



Australian Prudential Regulation Authority instrument fixing charges No. 1 of 2009

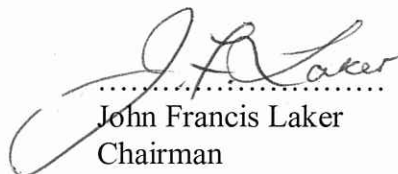
Internal Models-based Method for determining the Minimum Capital Requirement for general insurers

Australian Prudential Regulation Authority Act 1998

I, John Francis Laker, a delegate of APRA, under paragraphs 51(1) (a) and (b) of the *Australian Prudential Regulation Authority Act 1998* FIX the charges specified in the Schedule.

This instrument takes effect on the first moment of the day next following the day it is registered on the Federal Register of Legislative Instruments.

Dated 18 June 2009


John Francis Laker
Chairman

Interpretation

In this Notice

APRA means the Australian Prudential Regulation Authority.

Federal Register of Legislative Instruments means the register established under section 20 of the *Legislative Instruments Act 2003*.

Schedule – Charges for services and applications

<u>Column 1</u>	<u>Column 2</u>	<u>Column 3</u>	<u>Column 4</u>
Nature of Services and Applications	Amount of the charge	Person required to pay the charge	When the charge is required to be paid
<p>Charges are fixed in respect of the following services and applications:</p> <ul style="list-style-type: none"> development of an appropriate policy framework and the establishment of the supervisory infrastructure and technical capacity required for implementing the Internal Models-based Method (IMB Method) for determining regulatory capital requirements; and receipt and assessment of applications from general insurers seeking approval to use the IMB Method under <i>Prudential Standard GPS 100 Capital Adequacy</i> and <i>Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups</i>. 	<p>\$302,500 (inclusive of GST) where the general insurer is the first general insurer within an insurance group seeking approval to use the IMB Method.</p> <p>This charge is non-refundable and is payable whether or not the general insurer eventually obtains approval for the use of the IMB Method.</p>	<p>A general insurer seeking approval to use the IMB Method.</p>	<p>14 days after receipt of APRA's invoice for the charge. The invoice may be issued at any time after the date this instrument takes effect.</p>
	<p>\$60,500 (inclusive of GST) where the general insurer is not the first general insurer within an insurance group seeking approval to use the IMB Method.</p> <p>This charge is non-refundable and is payable whether or not the general insurer eventually obtains approval for the use of the IMB Method.</p>		

AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

COST RECOVERY IMPACT STATEMENT

**For applications by general insurers to use the
Internal Model-based Method for determining the
Minimum Capital Requirement**

18 June 2009

Table of Contents

1. OVERVIEW

- 1.1 Purpose
- 1.2 Background
- 1.3 Government cost recovery policy

2. POLICY REVIEW-ANALYSIS OF ACTIVITIES

3. DESIGN AND IMPLEMENTATION

- 3.1 Basis of charging - fee or levy
- 3.2 Legal requirements for the imposition of charges
- 3.3 Costs to be included in charges
- 3.4 Outline of charging structure
- 3.5 Summary of charging arrangements

4. ONGOING MONITORING

- 4.1 Monitoring mechanisms
- 4.2 Stakeholder consultation
- 4.3 Periodic review

5. CERTIFICATION

APPENDIX

Cost recovery table

1. OVERVIEW

1.1 Purpose

This CRIS assesses the impact of imposing, by means of a disallowable instrument under paragraphs 51(1)(a) and (b) of the *Australian Prudential Regulation Act 1998* (the APRA Act), a fee commencing from 2008-2009 for the recovery of specific costs associated with the modification of the prudential framework for implementing the Internal Models-based Method (IMB Method) for determining the Minimum Capital Requirement (MCR) for general insurers (including general insurance groups), and for assessment of applications from general insurers that have sought to use that approach for assessing their capital adequacy requirements (the proposed fees). The purpose is to provide transparency and consistency in the raising of such fees in line with government's cost recovery guidelines. The Department of Finance and Deregulation has been consulted in the preparation of this CRIS.

1.2 Background

APRA is a statutory authority set up under the APRA Act and is subject to the *Financial Management and Accountability Act 1997* (FMA Act). APRA is largely funded by an annual appropriation which is based on industry levies after the deduction of the Treasurer's determination for monies collected for ASIC and the ATO (section 50 of the APRA Act). In addition, APRA can charge fees for services and applications under section 51 of the APRA Act. The levies are determined on recommendations to the Treasurer by Treasury and APRA, based on estimates of the amounts needed to fund APRA's operations less fees, interest on investments plus or minus the movement in reserves. The annual change in levies is communicated to the financial sector through a process of consultation. As levies are based on the reported asset values of institutions, more or less levies are collected than that estimated in the modelling used to support the levies determination. Therefore, APRA may make surpluses and deficits which add to or decrease the accumulated reserves. This is apparent from the Annual Financial Statements.

Levies are derived from broad estimates of the cost of supervision by industry sector and overheads are allocated in proportion to supervisory cost. The primary purpose of APRA is the regulation of bodies in the financial sector (APRA Act section 8). Where an institution requires a specific elective service, APRA has the ability to charge a direct fee under section 51 of the Act. For specific one-off services outside direct supervision of regulated entities, such as assistance offered to other government agencies or overseas regulators, APRA seeks to recover the associated costs with specific fees. This reduces the levies that institutions pay and is seen by the financial industry as desirable, as it reduces the cross-subsidies for both special services and services unrelated to direct supervision.

APRA is required to undertake prudential supervision of general insurers according to its statutory authority laid out in the APRA Act and within the legal framework of the *Insurance Act 1973*. The 2002 general insurance reforms introduced, for the first time, provision to apply for approval to use the IMB Method to determine regulatory capital requirements. In 2007, some insurers advised APRA of their intention to apply for approval to use the IMB Method. Given the developments since 2002, both in Australia and internationally, and in both banking and insurance industries, APRA has taken the opportunity to review the prudential framework relevant for model use; to provide approval to use the IMB Method, APRA has had to develop a framework for decision-making and assess the applications for approval.

1.3 Australian Government Cost Recovery Policy

In December 2002, the Australian Government adopted a formal cost recovery policy to improve the consistency, transparency and accountability of its cost recovery arrangements and promote the efficient allocation of resources. The underlying principle of the policy is that entities should set charges to recover all the costs of products or services where it is efficient and effective to do so, where the beneficiaries are a narrow and identifiable group and where charging is consistent with Australian Government policy objectives. Cost recovery policy is administered by the Department of Finance and Deregulation and outlined in the Australian Government Cost Recovery Guidelines (Cost Recovery Guidelines).

The policy applies to all FMA Act agencies and to relevant Commonwealth Authorities and Companies Act 1997 (CAC Act) bodies that have been notified. In line with the policy, individual portfolio ministers are ultimately responsible for ensuring entities' implementation and compliance with the Cost Recovery Guidelines.

2. POLICY REVIEW-ANALYSIS OF ACTIVITIES

The recovery of the proposed fee for applications by general insurers for approval to use the IMB Method is supported by the following analysis.

Alignment with objectives

The objective of APRA is defined within the outcome "public confidence in the financial system", which is based on stable and safe financial institutions able to meet their promises to their depositors, policyholders and beneficiaries. Capital adequacy is the key to assuring that financial promises can be met. A major component of APRA's supervisory work is the assessment of capital adequacy. For general insurers, the relevant standard is *Prudential Standard GPS 110 Capital Adequacy (GPS 110)*¹ and *Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups (GPS 111)*², which allows a general insurer to determine its Minimum Capital Requirement (MCR) by means of the Prescribed Method (which is the default) or the IMB Method. The cost of specific work carried out by APRA on the supervisory framework required to permit the use of the IMB Method should be recovered.

Description of activity

The activity for which the proposed fee is made is work on the modifications of the appropriate prudential standard and prudential practice guide, the development of the process for providing approvals to use the IMB Method and assessing applications for its use.

Stakeholders

Current stakeholders are the insurers that have expressed an interest in obtaining APRA approval to use the IMB Method to determine their MCR.

¹ Made by *Insurance (prudential standard) determination No. 2 of 2008 - Prudential Standard GPS 110 - Capital Adequacy* on 23 June 2008. FRLI reference F2008L02254.

² Made by *Insurance (prudential standard) determination No. 15 of 2008 - Prudential Standard GPS 111 - Capital Adequacy: Level 2 Insurance Groups* on 17 December 2008. FRLI reference F2009L00010.

Cost recovery alternatives

The identification of this specific cost recovery activity is based on consideration of the way in which APRA is most appropriately funded for this activity. APRA has a choice of recovering costs through levies applied across all APRA regulated entities or the general insurance sector, or through specifically raising a fee for services to the main beneficiaries of the IMB Method, namely the general insurers seeking to use that approach for assessing their capital adequacy.

The Cost Recovery Guidelines advise that where possible, a fee for service is preferred to a levy provided the fee is efficient, cost effective and consistent with policy objectives. The use of levies gives rise to potential cross-subsidies, which is not consistent with cost recovery policy.

There are three choices open to APRA in respect of the development work undertaken and processing of applications for the IMB Method:

- (i) decline to accept applications from general insurers to use the IMB Method;
- (ii) use levies to fund the costs; or
- (iii) use a specific fee for service.

The first option is not sustainable as use of the IMB Method has been available since the 2002 general insurance reforms, although it has only during 2007 that any general insurers have expressed an interest in seeking approval to use the IMB Method.

The use of levies to recover the cost would involve significant cross-subsidy from the majority of general insurers that will not seek approval to use the IMB Method, and hence is not consistent with cost recovery policy. All of the general insurers that have to date expressed an interest in using the IMB Method already pay the maximum levy under the restricted component of the financial sector levy. The further cost of developing the IMB Method would not increase their marginal levy rate, and so the bulk of funding the development and assessment work for the IMB Method would fall onto those that will not benefit from its use.

The use of a specific fee to recover the costs of developing the framework for the IMB Method and assessing applications for its use will target the main beneficiaries of the work and hence is consistent with cost recovery policy.

The efficiency and effectiveness of the charge

APRA is largely funded by industry. There is an annual consultation process with representatives of the industry sectors for ADIs, general insurance, life insurance and superannuation. This consultation reviews the costs of APRA and the sources of funding including fees, levies and the interest earned on investments. The intention is to provide a stable, transparent and easily administered means of funding APRA. Generally, direct cost recovery, in which supervisory work performed is charged to an institution, is not efficient and levies provide a sounder basis. Direct fees for service often result in volatile charges that are unpredictable for both APRA and the institutions. In addition, as a general rule, APRA would not be able to procure and fund in advance the specialist expertise needed to carry out supervision without the certainty and existence of funding prior to carrying out the activity. Furthermore, when applied in inappropriate circumstances, direct charging

may have negative spill-over effects, with institutions requiring advice being deterred from seeking it on the basis of the higher costs involved.

Nevertheless, direct charging is appropriate in certain circumstances, and industry representatives support the use of specific charges where this is practical. In particular, where elective services are provided by APRA (eg assessment of and issuing of a licence to a particular institution), direct user fees are appropriate and avoid cross-subsidisation. The work on developing the IMB Method and processing applications for approval falls into this category because it is referable to specific financial institutions and can be directly measured. The likely major recipients of the charge have been consulted and understand the basis of the costs that are expected to be incurred in carrying out this work and are aware of the proposed approach to recovering these costs.

Conclusion

The activity is appropriate to be cost recovered by means of the proposed fee.

3. DESIGN AND IMPLEMENTATION

3.1 Basis of charging - fee or levy

APRA has limited resources to apply to elective services. APRA has been requested by certain insurers to consider applications for approval to use the IMB Method. For APRA to carry out this work, resources will need to be diverted from other supervisory activities. The general insurers that are expected to apply for approval to use the IMB Method are aware that there will be a fee charged by APRA for assessing their application for approval, including its likely level, and have indicated their intention to proceed with the application process, including payment of any fees.

The work on developing the framework for use of the IMB Method and processing of applications for approval to use that approach to determine their capital adequacy, is an activity which is referable to specific financial institutions and can be directly measured. A direct fee is therefore the most appropriate means of recovery of the costs involved.

The relevant general insurers are willing to contribute to the development and the cost of approval for use of the IMB Method.

3.2 Legal requirements for the imposition of charges

APRA has power (relevantly) under section 51 of the APRA Act to impose fees for services and applications. As the proposed fee is reasonably related to the cost of undertaking the work required to develop the IMB Method and assessing applications, the fee does not amount to taxation.

3.3 Costs to be included in charges

A project has been set up to cover the development of the IMB Method and the assessment of the initial applications against which the specific staff who are working on the project record their time.

It is expected that APRA will receive three or four applications for approval to use the IMB Method over the period 2008 - 2011. The estimated cost for the project, including assessing four applications by 2010-2011, is \$1.1 million. This does not include the

estimated additional ongoing supervision costs for those insurers for whom approval is given to use the IMB Method for MCR purposes.

3.4 Outline of charging structure

It is intended that the initial application fee be fixed at \$275,000 (plus GST). This fee would be applicable for the first application received from any insurance group.

Many insurance groups are currently operating with several insurance licences and hence it is likely that more than one application for approval to use the IMB Method will be received from the same group. In such scenarios, the incremental effort required to assess the second application has been estimated to be about 20 per cent of the effort and time required to assess the first application from an insurance group. Therefore, it is recommended that the application fee for second and onwards applications from an insurance group be \$55,000 (plus GST) i.e. approximately 20 per cent of the application fee for the first application.

In addition, the on-going supervision effort for those insurers for whom approval has been given to use the IMB Method for MCR purposes will increase as the internal models that are used for this purpose are complex, will evolve and will need regular monitoring and assessment by APRA. Therefore, an additional annual fee will be charged to these insurers. This fee has not been determined to date. To ensure consistency of approach, the fee will be considered by APRA in conjunction with the determination of the ongoing additional supervision fees that will be applied for ADIs that are approved to use the advanced approaches available under the Basel II capital standards. Details of the annual charge will be outlined in a separate Cost Recovery Impact Statement once information becomes available.

Duration of the charge

The application fee is a one-off charge which is to be paid at the time the insurer lodges an application for approval to use the IMB Method.

The additional annual fees that relate to the additional costs of ongoing supervision of general insurers that have approval to use the IMB Method are intended to recover these additional supervision costs. These fees will be charged annually after the insurer has gained approval for use of the IMB Method, until such time as that approval is revoked or alternative arrangements are put in place.

Recipients of the charge

The recipients of this charge are the general insurers that apply for approval to use the IMB Method to determine their MCR.

3.5 Summary of charging arrangements

The proposed application fee of \$275,000 (plus GST) for the first application received from any Group and the fee of \$55,000 (plus GST) for the second and onwards applications from an insurance group will be charged at the time of application for approval to use the IMB Method.

4. ONGOING MONITORING

4.1 Monitoring mechanisms

The costs of development of the IMB Method and approval of certain general insurers seeking to utilise that method are charged to a unique project cost code and monitored as part of APRA's annual budget review processes.

4.2 Stakeholder consultation

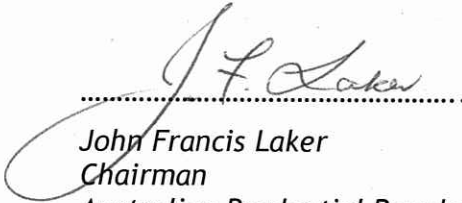
The general insurers that are expected to apply for approval to use the IMB Method, and hence are the expected recipients of the charge, have been consulted. They are aware that there would be a fee charged by APRA for assessing their application for approval, including its likely level, and have not indicated any objections to the proposed fee.

4.3 Periodic review

The cost recovery arrangements for the assessment of applications to use the IMB Method will be subject to an annual review process.

5. CERTIFICATION

I certify that this CRIS complies with the Australian Government Cost Recovery Guidelines.


.....
John Francis Laker
Chairman
Australian Prudential Regulation Authority

Date: *18 June 2009*
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APPENDIX

General Insurer Internal Model - Costing Template			
	2007/08 \$'000	2008/09 \$'000	2009/10 \$'000
A. Estimated costs			
FTE	2.4	1.8	1.6
Employee expenses	427	321	275
Employee Administration	0	0	0
Office Administration (Travel & Accommodation)	43	0	34
Allocated Overheads	0	0	0
Total estimated costs	470	321	309
Total costs to be recovered over 3 years	1,100		

Australian Prudential Regulation Authority instrument fixing charges No. 1 of 2009

For applications by general insurers to use the Internal Model-based Method for determining the Minimum Capital Requirement

EXPLANATORY STATEMENT

Issued by the authority of the Australian Prudential Regulation Authority (**APRA**)

Australian Prudential Regulation Authority Act 1998, paragraphs 51(1)(a) and (b)

This explanatory statement relates to the instrument fixing charges which is made under paragraphs 51(1)(a) and (b) of the *Australian Prudential Regulation Act 1998* (the **APRA Act**) and which is dated 18 June 2009 (the **instrument**). The instrument, made by a delegate of APRA, imposes a charge for certain services provided by APRA relating to the modification of the prudential framework for implementing the Internal Models-based Method (IMB Method) for determining the Minimum Capital Requirement (MCR) of general insurers (including Level 2 insurance groups) and assessment of applications from certain insurers that have sought to use that approach for assessing their minimum capital requirements.

Background

Legislative framework

The APRA Act is administered by APRA. APRA has statutory responsibility for the prudential supervision of the superannuation industry, the life insurance and general insurance industries, and authorized deposit-taking institutions (ADIs).

Subsection 51(1) of the APRA Act provides that APRA may, by legislative instrument, fix charges to be paid to it by persons in respect of:

- (a) services and facilities that APRA provides to such persons; and
- (b) applications or requests made to APRA under any law of the Commonwealth.

(These paragraphs reflect the contents of paragraphs 51(1) (a) and (b).)

Subsection 51(2) of the APRA Act provides that a charge fixed under subsection 51(1) must be reasonably related to the costs and expenses incurred or to be incurred by APRA in relation to the matters to which the charge relates and must not be such as to amount to taxation.

General Insurance Internal Models-based Method

Under *Prudential Standard GPS 110 Capital Adequacy* (GPS 110)¹ and *Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups* (GPS 111)², general insurers may

¹ Made by *Insurance (prudential standard) determination No. 2 of 2008 - Prudential Standard GPS 110 - Capital Adequacy* on 23 June 2008. FRLI reference F2008L02254.

² Made by *Insurance (prudential standard) determination No. 15 of 2008 - Prudential Standard GPS 111 - Capital Adequacy: Level 2 Insurance Groups* on 17 December 2008. FRLI reference F2009L00010.

choose one of two methods for determining the Minimum Capital Requirement (MCR). These are the:

- Internal Model-based (IMB) Method; or
- Prescribed Method.

The Prescribed Method is the 'default' method and is currently being used by all authorised general insurers.

During 2007, some insurers commenced discussions with APRA with a view to obtaining approval to use the IMB Method to determine their MCR. General insurers seeking to use the IMB Method must have APRA's approval to do so.

The IMB Method is expected to benefit those general insurers that seek to adopt it because it will align their regulatory capital requirements more closely with their individual risk profiles and their internal risk and capital management processes. This approach should also result in more efficient use of capital in the industry.

However, at least in the short term, only a small number of general insurers are expected to apply for approval to use the IMB Method because it requires the general insurer to have and maintain an advanced and stable approach to risk management together with a prudent approach to capital management.

APRA met in November 2007 with those insurers with a likely interest to discuss the procedure for internal model applications. To date, APRA has received two draft applications for approval to use the IMB Method. It is expected that APRA will receive three or four final applications for approval to use the IMB method over the period 2008-2011.

Adoption of the IMB Method by a wider range of general insurers remains a far more uncertain proposition at this stage.

APRA's work relating to implementation of the IMB method

APRA's work relating to the implementation of the IMB Method has three phases, as follows:

	IMB method	Status
Phase I	Modifications to prudential standards and development of prudential practice guide and assessment process	Complete
Phase II	Assessment of applications for approval	Ongoing
Phase III	Ongoing monitoring and supervision	Will commence after approval is given in Phase II.

Phase I commenced in 2007-08 and was completed in 2008-09. It involved the development of the policy and technical framework for providing approvals to use the IMB Method and processes for assessment of applications. Phase II commenced in February 2008 and will continue through to 2010-11 (or completion of the expected applications). It involves the in-depth review of the application material submitted by the individual

general insurers, including necessary on-site reviews, and the provision of feedback to the insurers. Finally, Phase III will involve the on-going monitoring of the capital adequacy positions of the general insurers that are approved to use the IMB method; this will be more intensive than for general insurers using the Prescribed Method due to the complexity and ongoing review of the internal models used.

Operation of Australian Prudential Regulation Authority instrument fixing charges No. 1 of 2009

The charge imposed by the current instrument is based on a two-tiered structure:

- (a) \$275,000 plus GST (which totals \$302,500) imposed on each of general insurers for the first application seeking approval to use the IMB Method made by the group;
- (b) \$55,000 plus GST (which totals \$60,500) imposed for each second and onward application for approval from a general insurance group.

These amounts have been set as a contribution to APRA's:

- Phase I work, being the development of an appropriate policy framework and the establishment of the supervisory infrastructure and technical capacity required for the introduction of the IMB Method; and
- Phase II work, being assessment of applications made by the general insurers.

Phase III work, being ongoing monitoring of the capital adequacy position of general insurers using the IMB method, will not commence until such time as general insurer(s) have been granted approval to use the IMB Method. The fees for this phase will be determined at a later date, in conjunction with the determination of the ongoing additional supervision fees that will be applied for ADIs that are approved to use the advanced approaches available under the Basel II capital standards for ADIs.

How the charge has been calculated

The charge is based on the need to recover APRA's costs for carrying out the policy and technical development work, and the assessment of the expected applications for approval to use the IMB method. Those costs are based on the estimated APRA staff time involved and any external costs that may be incurred that are directly attributable to the project. In addition, an allowance for direct overhead costs has been added to the salary costs. On this basis, APRA's total estimated costs in respect of the implementation of the IMB Method for the period from 2007-08 to 2010-11 have been estimated at \$1.1 million. (As noted above, this does not include the estimated additional costs for the ongoing monitoring of the capital adequacy position of general insurers using the IMB method.)

The charges are reasonably related to the costs and expenses incurred

As indicated above, the charges set by the instrument are fixed on a cost recovery basis for the work to which they apply. They are based on estimated effort involved in the discharge of APRA's responsibilities and incorporate all the direct costs and appropriate overheads.

The charges do not amount to taxation

As the charges are reasonably related to the costs incurred by APRA in providing the services concerned, the charges do not constitute a tax.

The charges are not retrospective

The charges are imposed prospectively. They are payable 14 days after receipt of APRA's invoice.

Cost Recovery Impact Statement

A Cost Recovery Impact Statement (*CRIS*) has been prepared for this instrument.

Consultation

As part of annual consultation, each industry sector is made aware of APRA's cost recovery process including the reduction of levies through direct user charging.

Before making the instrument, APRA informed the general insurance sector of the proposed charges. The general insurers that are expected to apply for IMB Method approval have raised no objection to the charges.