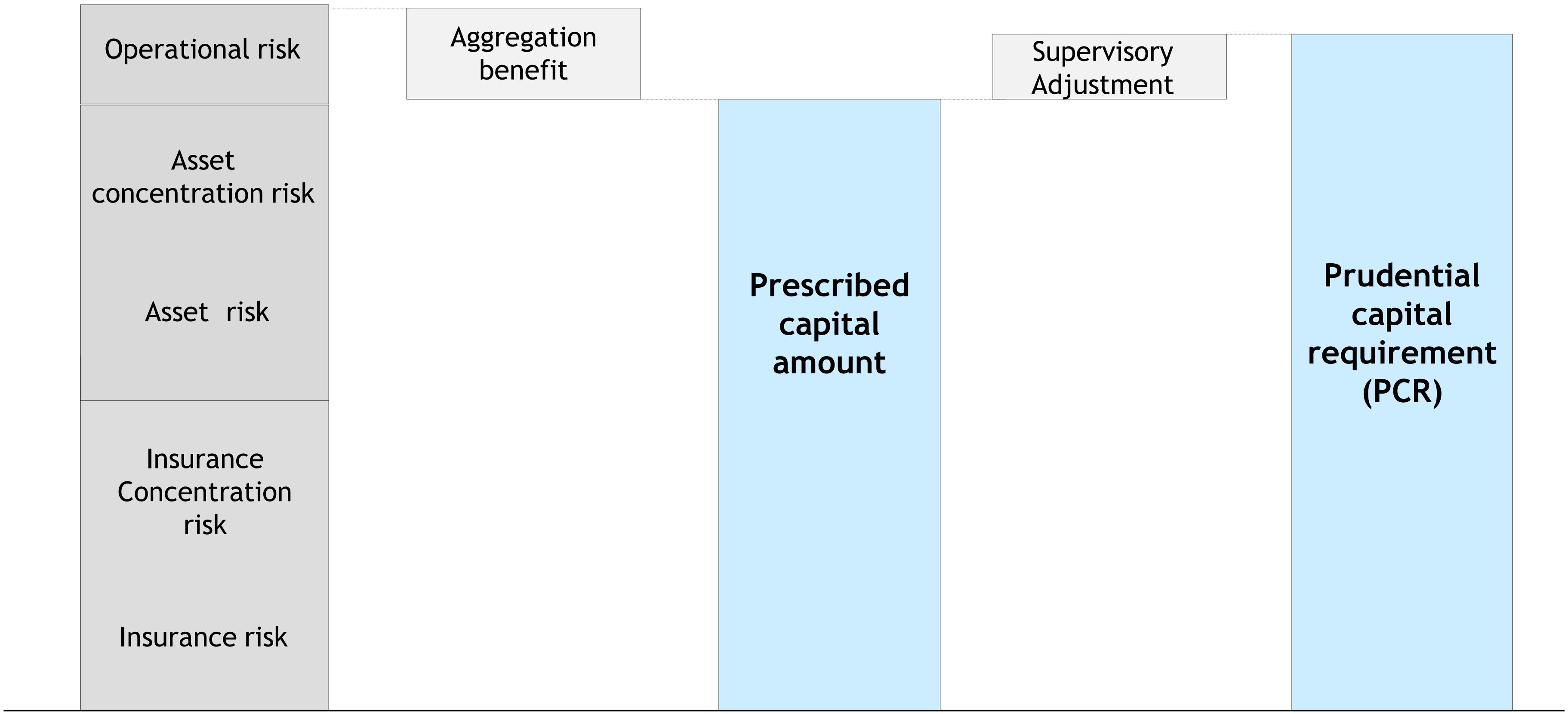
Insurance Capital Review

Seminar - General Insurance

Hosted by:
- Institute of Actuaries of Australia
- Insurance Council of Australia
- Financial Services Council

Sydney - 9 June 2011

Components of required capital



Summary of Proposals

Subject area	Submissions on proposals	Revised proposals
Asset Risk	• Calculations considered complex • Some factors considered too high • Some factors overly pro-cyclical	• Simplification of calculations • Factors revised to be less pro-cyclical and lower in magnitude
Asset concentration risk	• Some limits considered too restrictive	• Limit increased for short term investments in APRA regulated entities
Operational risk	• Formula overly sensitive to normal insurance fluctuations	• Revised formula
Insurance risk	• Inflation risk accounted for in both asset risk and insurance risk	• Reduction in insurance risk capital factors for long-tail classes
Insurance concentration risk	• Whole of portfolio vs single site • Large capital impact and increased complexity	• Whole of portfolio retained • Formula simplified and capital impact reduced
Level 2 groups	• Further clarification required	• Most Level 1 proposals implemented at Level 2 with some modifications

Asset Risk

Revised proposals:

- Existing Investment Risk charge replaced by the Asset risk charge
- Asset risk charge based on a series of stresses to the balance sheet:
  - Real interest rates: +/- stress to real yields
  - Expected inflation: +/- stress to CPI expectations
  - Currency: +/- stress to exchange rates
  - Equity: increase in dividend yield
  - Property: increase in rental yield
  - Credit spreads – increase in spreads and ‘jump to default’
  - Default – decrease in value of asset

Asset Risk (continued)

Revised proposals:

- Real interest rate and inflation modules:
  - simplified by removing duration dependent factors
  - reduced impact at short durations
  - limits on stresses reduce pro-cyclicality
  - remove dependence on inflation assumption
- Credit spreads:
  - separate category for re-securitised assets
  - stresses reduced for bonds and most structured assets
  - separate default and spread stresses
- Volatility module removed

Asset Concentration Risk

Revised proposals:

- Limits introduced on large exposures to individual assets or to a single counterparty or group of related counterparties
- Limits expressed as a percentage of capital base
- Increase in limits for exposures to unrelated APRA-regulated entities from 50% to 100% of capital base for short-term assets
- Insurers allowed to treat collateral of reinsurance exposure as either an exposure to originating reinsurer or a bank exposure to the entity providing the collateral
- Corporate captives can apply to APRA for exemption from prescribed limits where the parent entity is non-APRA regulated

Operational Risk

Revised proposals:

- New charge for operational risk, based on:
  - insurer size (greater of GWP and net insurance liabilities);
  - changes in insurer size (as measured by changes in GWP)
- Formula revised to take account of feedback received:
  - use of net rather than gross insurance liabilities
  - insurance liabilities deleted from ‘change’ component
  - focus on incremental not absolute change reduces cliff effect
  - reduced charge for reinsurers

Insurance Risk

Revised proposals:

- Overall insurance risk charge structure remains unchanged, with the following amendments
  - Mortgage insurance and travel insurance risk charges 'stepped up' to higher levels
  - 'Other' category removed, with the Appointed Actuary to select the appropriate grouping
  - Reinsurance classes of business aligned with direct groupings
- Insurance risk capital charge factors for liability classes reduced by 1% for outstanding claims and 1.5% for premiums liabilities
- Separate determination of gross risk margin at 75% PoS not required, but Appointed Actuary will need to comment on gross uncertainty in ILVR
- No limits on diversification in risk margins, but APRA will require insurers to report stand-alone risk margins by APRA class of business

Insurance Concentration Risk

Revised proposals:

- 1 in 200 year whole of portfolio requirement for vertical cover
- New horizontal cover requirement for natural catastrophe exposures
- Horizontal requirement considers the impact on capital (both retained losses and cost of reinstatement cover) under two scenarios:
  - occurrence of 3 x 1 in 10 year events in the year, OR
  - occurrence of 4 x 1 in 6 year events in the year.
- Credit given for allowances already made in premiums liabilities for the cost of catastrophic events (‘C’), as determined by Appointed Actuary
- Formula simplified to be the greater of either the vertical or horizontal requirements
- Requirement for at least one contractually agreed reinstatement of vertical catastrophe cover

Insurance Concentration Risk (continued)

Revised proposals:

- Non property – adjustments allowed for:
  - event losses already included in premiums liability provision
  - impact of stop loss reinsurance protection
  - No offset for insurance risk charges
- Lenders mortgage insurance:
  - probability of default factors revised to reflect revisions to ICRC formula and move to 99.5%
  - Relativities between LVRs and std/non-std adjusted based on empirical evidence

Other proposals

- **Inadmissible assets**
  - Minimum capital requirements of any investments in subsidiaries, joint ventures and associates will be treated as inadmissible
- **Aggregation benefit**
  - Correlation factor reduced from 50% to 30% for QIS 2 (except for LMI)
- **Quality of capital**
  - Broadly align requirements with ADI requirements

Level 2 proposals

- Proposals are based on revised Level 1 proposals with some modifications:
- Asset risk
  - For RIR & INF modules, non-material currency exposures can be converted to AUD
- Insurance concentration risk
  - Whole of portfolio approach to be applied on a regional basis, with regions to be agreed with APRA
- Operational risk
  - to be assessed on a consolidated basis rather than as the sum of entity level requirements
- Inadmissible assets
  - Deduction applies to investments in joint ventures and associates

Questions?

Formulae

- **Operational risk charge:**
  - $\alpha \times (\max\{GP, NL\} + |\Delta|)$

where:

- α is 3% for direct business, 2% for inwards reinsurance
- GP is total annual written premiums (gross of reinsurance)
- NL is central estimate of insurance liabilities (net of reinsurance)
- $|\Delta|$ is the absolute value of the change in gross written premium for the latest 12 months in excess of +/-20% of the gross written premium for the preceding 12 months

Formulae

- **Insurance Concentration Risk Charge:**

  Max (VR_{prop}, $VR_{non\text{-}prop}$, $ICRC_{LMI}$, H3, H4)

where:

VR_{prop}	Vertical requirement for property risks
$VR_{non\text{-}prop}$	Vertical requirement for non-property risks
$ICRC_{LMI}$	Vertical requirement for lenders mortgage insurers
H3	net retained loss and cost of reinstatements for three 1 in 10 year loss events, less **C**
H4	net retained loss and cost of reinstatements for four 1 in 6 year loss events, less **C**
C	annualised portion of premiums liabilities relating to events that lead to a substantial number of claims

Formulae

- **Insurance Concentration Risk Charge - LMI:**

  $ICRC_{LMI}$ = PML - ALR - NPL (ED),

  subject to a minimum of 10 per cent of PML

where:

PML	probable maximum loss
ALR	allowable reinsurance, lesser of 60% of PML and contractually available reinsurance assets
NPL (ED)	net premiums liabilities that represent potential losses from an economic downturn