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Sent via: PolicyDevelopment@apra.gov.au

To Whom It May Concern

Aon welcomes the opportunity to provide comments on APRA's consultation on targeted adjustments to general insurance reinsurance settings (the 'APRA letter'). Aon agrees to our submission being made public.

As a leading reinsurance broker, Aon is in a strong position to provide APRA with feedback on ways to promote access to reinsurance and assist in understanding the impact of changes to the reinsurance framework on reinsurance appetite and premium levels. Whilst we are not an APRA-authorised insurer or reinsurer, we are actively involved in a large majority of the reinsurance transactions emanating from Australia, and provide APRA-regulated insurers with advice and input to interpretation of the framework as well as informing their reinsurance strategy and placement decisions.

The views presented here are based on our experience in placing reinsurance arrangements for APRA-authorised insurers combined with insights gleaned from our global operations in the (re)insurance industry. We are available to meet with APRA to aid with ensuring APRA's objectives and proposals create genuine change in access to reinsurance.

Aon supports APRA's position that reinsurance provides significant benefit to Australian insurers and policyholders. We note that increased retentions over the last few years have resulted in more retained risk to insurers and that, in addition, there has been an increase in reinsurance costs over the same period. We note also that these factors, in conjunction with external factors such as higher than normal inflation, have resulted in increased insurance costs to policyholders.

We note that APRA has sought both general and specific feedback on adjustments to the reinsurance framework, as well as technical updates. We set out our feedback in these categories below. We believe that addressing the three key areas we have raised on reinsurance settings in Question 1 below will provide benefit to insurers and therefore policyholders.

APRA Question 1: 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 Settings: Natural Perils Horizontal Requirement (NP HR)

Aon notes that the NP HR was first calibrated in 2011 and revised in 2012, resulting in the scenario whereby three 1-in-10 year events or four 1-in-6 year events were deemed representative of a 1-in-200 year scenario for a series of smaller sized events. This change in APRA's capital calculation resulted in insurers purchasing third and fourth event covers that can sometimes have significant spend and therefore increase costs to policyholders. It is Aon's view that APRA could re-visit the need for, and/or the calibration of, the NP HR. Ways in which this could be achieved include:

- the number of events could be reduced and instead an insurer be required to review and consider the impact of further events and the adequacy of reinstatements through its ICAAP (similar to paragraph 17 of GPS 116);
- an insurer's NP HR is based on a lower number of events, but once an event occurs that materially depletes any reinsurance cover, there is a re-calculation of the NP HR if back-up covers are not purchased; and/or
- APRA could revisit the calibration of the scenarios such that the overall achieved representation is decreased from 1-in-200 years to circa 1-in-50 years or 1-in-100 years. Aon would be able to assist APRA with determining the number of and return periods for these amended scenarios.

Alternatively, the NP HR could be removed altogether and the impact of a series of smaller events be considered as part of an Insurer's ICAAP. A material change to (or removal of) the NP HR could result in insurers removing the need to purchase some covers where the cost is passed onto policyholders.

Reinsurance Settings: Credit for Catastrophe Bonds and Insurance-Linked Securities

Aon notes APRA's letter from August 2023 in relation to use of alternative reinsurance arrangements. The use of capital markets-based transactions by APRA-regulated entities has continued to lag the global insurance and reinsurance industry with the primary reason being the regulatory hurdles in Australia. Despite domestic general insurers purchasing some of the largest reinsurance programs globally, the use of alternative capital is in the low single digit percentages and, in some instances, zero. As a result, domestic general insurers have had less opportunity to diversify their reinsurance counterparties, take advantage of opportunistic pricing environments to drive reinsurance pricing tension, and access multi-year reinsurance arrangements.

The catastrophe bond market and broader alternative capital markets' growth has outpaced that of traditional reinsurance capital, despite significant loss activity since 2017. The market provides over 100 entities globally with the ability to source effective risk transfer solutions beyond the traditional reinsurance market. These entities are regulated and/or domiciled in the United States, Bermuda, the United Kingdom, Spain, France, Germany, Italy, Japan, New

Zealand and Hong Kong. In each jurisdiction the catastrophe bond product is viewed favourably by the regulator given the multi-year and fully collateralized nature of the product.

We see the key hurdles for catastrophe bond issuances currently as:

- i. the requirement for a pre-paid reinstatement;
- ii. trust account structure; and
- iii. uncertainty in regard to APRA approval and/or capital credit provided by the reinsurance agreement.

Within the current constraints of the regulation, especially the requirement for the pre-paid reinstatement up to 1-in-200 years, the cat bond product has not been economical given the minimum premium requirements. That being said we have observed that catastrophe bonds offer highly competitive pricing in the lower and middle parts of reinsurance programs which is also the area of the program where there is higher traditional pricing volatility.

Aon's recommendation would be to align the regulation of these products more closely to that of global insurance regulators to make catastrophe bond transactions more viable to domestic general insurers which in turn allows for them to diversify their reinsurance program, take advantage of competitive pricing when available, and access fully collateralized reinsurance arrangements to reduce the credit risk of the reinsurance panel.

Reinsurance Settings: Asset Risk Charges for Non-APRA-Authorised Reinsurers

Aon notes that the Asset Risk Charge in Prudential Standard GPS 114 Capital Adequacy: Asset Risk ('GPS 114') has risk charges for non-APRA-authorized reinsurers, which also vary by Counterparty Grade. Aon would encourage APRA to reconsider the calibration of these risk charges, particularly those for "past the second balance date" where the reinsurer is not yet required to pay the insurer as underlying claims are not settled. If the differential between APRA and non-APRA Authorised Reinsurers was lowered, this may allow insurers to make use of additional reinsurance capacity from outside Australia.

Approval Processes: Aggregate cover in Natural Perils Vertical Requirement (NP VR)

Aon notes that in 2019, APRA explicitly removed the requirement for consultation with APRA for recognition of reinsurance premium protections and capital market structures given the increased familiarity with these structures. It is our view that APRA could continue the removal of referrals to APRA on structures by automatically recognising credit for aggregate covers in the NP VR. This could be completed by amending paragraph 26 of Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge ('GPS 116') such that the insurer can take credit in the same way as credit is given in the Natural Perils Horizontal Requirement and Other Accumulations Vertical Requirement for these covers. This would remove the burden of applying for credit and agreeing a methodology with APRA.

APRA Question 2: 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 Attachment B?

Switch From All Perils Requirement to Single Peril

Aon agrees that this change to the requirements in GPS 116 would reduce the minimum limit that is required to be purchased in order to reduce the NP VR for reinsurance recoverables, which may provide a small amount of benefit to policyholders. This change makes two key assumptions:

1. Insurers only purchase to the 1-in-200 year whole of portfolio requirement – often the risk appetite of insurers is higher than this and therefore may not result in a change to limit purchased; and
2. Some insurers have exposures in other jurisdictions (eg New Zealand) and therefore they may still need to buy more reinsurance than the 1-in-200 year single peril requirement.

We also note that it is not clear in APRA's letter whether the single peril is also single site, or whether it is the loss occurring across all locations for that peril. If APRA was to go ahead with the change, GPS 116 would need to be clear on the specific calculation to be undertaken, including the treatment of insurers with exposures in multiple jurisdictions.

It is important to note that each insurer has different exposures to different perils and therefore the benefit for each insurer may vary significantly, depending on whether their 1-in-200 year whole of portfolio loss is driven by a single peril, or equal loss exposure to more than one peril.

Finally, we would note that the 1-in-200 year level is higher than many international peers and whilst we support a prudent level of reinsurance for significant sized events and the overall calibration of APRA's capital framework, APRA could consider reducing the NP VR calibration to lower than 1-in-200 years. This statement also holds true for the calibration of NP HR.

If an insurer was to only purchase the minimum reinsurance, this would reduce the top layer(s) of insurer programmes. At this level of the placement, however, minimum rates are charged and so we would estimate that such a change would reduce an insurer's total premium for catastrophe excess of loss reinsurance by less than five percent.

Remove Reinstatement Requirement above 1-in-100 years

Aon agrees that this change in GPS 116 would theoretically introduce a discount to reinsurance premium of insurers above 1-in-100 years. However, we would note that reinsurers do not typically give a large discount for the removal of a reinstatement at high return periods and we see an immaterial impact on the total reinsurance premium for insurers. We would also note that we would not generally expect insurers to necessarily 'give up' this reinstatement as it does not save them a material amount of in upfront premium, but could be quite expensive to purchase after a major catastrophe event.

Aon notes that the removal of the requirement to have a reinstatement may induce catastrophe bonds to the Australian market to participate above 1-in-100 years. However, the premium for catastrophe bonds at this level can often be materially higher than traditional reinsurance and therefore not save insurers (and therefore policyholders) any premium.

Remove Reinstatement Premium from NP VR and Other Accumulations Vertical Requirement

Aon agrees that this change in GPS 116 would have two impacts:

1. the potential reduction in NP VR and therefore ICRC and Prescribed Capital Amount (PCA); and
2. the potential for insurers to switch to paid reinstatements and reduce upfront premium on catastrophe excess of loss programmes.

On #1, we note that a limited number of insurers currently have paid reinstatements on their catastrophe excess of loss programmes and therefore we do not envisage a material change to NP VR or PCA. Further to this, we would note that many insurers have their NP HR drive the ICRC so there may be zero benefit of this charge.

On #2, the switch to paid reinstatement could see a reduction in upfront premium by as much as 10% of the programme premium, assuming that reinsurers pass on the theoretical saving by receiving reinstatement premiums after an event. Aon would caution APRA that this would not necessarily be taken up by insurers, particularly on the first layer(s) of programmes. With a pre-paid reinstatement, insurers make a full recovery on layers and do not have to make payment for a reinstatement. With a paid reinstatement, these low layers will higher premiums and the need to pay for the reinstatement will reduce the benefit of the reinsurance to the insurer and therefore policyholders.

Overall, we would reiterate that whilst we agree the three proposed changes may have some theoretical impact on reinsurance premium for insurers, it does make key assumptions about insurer behaviour which may not play out in practice. We would encourage APRA to instead consider the recommendations we have made under Question 1 as well as the overall 1-in-200 year calibration level of the Insurance Concentration Risk Charge requirements.

APRA Question 3: Are there any further technical refinements to the GI reinsurance framework that APRA should consider?

Technical Refinements in APRA's letter

Aon supports the technical refinements set out in Attachment B of APRA's letter. We particularly support the amendment to the definition of aggregate cover and allowing the Appointed Actuary to determine the capital outcome for certain types of reinsurance.

We make the following additional recommendation: APRA re-visit the wording of paragraph 13 of GPS 116, specifically the use of the words "subsequent to the deadline specified in under the two month rule" in part (b) as it creates an unnecessary gap in time between missing inception date and awaiting the two months to pass for credit to be given to reinsurance that is incepted outside of the single treaty date.

As mentioned above, we are available to meet with APRA to discuss any of the above topics. Please contact myself or [REDACTED] should you have any questions in relation to our submission.

Kind regards

[REDACTED]

Reinsurance Solutions, Aon

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