Insurance Capital Review

Seminar

Life Insurance

IAAust ICA FSC - Sydney

9 June 2011

Agenda

- **Major themes from consultation**
- **Capital base**
- **Discount rates**
- **Capital charges**
  - Insurance risk
  - Operational risk
  - Asset risk
- **Questions**

Major themes from consultation

- Proposals were overly complex
- Proposals were overly conservative
- Proposals were pro-cyclical
- Impact varied widely between companies
- Minor impact on investment linked funds

Capital base - response

- **Adjusted policy liabilities**
  - Combine all non-discretionary business for TV minimum
- **Inadmissible assets**
  - Goodwill in genuine arm's-length investments will be admissible
  - Tax benefits associated with termination values might become admissible
- **Quality of capital**

Risk-free discount rates

- **Derived from CGS yields**
- **Extrapolate by reference to other instruments**
- **Liquidity premium in certain circumstances**
  - For immediate annuities & fixed term/rate (with TV reducible to APRA minimum) & funeral bonds
  - Set as a constant for QIS2 (30 bps)
  - Aim to use a prescribed formula in standards (yet to be developed)

Insurance Risk

- Random mortality & morbidity
- Future mortality & morbidity
- Mortality and morbidity event
- Longevity
- Lapses
- Servicing expenses
- Correlations
- Repricing
- Short term losses

Insurance Risk - response

- **Event stress**
  - One event stress affecting both mortality and morbidity
  - Minimum event stress is a pandemic scenario spread over 2 years
- **Repricing**
  - Allow repricing from 12 months after reporting date
  - But not in response to random or event stresses

Insurance Risk - response

- **Termination values**
  - Remove stressed termination values at reporting date
  - Stressed TVs still apply 12 months from reporting date
  - Broader product groups reduce impact of TVs
- **Reduced correlation factor**
  - Future mortality/morbidity reduced from 50% to 25%
- **Increase risk sensitivity**
  - Lapse stress is no longer a prescribed amount

Operational risk

Revised formula

- $\alpha \times (\max\{GP, NL\} + |\Delta|)$

where:

- α is 3% for risk, 0.25% for non-risk (2%, 0.15% reinsurers)
- GP is gross premium income
- NL is net adjusted policy liabilities
- $|\Delta|$ is the change item based on premiums and/or claims

Operational risk

- **Depends on ‘size’ and change in ‘size’ over 12 months**
- **Separate charges for risk and non-risk business**
- **Lower charges for reinsurers**
- **Change item**
  - Extra capital charge for rapid growth or decline
  - Measured using premiums and claims
  - Threshold increased from 10% to 20%
  - Charge only applies to excess over threshold

Asset Risk

- **Seven asset risk modules**
  - Real interest rates
  - Expected inflation
  - Currency
  - Equity
  - Property
  - Credit spreads
  - Default risk
- **Aggregated using a correlation matrix**
- **Stresses apply to all admissible assets**

Asset Risk - response

- **Real interest rates and expected inflation**
  - Simplify by removing duration dependent factors
  - Reduce impact at shorter durations
  - Reduce pro-cyclicality by limiting stresses (max 200 bps for real interest rates)
  - Remove dependence on inflation assumption

	Real interest rates	Expected inflation
+	0.3 x nominal rate	125 bps
-	0.25 x nominal rate	100 bps

Asset Risk - response

- **Volatility**
  - Simplify by moving equity volatility into equity module
  - Reduce pro-cyclicality by changing equity volatility stress to +15 per cent
  - Remove interest and currency volatility stresses

Asset Risk - response

- **Credit spreads**
  - Improved risk sensitivity
  - Separate category for re-securitised assets
  - Separate default and spread stresses
  - Semi government debt stepped up one counterparty grade

Asset Risk - response

- **Default risk**
  - Simplify by removing the requirement to use stressed reinsurance assets and OTC derivatives
- **Correlation matrix**
  - Increase some factors to improve consistency

Other issues

- **Aggregation benefit**
  - Correlation factor reduced from 50% to 30% for QIS2
- **Methodology**
  - Participating and other discretionary business
  - Tax assets
- **General fund**
  - $10m minimum, with offsets

Questions?