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Dear Neil,

## **REVIEW OF CAPITAL STANDARDS FOR GENERAL INSURERS AND LIFE INSURERS**

Thank you for providing Suncorp with the opportunity to comment on the life and general insurance capital (LAGIC) draft Prudential Standards that were released on 9 December 2011. Although the draft standards incorporate various changes since the 2<sup>nd</sup> Quantitative Impact Statement (QIS2), a number of our concerns remain. These concerns are primarily in relation to the implications on our general insurance business and the general insurance industry as a whole.

Under the proposals we believe that the general insurance industry will be required to hold significantly more capital and/or purchase additional reinsurance, without commensurate benefits to policyholders or insurers. We expect that additional costs will need to be passed onto consumers leading to affordability issues and motivating consumers to purchase less, or even discontinue entirely, their insurance coverage. In addition, smaller general insurers may not have the capacity to fund the additional capital and/or reinsurance requirements. They may therefore decide to exit certain products or possibly the Australian general insurance market entirely. The industry as a whole may undergo significant consolidation, resulting in less competition and less choice for consumers. Further, domestic insurers are placed at a competitive disadvantage against foreign players if those foreign insurers can leverage the balance sheet of their global parent and place any additional reinsurance with their parent at internal prices rather than market based prices. We believe that this was not the intention of the draft standards.

We also have some concerns with the new detail provided for the first time for insurers in relation to capital composition and transition arrangements.

APRA has stated an intention to align the approach to capital management across the industries it regulates and this is implicit in its treatment on many issues throughout the standards. Whilst Suncorp supports this as a general principle, this should not result in the identical treatment across Banks and Insurers in every instance given the different risk profiles and characteristics. We have identified specific instances where we have concerns with identical treatments and also highlighted one area (investment in subsidiaries) where greater alignment could have been achieved.



We have outlined areas of particular concern with the proposed standards in the sections which follow.

## **Issues common to both Life and General Insurers**

### ***Interpretation of the Draft Standards***

We believe that the draft standards require significant clarification in certain areas. In some cases we are unclear on APRA's intent, and we are having difficulty in interpreting the correct application of the standards, and therefore the implications on our Life and General Insurance businesses. This uncertainty has the potential to lead to inconsistent application of the standards across the industry. The areas of greatest uncertainty are discussed in Attachment 1 which provides more detail in relation to specific concerns we have with the draft GI standards.

*We suggest that a joint working group of APRA and industry representatives be created to discuss the intent and implications of the wording in the draft standards. We further suggest that any revised wording for the draft GPS116 be socialised with industry either formally or informally prior to issuance of the final GPS116. This will reduce the chance of any unintended consequences of the amended wording.*

### ***Risk Sensitivity***

While one of the stated aims of the draft standards is greater risk sensitivity, we believe that the standards in some instances are less risk sensitive than the current standards, for example in relation to the proposed calculation for the ICRC. We believe that this was not the intention of the draft standards.

*We suggest that the working group, as outlined above, include this issue within their discussions.*

### ***Capital Composition***

In APRA's December 2011 response paper (p27), it was proposed that CET1<sup>1</sup> for insurers under LAGIC must at all times exceed 70% of the prudential capital requirement (PCR) and the Tier 1 capital must at all times exceed 80%. We believe that the target is excessive for the insurance industry, particularly when compared to the lower CET1 proportions implicit in the targets currently proposed for ADIs under Basel III.

We believe that insurance companies are exposed to less financial and liquidity risk than ADIs, and therefore the amount of capital held in the highest quality component (CET1) should be less than that of ADIs, or at the very most, equal to, thereby satisfying APRA's stated aim to achieve alignment across their regulated industries.

Suncorp acknowledges that ADIs will also have a capital conservation buffer (CCB) phased in which would make overall CET1 portions closer to the proposed 70% of PCR under the LAGIC Standards. However, the timeframe for commencement of the staged approach for CCB is 2016, with it completely in effect from 2019.

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<sup>1</sup> Common Equity Tier 1



Accordingly, we are unclear as to why disparities exist on both the actual capital requirement and the timeframes for compliance – why are both more onerous on insurers?

In addition, it is worth noting that general insurers are required to value their insurance liabilities to at least a 75<sup>th</sup> percentile level of sufficiency, providing significant additional 'capital like' balance sheet strength. Similarly, life insurers are required to hold margins against their best estimate of liabilities.

*We suggest that the CET1 and Tier 1 proposals should be set at a lower level which recognises the different risks and characteristic of Insurers and makes an appropriate allowance for their additional "capital like" balance sheet strength.*

### **Eligibility of Sub-Debt**

APRA's December 2011 response paper (p28) outlines that existing non-eligible capital instruments are to be amortised at a rate of 10% per annum from 1/1/2013 until the instrument's first call date. This is the first time the proposed transitional treatment of subordinated debt for insurers has been set out.

Whilst in principle we agree with the concept of amortising shorter dated instruments for regulatory purposes, most general insurer issued subordinated debt is not short term. In most cases the call dates of these instruments are well before the date at which they would otherwise be eligible for amortisation.

Many of those long term subordinated debt instruments, including those for Suncorp's general insurance business, were put in place well in advance of the GFC, Basel III, and the LAGIC proposals. These instruments therefore did not contain terms which either meet the new LAGIC standards or allow sufficient flexibility for these terms and conditions to be altered. In this regard, we believe the amortisation of subordinated debt from 1 January 2013 to be excessive.

We recognise the proposed transitional treatment is driven by a desire to align transitional arrangements for subordinated debt with those for ADIs. However, we consider there are material differences in the nature of the instruments which warrant a different approach for insurers to ADIs. For example, as mentioned above, general insurers have typically issued long term subordinated debt, as opposed to shorter term subordinated debt issued by ADIs (e.g. 20-year non call 10-year, versus 10-year non call 5 year). Further whilst ADIs can still use the instruments during transition as a source of funding for their lending business, the capital excluded for regulatory purposes has no corresponding use for insurers.

*We suggest that the application of an amortisation requirement for subordinated debt instruments be delayed until the first call date of each instrument.*

### **Transitional Arrangements**

We note that in section 1.4 of the December 2011 response paper, APRA states that it will assess information submitted by insurers in the fourth quarter of 2012 and advise insurers of its decisions on requests for transitional arrangements as soon as practicable. We feel that the timing of this notification is too close to the proposed LAGIC implementation date, and will result in insurers facing significant uncertainty just prior to the implementation date.



## **Issues specific to General Insurers**

### ***Transition for ICRC***

The proposed LAGIC timetable envisages that the final standards for the ICRC will be published by APRA in May 2012 (with Prudential Practice Guides expected to be released in September 2012). We believe that there are two components supporting a need to delay the application of the ICRC. First of all, given that premium changes for existing policies are made on their renewal, it will take a significant period of time for premium changes to be fully applied and premium earned. Secondly, those changes can only be made after there is complete clarity for the industry in relation to the application and effect of the standards.

For example, for insurers with a 30 June reinsurance treaty year, May 2012 coincides with the period during which those insurers will be finalising their reinsurance coverage for the year to 30 June 2013. As a result, those insurers, including Suncorp, will be unable to determine with certainty the most effective reinsurance structure for their business.

*We suggest that the implementation date for the ICRC standard be delayed until reinsurance renewal date for each insurer occurring on or following 1 January 2014. This is to provide the industry with sufficient time to obtain complete clarity around the standards, to ensure that appropriate reinsurance programmes can be put in place, and so that the industry has adequate time to reprice their portfolio.*

Attachment 2 of this letter sets out a suggested implementation for this transitional introduction of the ICRC.

### ***No disadvantage for existing corporate structure***

Suncorp appears to be substantially disadvantaged under LAGIC by its corporate structure and will need to re-structure to address this. Suncorp will liaise separately with APRA to seek any necessary transitional relief to facilitate this.

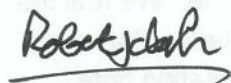
### ***Level 1 Entity Capital Trapping***

APRA's December 2011 response paper referred to a change in the current treatment for investments in subsidiaries of an insurer, whereby a parent insurer will need to deduct the prescribed capital amount of its subsidiaries. The outcome of this change would then be an inconsistent treatment between ADIs and insurers.

Due to general insurance accounting rules, in some cases the prescribed capital amount of a subsidiary can exceed the value that the subsidiary represents in the parent insurer's accounts. Suncorp requests that APRA confirm whether its intention is that if the prescribed capital amount of a subsidiary insurer exceeds the tangible book value in the parent's accounts, then it is the tangible book value that is deducted.

*Suncorp would appreciate clarification of this question at the earliest opportunity.*

Yours sincerely,



Robert Clark  
Chief Investment Officer



## **ATTACHMENT 1 – Detailed Comments on the Draft Prudential Standards**

### **GPS116 – Capital Adequacy: Insurance Concentration Risk Charge**

#### **Major points - GPS116**

##### *1) Gross vs Net PML Calculation*

The draft GPS116 requires an insurer to calculate a gross event with a given return period and then to deduct certain items such as reinsurance recoveries. As an example, clauses 10-19 set out the calculation of an insurer's natural perils vertical requirement (NP VR).

Suncorp believes that the wording in the draft GPS116 will not achieve what we believe is APRA's intention. Specifically, we believe that APRA's intention is for an insurer to calculate its worst net loss (adjusted for reinstatement premiums / costs) that is expected to occur once every 200 years. In contrast, the draft GPS116 requires the calculation of the gross loss that will occur once every 200 years, and then for reinsurance recoveries to be applied to that gross loss.

In many situations, the two calculations will result in the same outcome. However, in some circumstances different outcomes could result from the two approaches.

By way of example (ignoring reinstatement costs / premiums for simplicity):

- An insurer's 1 in 200 year gross loss may be a Sydney earthquake that causes \$1,000m of gross damage, which, after reinsurance provides a net loss of \$50m.
- However, the insurer may purchase differing levels of reinsurance for different geographies / perils etc, such that a gross loss of \$250m to a Brisbane cyclone (which may be a 1 in 100 year event), may result in a net loss of \$100m. That is, higher than the first event, even though the gross loss has a higher probability.

The draft GPS116 as currently written, would require a NP VR of \$50m, whereas we believe that APRA's intention would be a NP VR of \$100m.

The correct outcome (assuming that our understanding of APRA's intention is correct) could likely be achieved in a number of ways. For example, it may be that statements such as that set out below would address the issue:

"If a gross loss with a whole-of-portfolio probability of occurrence which is higher than 0.5% would result in a higher NP VR, then the insurer's NP VR should be set equal to that higher amount."

It is important that any re-wording consider the total requirement (eg NP VR), rather than just the losses, to ensure that any differentiation in reinstatement or other adjustments are also captured.

Should this issue not be addressed, then it is likely that reinsurance programs will be designed to take advantage of the current wording.

Clauses in the draft GPS116 to which this issue is relevant include:



- Clauses 10-19 (NP VR)
- Clauses 20-26 (NP HR; H3 requirement)
- Clauses 27-31 (NP HR; H4 requirement)
- Clauses 36-45 (OA VR).

Suncorp does not write Lenders Mortgage Insurance (LMI), but encourages APRA to ensure that similar issues do not exist in Attachment A to GPS116 which relates to LMI.

## 2) *Erosion of Aggregate Reinsurance Cover Deductible*

When calculating its Other Accumulations Vertical Requirement (OA VR), Clause 42 allows an insurer to reduce the retention on any aggregate stop-loss reinsurance arrangements for any portion of paid and outstanding claims and premiums liabilities that contribute to the insured's retained losses. Suncorp supports this allowance.

Suncorp believes that a similar allowance should exist for an insurer when calculating its Natural Perils Horizontal Requirement (NP HR), in relation to both aggregate catastrophe reinsurance and aggregate stop-loss reinsurance. Whilst paid and outstanding claims are unlikely to be relevant, where an insurer's premiums liabilities includes allowance for events that would erode an insurer's retention for such aggregate covers, then Suncorp proposes that an insurer can reduce the retention on any aggregate catastrophe stop loss reinsurance for those events, where those events have not been included in the PL offset.

## 3) *PL Offset*

Clause 33 sets out the calculation of the "PL offset". Parts (a) and (b) set out the calculation of the annualised premiums liability central estimate. Part (c) then instructs an insurer to apply the diversified risk margin and then the premiums Liability Risk Capital Factor, as a percentage, to that amount.

This does not accurately reflect the example which APRA sets out on page 45 of its Response Paper, where the annualised premiums liability central estimate is to be multiplied by (1+diversified risk margin) and then by (1+Premiums Liability Risk Capital Factor).

Suncorp suggests that the wording of Clause 33 be amended to clearly reflect APRA's intention. If APRA's intention is different to the example in the Response Paper, then this should be indicated as a matter of priority because this could have material impact on an insurer's ICRC.

## 4) *Level 1 and Level 2 Differences*

The draft GPS116 covers both Level 1 insurers and Level 2 insurance groups. It achieves this by referring in numerous places to "current reporting period" and "next reporting period" rather than identifying a particular time period. This is presumably to allow for the fact that the reporting period is different for Level 1 insurers (3 months) and Level 2 insurance groups (6 months).

These references to "reporting period" however result in a number of outcomes which Suncorp does not believe is appropriate. In particular, in some circumstances



differences in calculation may occur between Level 1 insurers and the Level 2 insurance group, for no reason other than the different reporting period length.

These differences are relevant for any Level 2 insurance group, but are particularly stark for the example where the Level 2 Insurance group consists solely of a NOHC and a single Level 1 insurer.

Suncorp is unable to suggest alternative wording at this time, as we are unclear as to APRA's intentions regarding the "reporting period" statements. However, we would put forward the following principles:

- Calculations should not differ between Level 1 and Level 2 simply because of the differing reporting period;
- Calculations should be based on the reinsurance program at the date of calculation; and
- Calculations should not require reinsurance programs to be in force for successive reporting periods.

Examples in the draft GPS116 are listed below.

- Clause 12, where the NP VR must be calculated taking into account the reinsurance program in place at the reporting date and the reinsurance program for the next reporting period. Given that reporting periods differ between Level 1 and Level 2, it is possible that differing reinsurance arrangements will need to be allowed for. Similar issues exist for Clause 38 for the OA VR.
- Clause 13 (c) requires potential growth over the reporting period to be allowed for when calculating a gross PML. Again, having this differ between Level 1 and Level 2 does not seem appropriate. Similar concerns exist for Clauses 23 (c) and 28(c).
- Clause 17 states that an insurer may apply to APRA to reduce its NP VR for reinsurance recoverables from aggregate reinsurance if the cover is in place for the current reporting period and the entirety of the next reporting period. It does not seem appropriate that the allowable reinsurance recoverables should differ between Level 1 and Level 2.
- Clause 21 states that an insurer's NP HR must be calculated at the reporting date on or prior to the inception date of the insurer's catastrophe reinsurance program and then held constant for the remaining duration of the catastrophe program. In most cases, this would require the same approach for Level 1 and Level 2, however if the reinsurance renewal date is at a date that is NOT a Level 2 reporting date (eg 30 September for a 30 June / 31 December reporting Level 2 group), then the potential for differences arises again.
- Clause 32 allows an insurer to reduce its H3 and H4 requirements for aggregate reinsurance recoveries if the cover is in place for the current reporting period and the entirety of the next reporting period. Suncorp recognises that Clause 21 states that an insurer's NP HR must be held constant during a year. However, this clause 32 can still result in differences between Level 1 and Level 2. Similar issues exist for clauses 41 and 42 for the application of aggregate stop-loss recoveries to the OA PML (and these issues are not mitigated by clause 21 as above).



## 5) *Intra-reporting period calculations*

The draft GPS116 seems to be written from a perspective of calculations as at a reporting date. However, an insurer must meet its PCR at all times. The draft GPS116 has a number of significant implications for intra-reporting periods which Suncorp believes are not appropriate, and are discussed below.

- Clause 12 states that an insurer's NP VR must be calculated and reported to APRA at each reporting date. Similar wording exists in clause 38 for the OA VR. In terms of intra-reporting period calculations, there are two potential approaches to these, both of which raise concerns for Suncorp, as follows.
  - If APRA's intention is that an insurer's NP VR does not change over the course of a reporting period, then the NP VR will not react to some potentially material changes in an insurer's risk profile. For example, an insurer's potential reinsurance recoverables or reinstatement premiums can change materially following an event. These could materially impact on an insurer's NP VR mid-reporting period.
  - If APRA's intention is that the NP VR reflect the insurer's risk profile at the calculation date (including mid-reporting period), then the requirement to take into account the reinsurance program at the reporting date and the next reporting period is unclear (given the calculation date is not a reporting date) and potentially has material implications for an insurer. For example, if a Level 2 insurance Group with a 30 June / 31 December reporting schedule is performing a calculation as at 5<sup>th</sup> January, then it will potentially require reinsurance to be in place until 31 December. For companies with a 1 July reinsurance renewal date this is not appropriate. The issue is equally as valid for insurers with different reinsurance renewal dates.
- Clause 13 requires an insurer's NP PML to include potential growth over the reporting period. Suncorp seeks confirmation that this is meant to be over the NEXT reporting period. In addition, if calculations are required mid-reporting period, Suncorp seeks clarification as to what potential growth is required to be included. Similar questions arise for clauses 23(c) and 28(c).
- Clause 17 allows an insurer to apply to APRA to reduce its NP VR for aggregate reinsurance recoveries if the cover is in place for the current reporting and the entirety of the next reporting period. If calculations are required mid-reporting period, then this may have a material impact as it potentially implies that a Level 2 insurance group will be unable to access this clause for the 2<sup>nd</sup> 6 months of each year (and the last quarter of the year for a Level 1 insurer). Suncorp is unclear regarding APRA's intention in relation to this issue. Similar questions exist for clauses 41 and 42 in relation to the OA VR.
- Suncorp seeks confirmation that the requirement Clause 32 for reinsurance to exist for the next reporting period is in the context of Clause 21 where the NP HR



is held constant over the year. That is, Suncorp seeks confirmation that the requirement in Clause 32 applies at the start of the year and does not apply continuously for the entire year.

6) *NP HR recalculation*

Clause 21 states that if there is a material change to an insurer's reinsurance program during the year, then the insurer must approach APRA to determine whether NP HR should be re-calculated.

Suncorp seeks confirmation that circumstances such as the erosion of an aggregate deductible or the exhaustion of an aggregate cover are not considered "changes" to a reinsurance program as they simply reflect the reaction of an existing program to subsequent events.

If items such as those discussed above ARE considered to be changes to an insurer's reinsurance program, then GPS116 should make it clear that the existing calculation of NP HR is applicable until otherwise advised by APRA, or else an insurer would be in a position of not knowing its regulatory capital position.

**Minor Point – GPS116**

- Clause 16 states "...the insurer must estimate the cost based on current reinsurance market conditions". Suncorp seeks confirmation that this means that no allowance is to be made for any expected change in price following the occurrence of the multiple events.

**GPS117 – Capital Adequacy: Asset Concentration Risk Charge**

- In relation to Table 2, it is not clear to Suncorp what is defined as a "short term exposure" and what is defined as a "long term exposure". We suggest APRA provide some clarification in this regard.

**GPS118 – Capital Adequacy: Operational Risk Charge**

- Suncorp submits that further explanation is needed as to how Clause 8 should operate for:
  - a) An insurer that has been operating for:
    - i) less than 12 months; and
    - ii) for less than 2 years?
  - b) An insurer that has purchased / sold a book of business?

**GPS114 – Capital Adequacy: Asset Risk Charge**

- Suncorp seeks confirmation that the discussion in clause 58 in relation to Grade 2 ratings and the split of Grade 1 ratings is simply because there are two levels of Grade 1, and hence all other grades are simply graded up a notch. A similar question arises for clause 66.



- Suncorp seeks confirmation of how the step-down in ratings grade in clause 67 will operate for reinsurers who are rating grade 7.

**GPS114 – Equity Stress, Paragraph 39**

Suncorp submits that a limit of 40% should be imposed on the equity valuation fall following the application of the dividend yield shock.

**GPS114 – Equity Volatility, Paragraph 41**

Suncorp submits that, to avoid misunderstanding, assets should be clarified as being derivatives on equity assets.



## **ATTACHMENT 2 – Suggested Transitional Implementation of ICRC**

As per our letter, we suggest that the ICRC standard should be delayed such that it comes into effect on the reinsurance renewal date for each insurer occurring on or following 1 January 2014.

If the remaining aspects of LAGIC are implemented earlier than this date, then this will have the effect of an insurer operating for a period in a post-LAGIC environment, but without the ICRC having come into effect.

For the period after LAGIC becomes effective, but before an insurer's ICRC applies, we suggest the following transition approach:

- The ICRC is replaced by the current Concentration Risk Charge;
- An insurer's Prescribed Capital Amount cannot be less than its MCR under the current rules;
- An insurer may apply to APRA to have its ICRC apply earlier; and
- If such an approval is forthcoming, then the insurer cannot apply to revert to the original treatment.



