Swiss Re

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Dear Mr Beckett,

Consultation on targeted adjustments to general insurance reinsurance settings

Swiss Re welcomes the opportunity to provide feedback about ways to promote general insurers' access to reinsurance, including alternative reinsurance arrangements. As APRA will know, Swiss Re and APRA have consulted regularly about this topic, most recently in October 2023, December 2022 and November 2020.

About Swiss Re

The Swiss Re Group is one of the world's leading providers of reinsurance, insurance and other forms of insurance-based risk transfer, working to make the world more resilient. It anticipates and manages risk – from natural catastrophes to climate change. The aim of the Swiss Re Group is to enable society to thrive and progress, creating new opportunities and solutions for its clients. Headquartered in Zurich, Switzerland, where it was founded in 1863, the Swiss Re Group operates through a network of around 80 offices globally.

The feedback in this submission, responds to the three questions, set out in APRA's letter to the industry, dated 7 November 2024, noting our focus has been primarily on the proposed amendments in Attachment A.

Impacts of APRA proposed adjustments as outlined in Attachment A

At the outset, we commend APRA's intent to review the settings under GPS116 as they pertain to the reinsurance settings, recognising the global reinsurance correction in 2023 and broader affordability challenges for original insureds. The intent to promote innovation and diversify access to reinsurance and/or alternative reinsurance capital is evident in the proposed changes, bringing APRA's requirements incrementally into line with global standards.

Please accept some general observations for APRA's consideration:

- The proposals put forward generally serve to dilute the capital requirements for tail/extreme scenarios (changes to all perils requirement and reinstatement requirement in particular), during which time insurers most acutely require reinsurance protection to remain solvent. The additional risk of systemic failure created by these proposed amendments pose additional and perhaps unanticipated burdens to Government and its established safety net-mechanisms, such as the Financial Claims Scheme (FCS).

- The use of alternative capital originated in markets and domiciles where there were (and continue to be) shortages of traditional reinsurance capacity relative to the demand for such cover, especially post a significant loss e.g. Florida / Hurricane Andrew (1992) and California / Northridge EQ (1993). Due to the challenges in attracting sufficient capacity, regulatory capital requirements in these domiciles have been necessarily more flexible in accommodating alternative capital and (in some cases) less stringent overall, to enable the operation of the local insurance market and provision of insurance coverage to policyholders. We also note that alternative reinsurance capital may be accessed by buyers to strategically diversify their reinsurance protection/capital. While the proposed changes bring APRA's requirements back into line with other global jurisdictions which better accommodate the use of alternative capital, further consideration could be made as to whether a pre-emptive weakening of the standard (primarily the removal of the reinstatement above 100yrs), versus a case-by-case approach (with some formalised guidance or framework) may be the best approach to helping insurers explore integration of these alternatives.

- No explicit consideration has been given to the horizontal component of the ICRC in the changes proposed. With recent hard market experience, the limited capacity and increased cost in securing indemnity-based, all perils, aggregate-type protections to offset this element of the ICRC posed material challenges. We encourage APRA to consider re-visiting this element of the standard, including (at a minimum) the eligibility of reinsurance alternatives which are not pure indemnity-based solutions to allow insurers flexibility in considering more innovative risk transfer solutions (e.g. parametric, ILWs, hybrids etc).

- Additional costs of cover and operational complexity, though not prohibitive, create additional challenges in adopting alternative capital:

    - While alternative capital investors have historically had the appetite to take on A&NZ peak perils risk, noting these provide valuable diversification to their peak US (EQ/Wind) portfolio concentrations, the traditional reinsurance market has been able to provide abundant capacity for A&NZ consistent with APRA's existing requirements (all perils coverage including reinstatement), and at a cheaper cost than the

    - alternatives. Pricing of traditional reinsurance for A&NZ perils would need to reach some level of parity with these alternatives before an economic benefit can be realised, however we anticipate that diversified reinsurance capital deployed in non-peak scenarios will remain more cost-effective than collateralised/alternative capital.
    - We observe that Australian risk in ILS placements has, for efficiency, often been bundled with peak peril exposures rather than as standalone placements. We note that in these cases the collateralised limit is shared across various scenarios.
    - We anticipate the main beneficiaries of these proposed changes being larger insurers with meaningful global footprints - where a level of price parity between traditional and alternative capacity already exists due to the convergence of reinsurer capital costs for peak perils and the capital market's returns for ILS.

- We support the proposed amendments to extend Appointed Actuaries' roles in assessing compliance of both traditional and alternative reinsurance against APRA's prudential requirements, recognising the reduced regulatory burden on industry this change brings.
    - This change will additionally help insurers build expertise in considering various reinsurance structures and enable further innovation within their reinsurance programmes/strategies.
    - We suggest APRA provide additional guidance for Appointed Actuaries in making assessments, including explicit guidance around consideration and quantification of basis risk (see page 6), as well as assessment of risk transfer under any reinsurances (traditional or otherwise) being considered, to help support AA's with these expanded responsibilities.

Below, we highlight the impacts and considerations to be made with respect to the individual amendments proposed within Attachment A.

All Perils Requirement: Allow insurers to calculate the 1-in-200 year loss for the largest single peril and buy all perils reinsurance to that level.

We recognise the proposed changes bring APRA's requirements more in line with other global solvency and rating agency approaches. We anticipate this change may have some (limited) benefit to insurers however also requires consideration of some (potentially) unintended consequences:

- Costs & Affordability: While some reduction in limit enables insurers to reduce their overall reinsurance spend, premium savings will be limited, with 'minimum rate-on-line' (or minimum price-for-capacity) premiums attached to these portions of reinsurance towers. Further still, these savings as a proportion of the insurers' total gross earned premium are marginal at best and are unlikely to provide meaningful cost savings at an overall insurer/industry/policyholder level.

- Multiple Peak Peril Drivers: Depending on the insurer's exposure concentrations, the adequacy of the vertical 1 in 200 year "worst peril" limit might vary substantially between insurers. Some consideration needs to be made of the residual risk that organisations face. For example, if an insurer has 4 different perils around same size contributing at the 1 in 200yr level, that would be a very different risk profile vs. an insurer only facing one peril at that level.

- Additionally, the inherent modelling uncertainty in estimating tail (200yr) outcomes is significant. To the extent there is meaningful peril diversification within an insurer's portfolio, using an all perils view for limit setting provides some implicit buffer which helps mitigate this uncertainty to some extent.

We remain impartial to this proposed change, noting the generally limited impact expected on both the limit purchased at an industry level and the limited cost savings expected from an affordability stand point.

Reinstatement requirement: 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).

This proposed change helps address one key limitation in implementing an alternative capital solution i.e. the lack of investor appetite to provide reinstatement cover. We do however feel this change has the potential to materially weaken the overall industry's solvency - particularly in its time of greatest distress (following a major loss event). Potential impacts and issues to be considered include:

- Correlation of Events: in the extreme tail, events are not necessarily independent (e.g. severe aftershocks following major earthquakes, with earthquakes often being the driver of the reinsurance structure limit). The Christchurch earthquake series is one example of directly correlated tail outcomes. In that same period, the ANZ region also experienced widespread Queensland flooding and Cyclone Yasi (which were each independent of the NZ earthquakes, but themselves correlated due to La Nina conditions). Whilst the NZ earthquakes were the only events with the scale to reach upper layers of Cat XL structures in 2010/11, we simply highlight the possibility of multiple correlated and/or uncorrelated event clustering within an annual cover period. In considering extreme tail risk, it is undesirable to assume that natural perils behave in a purely Poissonian (ie uncorrelated) fashion.

- Market Dislocation/Back-up cover availability: As recent experience has shown, the ability to secure affordable and adequate back-up cover in a post-loss environment may be limited. Even with the recent Australian floods (2022) and Auckland floods/TC Gabrielle (2023) - both scenarios considered well below 1 in 100 year whole-of-portfolio events by the reinsurance market and relatively moderate in size compared to a market limit loss, the challenges in securing back-up reinsurance coverage were evident. Additionally, under the proposed amendment, the occurrence of a first loss above 1-in-100 years would require insurers and brokers to seek back-up cover on a 'next loss in' basis – something which the reinsurance market typically has very little appetite for, noting the above mentioned-concerns around correlations in the tail and the generally heightened level of risk and uncertainty immediately following a loss. Reinsurers may also restrict appetite for additional loss exposure to protect their earnings and/or capital in a year affected by major losses in the region, or globally.

- While the removal of the reinstatement requirement may make alternative capital more viable for local insurers, the need for all perils protection all the way through the programme may still pose challenges to investors who have historically preferred named perils-coverage, where credible modelling agents (and models) exist.
  - In several instances, it may be easily demonstrable that only a few peak perils materially contribute in the segment of the reinsurance tower where alternative capital might be considered. To improve the chance of reaching a pragmatic outcome in such instances, we would encourage APRA to provide guidance around how insurers may best frame its request for credit, including some indication of APRAs tolerance for basis risk and how insurers (and their AA's) may consider quantifying this.
  - We additionally note that there is limited appetite within the reinsurance market to provide a basis risk-solution (difference in conditions cover), which in any case would likely make the overall structure (i.e. the alternative capital solution plus the DIC cover) even less economically viable to the insurer.

- Cost benefit: As discussed previously, we anticipate that the use of alternative capital (for A&NZ risk in excess of 1:100 year attachment) will be more expensive than traditional reinsurance capacity (inclusive of the reinstatement). Additionally, we don't anticipate the reinsurance market will provide material price discounts for the removal of the reinstatement, noting that the price is largely determined by the first-event probability, and minimum rate-on-line pricing for capacity prevails in this section of the programme.

- While we acknowledge there is limited ability for APRA to influence solvency regimes in other domiciles, it must be noted that for insurers with A&NZ footprints, where peak peril/exposure maybe driven by NZ EQ (Wellington), similar/mirror changes (removal of the reinstatement requirement in particular) would need to be made to enable the effective implementation of any alternative capital solutions in this top section of the reinsurance programme.

- From a reinsurer's perspective, we note the benefits to our own business in reducing extreme tail risk for second events with return periods greater than 1:100 years. In reducing this regulatory for reinstatement through the tower, insurers/boards in general may find it more difficult to secure this protection, even if they desired to purchase the reinstatement for certainty of coverage for next event. If there is no regulatory requirement for insurers to buy this coverage, reinsurers may choose to limit their offering to single shot coverages excess of 1:100 years.

While this amendment removes one key impediment to utilising alternative capital, the proposal weakens the industry's resilience to extreme events overall, making it comparatively more vulnerable at times of acute stress. We would therefore not support this pre-emptive amendment, but rather advocate for an approach where APRA gives due consideration to proposals on a case-by-case basis, where insurers can demonstrate their ability to mitigate these residual risks through their REMS, ICAAP or other means.

Reinstatement Premium Requirement: Remove the requirement for reinstatement premium to be held in the natural perils vertical requirement and other accumulations vertical requirement of the ICRC.

We welcome the proposed changes to not require capital to be held against the cost of reinstatement. This brings Australia back into line with the global reinsurance market where paid reinstatements across reinsurance towers are generally a standard feature. This is important as paid reinstatements help to share the impact of change risk (e.g. from emerging loss trends, especially at the frequency end of the programme) between insurer and reinsurer. This also ensures better alignment (via a form of loss participation) between insurer and reinsurers across all loss levels.

While the horizontal component of the ICRC has not been explicitly dealt with, this proposed change provides additional flexibility in considering paid reinstatement (or loss additional premium) alternatives in the lower layers & aggregate space, where there is likely overlapping benefit to the horizontal components of the risk charge.

Further technical refinements to the GI reinsurance framework for APRA's Consideration

Guidance on Basis Risk

With the proposed changes, more burden will be placed on Appointed Actuaries to quantify and manage any residual basis risk (both for vertical and horizontal/aggregate reinsurance structures) through their ICAAP. Other solvency regimes such as Solvency II, allow for basis risk to be explicitly modelled within internal/capital model frameworks. Given the relative nascency of alternative capital solutions in this market, we feel some structured guidance around how basis risk may be considered, measured and APRA's tolerance for basis risk within any reinsurance structures considered, would be a necessary to help support the industry's take-up of these alternatives.

Swiss Re

<u>Update to GPG 245 – Cession Ratio for Category C insurers</u>

APRA could consider raising the cession limit for Category C insurers (from 60% to say 80-90%) when the cession is to the parent company. This would allow more flexible reinsurance structures to manage net retained risk, optimize capital management, and ultimately help reduce capital costs passed on to end consumers.

Thank you for the opportunity to provide this submission. If you would like to discuss the observations in this submission, please feel free to contact me.

Yours sincerely,

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[redacted]
Chief Risk Officer
Swiss Re Asia Pte Limited. Australia Branch