

General Manager, Policy
Australian Prudential Regulation Authority

Hannover Re makes this submission in response to APRA's consultation on targeted adjustments to general insurance reinsurance settings outlined in the letter to all general insurers and reinsurers dated 7 November, 2024. APRA has invited written submissions on the issues and proposals outlined.

APRA has appetite to review capital requirements and proposes some technical refinements, with the aim of promoting access to all forms of reinsurance, reducing regulatory burden and improving consistency.

Hannover Re makes this submission regarding the specific proposed adjustments to the capital requirements, the process for approving the capital benefit of reinsurance arrangements, and technical refinements.

Adjustments to the capital requirements

GPS 116 outlines the method for calculating the Insurance Concentration Risk Charge (ICRC) component of the PCA and stipulates that an insurer must hold capital against a 1-in-200 year loss on a whole of portfolio basis. Capital required can be reduced by reinsurance covering events up to the 1-in-200 year loss for all perils with a contractually agreed reinstatement and any additional reinstatement premium is included in the ICRC.

APRA is aware that these requirements can constrain access to alternative reinsurance arrangements and has appetite to review the above three requirements.

APRA acknowledges that the potential adjustments detailed represent an easing of the current requirements but continues to expect robust reinsurance management with insurers demonstrating the use of non-traditional reinsurance solutions is within risk appetite and any added risk considered in the ICAAP.

While the proposed adjustments may allow increased consideration of alternative reinsurance solutions, the improvement is likely not material and is also unlikely to resolve issues relating to availability and affordability. We note also that alternative reinsurance solutions are not necessarily lower cost options, depending on the market cycle and the specific structure required. However, the proposed adjustments may lead to a lower level of capital adequacy for the Australian market compared to international peers which is not a desirable outcome – refer recently adopted IAIS International Capital Standard.

All perils requirement

Allowing insurers to calculate the 1-in-200 year loss for the largest single peril and buy all perils reinsurance to that level does not materially further any of the objectives APRA is aiming to achieve, and represents a departure from international standards and practice in catastrophe risk management.

This adjustment would bring the capital requirement below the broad international standard which APRA noted as having capital adequacy measured on an all perils basis at a 1-in-200 year loss or beyond or at more extreme return periods for specific single perils. While individual insurers may choose to manage their capital and reinsurance purchase to a higher return period based on their own risk appetite, this adjustment would be an easing of the current capital requirement for the Australian market which could create unintended systematic risk in

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what is a highly volatile Natural Catastrophe region. Furthermore, an incentive to reduce reinsurance purchase would likely result in materially different levels of downside capital protection for different members of the insurance marketplace, with private companies and member-owned insurers purchasing less reinsurance, while publicly traded companies, with significant overseas exposures, continuing to purchase reinsurance in accordance with broad international and rating agency norms. Australian insurers who are also market leaders in New Zealand may also see little change in their vertical limit requirements, with a shift to New Zealand capital requirements as the driver.

Whilst the potential lower limit requirement would reduce overall capacity demand, it is Hannover Re's experience that supply is not a constraint at the top layers of the Vertical Towers. Availability and cost issues are more likely experienced at the lower layers due to high frequency catastrophe loss activity in the Australian market. Access to alternative forms of reinsurance, such as cat bonds and ILS, would also not be improved as these are more likely to provide specific peril cover rather than all perils cover.

Reinstatement requirement

Removing the reinstatement requirement for the layers above 1-in-100 may improve access to alternative capital as these are often structured with no reinstatements.

We do note that extreme events may not be independent, such as a very large earthquake and subsequent aftershocks. After a 1-in-200 event it may be difficult or very costly for insurers to reinstate reinsurance cover and failure to do so may significantly expose them to further events.

Reinstatement premium requirement

Not requiring the cost of reinstatement to be included in the ICRC is likely to lead to placements with paid reinstatements, which is more consistent with other international markets. While this would lead to lower upfront reinsurance cost for insurers, it does create the situation that when a loss occurs, insurers would need additional and potentially higher reinstatement cashflow on top of claims costs. Prudent management would suggest an appropriate amount is held for the cost of reinstating catastrophe cover regardless of capital requirements, which would lead to neutral affordability impacts.

Process for approving the capital benefit of reinsurance arrangements

APRA is proposing extending the role of the Appointed Actuary to enable the AA to assess the capital treatment of alternative reinsurance arrangements for compliance with APRA's prudential requirements and reduce the number of referrals that need to be submitted to APRA. APRA currently needs to approve capital adjustments for non-standard reinsurance structures, such as Stop Loss and Adverse Development Cover, as well as alternative reinsurance, to ensure appropriate capital outcomes.

Hannover Re welcomes the proposal and the reduction in regulatory burden in principle. It would also facilitate better access to alternative reinsurance as more efficient assessment of the capital impact of these covers would increase insurer willingness to use these covers.

APRA proposes to update the framework with principles for considering reinsurance so that for certain arrangements the AA can determine the appropriate capital outcome. This would be a welcome refinement and we would encourage sufficient details to be published in the guidance in order to ensure consistency in treatment across the industry that is not solely dependent on the judgement of individual AAs. We would also encourage APRA to clearly specify the boundaries beyond which referral to APRA would still be required.

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Technical refinements

Hannover Re supports APRA's proposal of technical refinements to the reinsurance framework to improve clarity and improve operational efficiency. We note that some proposals require further details, such as the process mentioned above and proposed definition of aggregate reinsurance, in order for the industry to provide more robust feedback on the proposed changes and their impact.

We welcome a wider review of technical elements on the topics above and the broader framework, including broader considerations regarding the use of internal retrocession for catastrophe reinsurance to enable more robust risk-sharing across the global reinsurance market and thereby optimise diversification benefits into the Australian market.