



24 February 2012

Mr Neil Grummitt  
General Manager, Policy Development  
Australian Prudential Regulation Authority  
GPO Box 9836  
Sydney NSW 2001

Via email to: [InsuranceCapital@apra.gov.au](mailto:InsuranceCapital@apra.gov.au)

Dear Sir / Madam

**Review of Capital Standards for General Insurers and Life Insurers**

The Actuaries Institute ("the Institute") is the sole professional body for actuaries in Australia, providing independent, expert and ethical comment on public policy issues where there is uncertainty of future financial outcomes. It represents the interests of over 3,800 members, including more than 2,000 actuaries.

Some of the principles that guide the Institute's inputs into public policy are:

- » Acceptance of public sector involvement where the market does not meet societal needs,
- » The need to take a long term policy view, with appropriate transitional arrangements,
- » Ensuring that consequences of risk taking behaviour are borne by the risk taker,
- » Issues of intergenerational equity, and
- » Clear and reliable information available for decision-making.

We refer to your Response Paper of 9 December 2011 and accompanying draft Prudential Standards and thank you for the opportunity to provide further comments, having previously submitted responses to Discussion Papers in 2010 and 2011.

The Institute welcomes the following developments in the Response Paper:

- » Clarification of the objective of the new standards,
- » The allowance for an illiquidity premium adjustment to discount rates,
- » Increased clarity about the required scope of an Insurer's ICAAP, and
- » Increased clarity around the calculation of the Insurance Concentration Risk Charge and the premium liabilities offset (C).



Our key concern remains the tight timescales during 2012 which will impinge on Actuaries' and Insurers' abilities to fulfil their professional responsibilities in relation to the new regulations. APRA can reduce this risk through releases of spreadsheet reporting templates and draft Prudential Practice Guides earlier than currently proposed.

### **Role of the Appointed Actuary**

The Actuaries Institute encourages increased interaction between the Board and the Appointed Actuary and the Institute firmly believes that the Board should set capital adequacy standards on the advice of the Appointed Actuary.

It is important that the Appointed Actuary is given responsibility to advise on the appropriateness of the capital calculations and the assumptions used within the capital calculations, as well as the implications of any changes proposed by the Insurer. Furthermore, the development and application of a target capital policy should also be subject to advice from the Appointed Actuary. This is to ensure that the Boards act in an informed manner with expert advice. The Actuaries Institute recommends that these responsibilities are specifically included in Prudential Standard LPS 110 Capital Adequacy and GPS 110 Capital Adequacy by, for example, requiring the Board to obtain the advice of the Appointed Actuary when fulfilling their responsibilities under Paragraphs 7 (GPS 110) and Paragraph 9 (LPS 110).

### **Harmonisation of Reporting Requirements**

Whilst the Actuaries Institute supports APRA's proposal to alter and harmonise the timing requirements for the ILVR and FCR for General and Life Insurers in principle, the Institute also recognises that the complexity of the General Insurance Appointed Actuary reports (both ILVR and FCR) in particular means that delivery of Board-approved reports to APRA within three months of an Insurer's balance date may sometimes be difficult. The Actuaries Institute recommends that APRA considers allowing Insurers to apply for an extension to the delivery date in appropriate circumstances.

APRA proposes that the annual ICAAP Report should be submitted four months after an Insurer's balance date. As the ICAAP Report will be a key strategic document setting out the Insurers capital management plans and processes the Actuaries Institute recommends that APRA allow Insurer's the flexibility to prepare their ICAAP Report at an earlier date, potentially aligning the ICAAP Report with the Insurer's business planning cycle. An Insurer's planning cycle would typically be completed just prior to the financial year-end thereby enabling the strategic considerations underlying the ICAAP process to be developed (as they currently are) in conjunction with normal business planning functions. Preparation and approval of the ICAAP Report could therefore be separated from the financial year-end reporting requirements of the ILVR and the FCR. In our view such an approach would be significantly more efficient from an Insurer perspective while there would be no loss of transparency or discipline in the regulatory regime from APRA's perspective.

### **APRA Supervisory Adjustments**

The draft standards allow APRA to:

- » Require a life company to adjust the values of its assets and/or liabilities, if APRA considers that the company's values are not prudent or reliable;



- » Adjust specific requirements for an insurance company's Prescribed Capital Amount (PCA) calculations;
- » Determine a supervisory adjustment to be included in the Prudential Capital Requirement (PCR) of a fund or insurance company, if APRA is of the view that there are prudential reasons for doing so;
- » Exclude any component of capital that APRA has reasonable grounds to believe does not represent a genuine contribution to the financial strength of the company;
- » Set higher minimum requirements for the capital base of a statutory fund;
- » Set higher minimum requirements for the capital base net of Tier 2 capital of a statutory fund; and
- » Require a life insurer to hold higher levels of capital, if APRA considers that the insurer's asset and/or liability valuations are not prudent or reliable.

The Actuaries Institute is concerned that such a range of adjustments will add complexity and uncertainty to the process and suggests that a single supervisory adjustment should provide sufficient controls around the capital calculations.

Specifically, adjusting the PCA will increase the difficulty in managing current and future capital requirements for Insurers, without clear guidance from APRA as to how to interpret the standards. In addition, there will be significant time and resources required by both Insurers and APRA to carry out reviews of both Pillar 1 and Pillar 2. The Actuaries Institute also considers that APRA will require a highly detailed level of information regarding individual Insurers' capital calculations in order to identify areas where the interpretations of the requirements are inappropriate.

The Actuaries Institute recommends that APRA specify a minimum lead time for any supervisory adjustments made to an Insurer's capital requirements or capital base, and review the wide range of adjustment options available.

### **Ongoing Review of Parameters**

There are a number of assumptions and parameters which APRA has specified in the draft Prudential Standards and there is a risk that these can become outdated or evidenced to be unsuitable over time. In particular, economic conditions may change resulting in revisions to future economic assumptions.

This is particularly relevant for the sections of the standards regarding:

- » The correlation matrix between asset classes;
- » The level of illiquidity premium;
- » Default factors for credit spread stresses; and
- » The maximum limits on interest rate shocks of 200 basis points.

The Actuaries Institute suggests that due process would be for APRA to review all parameters in the new standards by the end of 2015 and every 3 years on-going. We recommend that the results of this review are published and the Actuaries Institute would welcome any opportunity to be involved in this process of review.



The Actuaries Institute also remains of the view that the operational risk capital charge is not risk sensitive and is at odds with the objectives of the LAGIC reforms. We acknowledge that APRA requires this to be part of the framework and encourage APRA to continue to look for ways to increase the risk sensitivity of this capital charge.

#### **Reduction in Capital Base – APRA Involvement**

The draft Prudential Standards include a requirement to obtain APRA's written consent prior to significant reductions in capital. The Actuaries Institute considers that the new capital regulatory framework, which places ownership on the Board for capital requirements, makes any additional intervention from APRA unnecessary. In addition, this requirement does not align with a principle-based framework and APRA's previous descriptions of their expected level of intervention based on an Insurer's position relative to target capital.

The Actuaries Institute recommends that APRA allows capital reductions without written consent in situations where surplus assets remained above Target Capital after the capital reduction. This would enable the Board to fully own the prudent capital management of the Insurer and make timely decisions on capital management in line with the Insurer's ICAAP without interaction with APRA.

In addition, the Actuaries Institute welcomes clarification from APRA as to what situations would be more or less likely to be given consent and how they will be able to provide timely consideration of requests to help Insurers manage capital.

#### **Statutory Fund Interaction**

Since QIS2, APRA has altered the proposed approach to offsets between statutory funds proposing that each statutory fund is treated as a stand-alone entity. This approach is not consistent with real life economic events as it requires an Insurer to hold capital on the basis that each statutory fund is experiencing different economic environments at the same time, when in fact this is unlikely to occur. The approach also does not recognise the ability of an Insurer to transfer capital between statutory funds. The Actuaries Institute recommends that the stress events which cause the maximum capital impact at a company level should be applied consistently across each statutory fund.

The Actuaries Institute anticipates that APRA's proposed approach will result in Insurers running projects to merge statutory funds or adopt synthetic investment strategies which we do not think was the intention of the Prudential Standards. This will increase industry costs and result in unnecessary communication to and potential confusion from policyholders.

#### **Illiquidity Premium – Scope and Determination**

In determining the scope of the products which can incorporate an illiquidity premium in the discount rate, APRA has stated that the application of the capital standards must be clear and unambiguous. It is still not clear as to why disability claims in course of payment reserves have been excluded from the range of products for which an illiquidity premium can be incorporated into the discount rate. The Actuaries Institute considers this a liability which is clearly defined, and cannot be surrendered for value by the policyholder, and which therefore should be valued at a discount rate allowing for the illiquidity premium.

The Actuaries Institute recommends that APRA articulates a clear principle for qualifying products. We also look forward to the release of APRA's proposed method for calculating the illiquidity premium.



## Implementation of New Capital Framework

### (a) Amendment to Actuarial Professional Standards

In their current form, the Draft Prudential Standards contain some changes to the scope of works required by the Appointed Actuary. These changes will require amendment to the relevant actuarial professional standards. Revisions to actuarial professional standards require a significant lead in time, preferably at least six months. Similarly, information notes or other less formal guidance to Appointed Actuaries will require significant development time. The Actuaries Institute therefore recommends that if changes are made to the scope of works required by the Appointed Actuary, that these changes are communicated earlier rather than later, so that enough lead in time is available to respond appropriately.

### (b) Planning for Transitional Arrangements

APRA's timetable for producing final Prudential Standards and draft Prudential Practice Guides is only three months before the implementation date, and final reporting standards are currently planned to be released less than three months before implementation. This will make it extremely difficult for Actuaries and Insurers to carry out sufficient analysis in order to make applications for transitional arrangements by APRA's deadline of 30 September 2012. The Actuaries Institute recommends that APRA reconsider this deadline for transitional arrangements and suggests that APRA defer the implementation date for six months.

The Actuaries Institute also notes that the excel workbooks for reporting to APRA are not planned to be released until June 2012, and recommends that these workbooks are released as soon as possible to assist the industry in the development of modelling and reporting tools.

In light of these tight timescales, the Actuaries Institute recommends that APRA issue a monthly update to industry stakeholders covering APRA's current thinking, interpretations and possible changes from the draft standards. It would also be desirable for APRA to hold implementation workshops where practitioners could discuss practical aspects of the new standards.

## Review of Wording in Draft Prudential Standards

The Actuaries Institute is seeking clarification from APRA in relation to the wording of certain sections of specific Prudential Standards, namely:

- » **Draft Prudential Standard LPS110 Capital Adequacy** (paragraph 36) requires that life companies adjust the prescribed capital amount by the aggregate amount of any tax benefits that cannot be offset against deferred tax liabilities. However, tax benefits which arise from increases in policy liabilities generally give rise to current tax benefits, which should be compared with current tax liabilities that are expected to arise in the twelve-month period prescribed in the draft standard.

The Actuaries Institute recommends that the standards are changed so that they refer to tax liabilities rather than deferred tax liabilities. Similar comments apply to references to deferred tax liabilities in draft LPS 112 and LPS 115.

- » **Draft Prudential Standard LPS 112 Measurement of Capital** refers in several places to 'own capital instruments'. The Actuaries Institute seeks APRA's confirmation that this applies only to deducting investments in instruments issued by the life company (which would probably breach the Corporations Act) and not by a related party, including any parent company.



- » There does not appear to be reference to the existing principle of "looking through" collective investments to underlying assets for the purposes of asset risk calculations. The Actuaries Institute suggests that wording be considered in **Draft Prudential Standard LPS 114 (Asset Risk Charge)** to set out the principles for this approach.

The Actuaries Institute would be pleased to discuss the issues raised in this submission or to respond to specific questions to assist APRA in the course of its work. Please do not hesitate to contact our Chief Executive, Melinda Howes, on [REDACTED] if there is any way we can assist.

Yours sincerely

David Goodsall  
President