



**Actuaries
Institute.**

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General Manager, Policy.
Australian Prudential Regulatory Authority
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SYDNEY NSW 2001

Email: PolicyDevelopment@apra.gov.au

Dear General Manager,

Consultation: Targeted Adjustments to General Insurance Reinsurance Settings

The Actuaries Institute ('the Institute') welcomes the opportunity to make a submission to this consultation.

The Institute is the peak professional body for actuaries in Australia. Our members work in a wide range of fields including insurance, superannuation and retirement incomes, enterprise risk management, data analytics and AI, climate change and sustainability, and government services. The Institute has a longstanding commitment to contribute to public policy discussions where our members have relevant expertise. The comments made in this submission are guided by the Institute's 'Public Policy Principles' that any policy measures or changes should promote public wellbeing, consider potential impacts on equity, be evidenced-based and support effectively regulated systems.

The Institute supports APRA's approach to periodic review and reconsideration of elements of prudential and capital requirements. This consultation on General Insurance reinsurance settings demonstrates APRA's capacity to update and streamline prudential requirements as circumstances change.

Our response focuses on the questions posed by APRA in the [consultation letter dated 7 November 2024](#).

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How could APRA adjust its reinsurance settings, or its process for approving the capital benefit of reinsurance arrangements, to improve access to all forms of reinsurance for general insurers?

Reinsurance is a critical element of risk management for individual general insurers and for the general insurance industry as a whole. The Institute supports changes to streamline the prudential requirements and maintain access for Australian insurers to global reinsurance arrangements and high-quality alternative protection markets. It is important that APRA's regulatory framework evolves to ensure new challenges, such as climate risk, can be met. The Institute believes that changes should be made in a way that retains the overall strength of the prudential framework, acknowledging that there may need to be trade-offs between particular elements of the framework.

We address APRA's specific proposals in the following section.

What are the likely impacts (including costs and benefits) of APRA adjusting requirements regarding all perils, reinstatement and capital requirements for reinstatement premiums as outlined in APRA's attachment?

Our response to the potential changes flagged by APRA is set out underneath each proposed change.

Capital requirement - All perils requirement

APRA's potential adjustment - Allow insurers to calculate the 1-in-200 year loss for the largest single peril and buy all perils reinsurance to that level.

Our response: The Institute proposes an alternate to APRA's suggested adjustment.

We expect that changing the method to estimate the Probable Maximum Loss (PML) from an 'all perils' at 1-in-200 years to be the 'single largest peril' at 1-in-200 years would lead to a very modest reduction in the upper limit of reinsurance protection that insurers require. The nature of the reinsurance required to be placed would remain as 'all perils,' but the amount of cover would reduce. For example, an insurer has calculated its 1-in-200 'all perils' loss to be \$1 billion, but the 1-in-200 year 'largest peril' loss may be \$850 million. The equivalent 'all perils' return period for an \$850 million loss may be 1-in-180 years. The insurer must still purchase 'all perils' cover, but now to the 1-in-180 year 'all perils' return period.

We note that reinsurance that covers 'all perils' will have been priced by the reinsurance market in light of the peril exposure and potential losses. In a situation where one peril (e.g. earthquake) dominates exposure at extreme levels, the price of reinsurance will reflect this. While cover is provided for storm and flood, the 'cost' of this cover at extreme return periods will be very low, because only earthquake actually has any significant risk at extreme return periods.

We understand, however, that the catastrophe bond market is more likely to offer named perils cover, rather than 'all perils' cover. For example, insurers may be able to more easily purchase protection for a single peril (such as earthquake), potentially for a single region. As a result, insurers face challenges in making use of catastrophe bonds and still cost effectively complying with GPS 116.

We believe a better outcome would be to retain the existing *level* of protection (cover up to the dollar level of the PML at 1-in-200 years on an ‘all perils’ basis) but allow more flexibility in *how an insurer structures the protection*. This would allow insurers to take advantage of catastrophe bonds, or other alternative forms of protection, for extreme tail events (which may be caused by a single peril), but have full reinsurance protection for more common perils.

This flexibility may include allowing single peril only coverage at high return periods (for example if a single peril and/or region dominates tail risk), and ‘all perils’ cover at lower levels.

Capital requirement - Reinstatement requirement

APRA’s potential adjustment - Given that the probability of two 1-in-200 year losses occurring in a 12-month period is statistically very low, the return period for which reinstatement is required could be lowered (for example to 1-in-100 year loss).

Our response: We agree with this proposal.

We believe this change could have several outcomes:

- It could slightly reduce the overall level of protection required to be held by general insurers. Currently, if a general insurer suffers a 1-in-200 year catastrophe outcome, they are automatically protected against a similar extreme event occurring again. However, as noted in the question, the chance of having two 1-in-200 year events occur during the same year is remote. This change would therefore slightly increase the risk for general insurers.
- It would reduce the pro-cyclical nature of the current vertical requirement (VR) following a large catastrophe. Under the current rules, if a 1-in-200 year event occurred, and the general insurer is protected by reinsurance, the VR could *increase* because the insurer will be required to allow for the cost of a *further* reinstatement. This is because the VR is calculated at each (quarterly) reporting date and must include the cost of reinstating all relevant catastrophe reinsurance cover (as outlined in GPS 116 paragraph 25). Removing pro-cyclical outcomes would be a positive outcome.
- This change would increase the ability of Australian general insurers to make use of alternative reinsurance solutions such as catastrophe bonds. In general, catastrophe bonds do not offer reinstatements.¹ As they tend to be used for upper layers which provide cover for large events (such as 1-in-100 year events or larger)² it would be difficult to make use of catastrophe bonds under the existing requirements that require a reinstatement. Allowing greater access to catastrophe bonds would be a positive outcome.

On balance, we believe that removing an element of pro-cyclicality in the current capital requirements, as well as clarifying the practical ability to access to catastrophe bonds, outweigh the reduction in protection from requiring reinstatements above 1-in-100 year event level.

¹ American Academy of Actuaries, *Insurance-Linked Securities and Catastrophe Bonds*, June 2022, page 10.

² American Academy of Actuaries, *Insurance-Linked Securities and Catastrophe Bonds*, June 2022, page 15.

Capital requirement - Reinstatement premium requirement

APRA's potential adjustment - Remove the requirement for reinstatement premium to be held in the natural perils vertical requirement (NP VR) and other accumulations vertical requirement of the Insurance Concentration Risk Charge (ICRC).

Our response: We disagree with this proposal.

We disagree with a complete removal of the requirement for reinstatement premium to be held in the NP VR. We believe there is a benefit to market practice in retaining a reinstatement premium requirement particularly at lower levels (e.g. 1-in-100 years).

The reinsurance market in Australia has evolved to include reinstatement cover as part of catastrophe reinsurance programs, and most programs will include one pre-paid (or 'free') reinstatement. This practice ensures guaranteed protection for insurers after a 'medium' sized event has occurred. As a result, we believe it is worthwhile retaining this requirement, and therefore disagree with the proposal.

Further APRA consideration - Appointed Actuary reviewing role. APRA will consider extending the role of the Appointed Actuary (AA) to enable the AA to assess the capital treatment of traditional and alternative reinsurance arrangements for compliance with APRA's prudential requirements. While APRA would still maintain supervisory oversight, this should reduce regulatory burden on industry by reducing the number of reinsurance arrangements that need to be referred to APRA.

Our response: We agree with this proposal.

We are generally supportive of this proposal. The reinsurance market and market practice has evolved since the initial introduction of Prudential Standard GPS 116 Capital Adequacy, and some types of reinsurance, such as aggregate reinsurance, are now common and generally well understood. The Appointed Actuary has a holistic view of the financial condition of an insurer, is required to act impartially,³ and has the technical skills to assess reinsurance arrangements.

While APRA's questions have focused on the Vertical Requirement of the ICRC, we believe that the role of the AA in assessing the capital treatment of traditional and alternative reinsurance arrangements could extend across all relevant prudential requirements (including the Horizontal Requirement of the ICRC, and elements such as the Insurance Risk Charge and Asset Risk Charge).

We recommend that additional responsibilities for the Appointed Actuary are set out in a similar manner to the existing Actuarial Valuation Report (AVR) and Financial Condition Report (FCR) requirements.⁴ In particular, we recommend that the insurer remains ultimately responsible for the capital treatment of traditional and alternative reinsurance arrangements, but that the Appointed Actuary would assess and provide written advice to the insurer on the appropriate treatment. As with the AVR and FCR, any such advice would also be provided to APRA.

We recommend that the Appointed Actuary should provide advice on appropriate capital treatment subject to principles that APRA develops. The principles would ensure consistency in the application of capital treatment across insurers. Members of the Actuaries Institute would be pleased to work with APRA in developing these principles, once APRA makes a decision on its approach to the other elements set out in this discussion paper.

³ Prudential Standard CPS 320 Actuarial and Related Matters paragraph 17(a).

⁴ Prudential Standard CPS 320 Actuarial and Related Matters paragraphs 24 and 30.

Following the development of APRA's principles, the Actuaries Institute anticipates developing a new Professional Standard and guidance materials to assist Appointed Actuaries with the new requirements.

We suggest that any such arrangements and the approach adopted by the Appointed Actuary to assess the capital outcome should be included in the Actuarial Advice Framework and documented in the FCR.

Further considerations

We note that changes would be required to both Level 1 and Level 2 requirements. Any principles developed to allow the AA to assess the capital treatment of reinsurance should consider both Level 1 and Level 2 requirements and implications.

Although APRA's questions have focused on the Vertical Requirement of the ICRC, we believe APRA should also consider equivalent changes to the Horizontal Requirement. In particular, we recommend APRA also consider whether multiple reinstatement premiums should be required to be included for the H3 and H4 calculations.

Are there any further technical refinements to the GI reinsurance framework that APRA should consider?

Our response to the technical refinements identified by APRA in Attachment B is set out underneath each refinement.

Technical Refinement - Reinsurance Arrangements Statement (ReAS)

APRA's potential solution - Update the ReAS to require insurers to include detail on catastrophe modelling.

Our response: If this is kept at a principles level then we agree.

There can be a large degree of complexity involved in catastrophe modelling, and while the modelling will be used to inform the reinsurance program, it will not necessarily determine the final program. If the requirement is kept at a principles level, and insurers are able to determine the level of detail that would be helpful to include in the ReAS, then we agree.

APRA should consider whether details on modelling for the Other Accumulations Vertical Requirement (which may not be traditional 'catastrophe modelling') should also be included in the ReAS. If so, we suggest that APRA provide guidance (through the Prudential Practice Guide) on what APRA would expect to see included.

Technical Refinement - Definition of aggregate reinsurance

APRA's potential solution - Amend the definition of aggregate reinsurance to reduce the volume of entity referrals to APRA.

Our response: We agree.

As noted in our responses above, aggregate catastrophe reinsurance is now a well understood and used form of protection within the Australian general insurance industry. There is no reason that it should not be automatically recognised as part of the Insurance Concentration Risk Charge calculation rather than first requiring an application to APRA.⁵

Technical Refinement - APRA approval of capital benefit of reinsurance arrangements

APRA's potential solution - Update the prudential framework with principles for considering reinsurance so that for certain arrangements, the AA can determine the appropriate capital outcome. This reduces the need for those arrangements to be submitted to APRA for approval.

Our response: We agree, as noted in our earlier response.

Technical Refinement - Non-modelled risks

APRA's potential solution – Clarify that non-modelled risks must be considered as part of an entity's catastrophe modelling process.

Our response: We have no objection to further clarifications.

We note that Prudential Standard GPS 116 Capital Adequacy paragraph 21(b) (and footnote 5) and Prudential Practice Guide GPG 116 Insurance Concentration Risk paragraph 25 appear to already require that non-modelled risks are considered and appropriately allowed for when calculating the ICRC.

However, we have no objections to further clarification.

Technical Refinement - Reinsurance Contract

APRA's potential solution – Update GPS 230 reinsurance contract requirements to include the need for arbitration and claim payment to be in Australia.

Our response: We do not have any objections to the proposed changes.

Technical Refinement - 'Two month rule' requirement

APRA's potential solution – Amend the 'two month rule' to refer to contract terms being legally binding and remove the requirement for contracts to be 'signed and stamped'.

Our response: We do not have any objections to the proposed changes.

⁵ Prudential Standard GPS 116 Capital Adequacy, paragraph 25.

Technical Refinement - Reinsurance guidance

APRA's potential solution – Update reinsurance PPGs to accurately reflect the latest APRA requirements and expectations, alongside streamlining reinsurance guidance.

Our response: We strongly support this.

We strongly support APRA's plan to update guidance material. Prudential Practice Guides are a valuable way that APRA sets out its view of better practice to the insurance industry and allows insurers to consider and adapt the guidance to their own unique circumstances. We support regular review and updating of Prudential Practice Guides.

The Institute would be willing to discuss this submission with you. If you would like to do so, please contact the Institute via (02) 9239 6100 or public_policy@actuaries.asn.au.

Yours sincerely



CEO