Capacity (LAC).

Further, if additional capital is to be raised, impacted insurers should be given an extended period to build up this LAC, similar or potentially longer (given insurers tend to be smaller and less frequent issuers) timeframes to that afforded to the major banks when they were required to build-up additional LAC.

We would welcome more information and clarity on the conditions, particularly for execution of other resolution options, that may lead APRA to require additional loss-absorbing capacity.CPS 900 - Guidance – insufficient level

Generally, there is insufficient detail on the requirements and expectations in the standard. For example, use of the words 'APRA may….' as opposed to 'Board/APRA Regulated Entity must…'. The discussion paper states that the resolution planning process is APRA led – more clarity is needed on what entities must have in place by January 2024 (standard effective date) and APRA's approach/timing of activities before and after January 2024, that is when will APRA commence resolution planning with an entity, APRA's expectation on pre-work from the entity and how will this process work?

There are other questions to consider regarding alignment with international regulatory requirements. The CPG 900 states:

> "APRA may establish a working group to facilitate the consideration of cross-border resolution issues with overseas regulators ".

How would CPS 900 interact with requirements of overseas regulators where the insurer owned material stakes in local insurers? Domestic insurers may have overseas operations resulting in opportunities/issues for example relating to offshoring. Is APRA collaborating and coordinating with other regulators such as RBNZ in this area?

We request further guidance from APRA on its interactions with other regulators.

CPS 900 Triggers – type of business failure

Consider the types of failures that could be contemplated by a general insurer. Potential causes of general insurer failure are:

- large cat. events combined with insufficient reinsurance and/or failure of reinsurers,
- emergence of a new form of latent claim, loss arising from systematic wording/underwriting/operational/cyber issue,
- failure of one or more of the big four banks impacting insurer asset portfolio.

Of the above examples, if a failure follows a large cat. event this event impacts the insurance industry and is not limited to an individual entity.

Some types of failures are best met by the community via the government, because in our view customers would be unwilling to pay the cost of the insurance industry holding additional capital and/or incurring additional expenses required to address the potential failure.

We suggest that a robust series of engagements and workshops between APRA and SFI's ahead of APRA commencing the first resolution planning activity would be valuable to better focus the scope and objectives of resolution planning.

We request examples from APRA on the types of failures and APRA provide clarity on its intention around capital.

Relationship to Administration

Both CPS 190 and CPS 900 are designed to reduce the likelihood and minimise the impact of entity failure. Paragraph 11 in CPS 900 states:

> "(c) resolution – means the process by which APRA or *other relevant persons* manage or respond to an entity:
>
> (i) being unable to meet its obligations; or
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> (ii) being considered likely to be unable, or being considered likely to become unable, to meet its obligations; or
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> (iii) suspending payment, or being considered likely to suspend payment;
>
> including through the exercise of powers and functions under this Prudential Standard or any other law;"

The concept of 'entity failure' as embedded in the definition of resolution, is broader than insolvency. This is concerning because there is a well-established body of law around insolvency and broadening the concept of failure beyond insolvency may be difficult for Boards and management to apply and navigate in practice.

The definition of 'resolution' in CPS 900, which could cover any entity being unable to meet its obligations (or being considered unlikely to meet its obligations) has no specific materiality threshold or link to solvency which makes it unduly broad.

In addition, the definition of resolution refers to 'other relevant persons' who may manage or respond to entity failure – it is not clear whether 'other relevant persons' means the Board of the entity, management, another regulator, an administrator/liquidator, or all of these.

We request that APRA provide guidance and clarity on its expectations.

Duplication across CPS 190 and CPS 900

The ICA seek clarity on the difference between an entity 'exit plan' as required by CPS 190 and APRA's 'resolution plan' for an entity as required by CPS 900. Similarly, clarity is also sought on what appears to be duplication of exit plan requirements across CPS 190 and 900. For example, CPS 190 paragraph 19(e) outlines that contingency plans must include *credible exit actions that could be taken to effect an orderly and solvent exit from regulated activity.*

Recovery options and exit options lie on different points of the supervisory crisis continuum. However, the exit options set out in CPS 190 and CPS 900 (eg. transfer of business and wind-down of business) share similar considerations in relation to feasibility or pre-positioning measures (changes in share services, legal structure etc.). Given the associated pre-positioning steps to support exit options in CPS 190 are closely akin to resolution planning, we suggest APRA consider integrating them into draft CPS 900. In doing so this will reduce overlap, improve consistency and reduce compliance cost.

CPS 900 – Material business activity

Paragraph 13 of CPS 900 requires an APRA-regulated entity to support APRA in the determination of whether it provides any critical function, which may include the identification of all material business activities of the entity.

The CPG 900 states

> "Functions that do not have a material impact on financial stability, industries or communities, or those that can be substituted with a minimum of time and cost would be unlikely to be considered critical".

Potentially this definition could be very broad and result in a new layer of prudential regulation across the industry that sits above the existing layer of prudential regulation. In particular, the reference to industries and communities could affect specialist insurers for example medical indemnity insurers who operated in a highly regulated market or regional insurers.

It is useful to recall that the origin of crisis resolution is in guarding against financial system crisis, that normally arises from the banking system because counterparty interdependencies. This is not a characteristic of general insurance. Extending the scope of this regulation too far beyond its origin puts at risks the effectiveness of the regulation itself.

We would welcome more information and clarity on what constitutes a 'material business activity', including an assurance that materiality would be defined in relation to financial system stability.

Application to subsidiaries/joint ventures

It is not immediately clear whether a Subsidiary/Joint Venture that is also an APRA regulated entity in a Group would be an SFI based on APRA's discretion due to the complexity of its operations or its membership of the Group and on the basis that it provides critical functions.

There is some guidance on page 19 of the Discussion paper but further guidance from APRA would be helpful. We request that APRA provide more information and guidance on its expectations for example, does the entity or APRA make the assessment on whether an entity is an SFI? What does APRA want to see in the resolution planning if there are a number of SFIs in a Group and can these SFIs roll up to the Group?

CPS 900 – Notification and disclosure and Review Frequency

Paragraph 33 of CPS 900 requires a regulated entity to notify APRA if it" intends to make changes to its business or operation…", however APRA have not provided any direction on timing for such notifications. We suggest APRA outline the timing for when such a notification is required (eg. prior to the changes being made).

The review frequency & approach of the plans in CPS 900 appears to be reasonable. However, it would make sense and be more efficient to align the timing of an ICAAP review with that for both the Recovery Plan and Resolution Plan

Paragraph 34 of CPS 900 states:

> "An APRA-regulated entity must not make any disclosures on resolution planning without the approval of APRA."

APRA should acknowledge the continuous disclosure obligation on listed insurers that may be triggered for example by pre-positioning actions. APRA should provide clarity on para 34 so that it does not potentially conflict with continuous disclosure obligations through a carve-out on listed insurers.

CSP 900 - Timeframe and implementation

The CPG 900 states that "Entities would only be subject to the requirements of CPS 900 when informed by APRA that it is commencing resolution planning. Prior to this, there are no requirements under CPS 900 that the entity would need to meet.".

Further guidance on expected timings for APRA to commence resolution planning would help regulated entities plan resourcing requirements, especially in light of other regulatory reform currently underway (including FAR and the review of LAGIC for IFRS17). For example, does APRA intend to commence resolution planning with some entities in advance of the 1 January 2024 implementation date or should entities expect the process to start some time after 1 January 2024? More broadly, we seek clarity from APRA on engagement touchpoints, timetable, and expectations, both leading up to 1 January 2024 as well as beyond, including the timeframe by which the organisation is expected to comply.

We trust that our initial observations are of assistance.

The ICA and insurers would welcome the opportunity to meet with APRA to discuss the items raised.

If you have any questions or comments in relation to our submission please contact [redacted], Senior Policy Advisor on [redacted].

Yours sincerely

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