Insurance Capital Review Seminars

General Insurance

September 2010

Hosted by

Institute of Actuaries of Australia

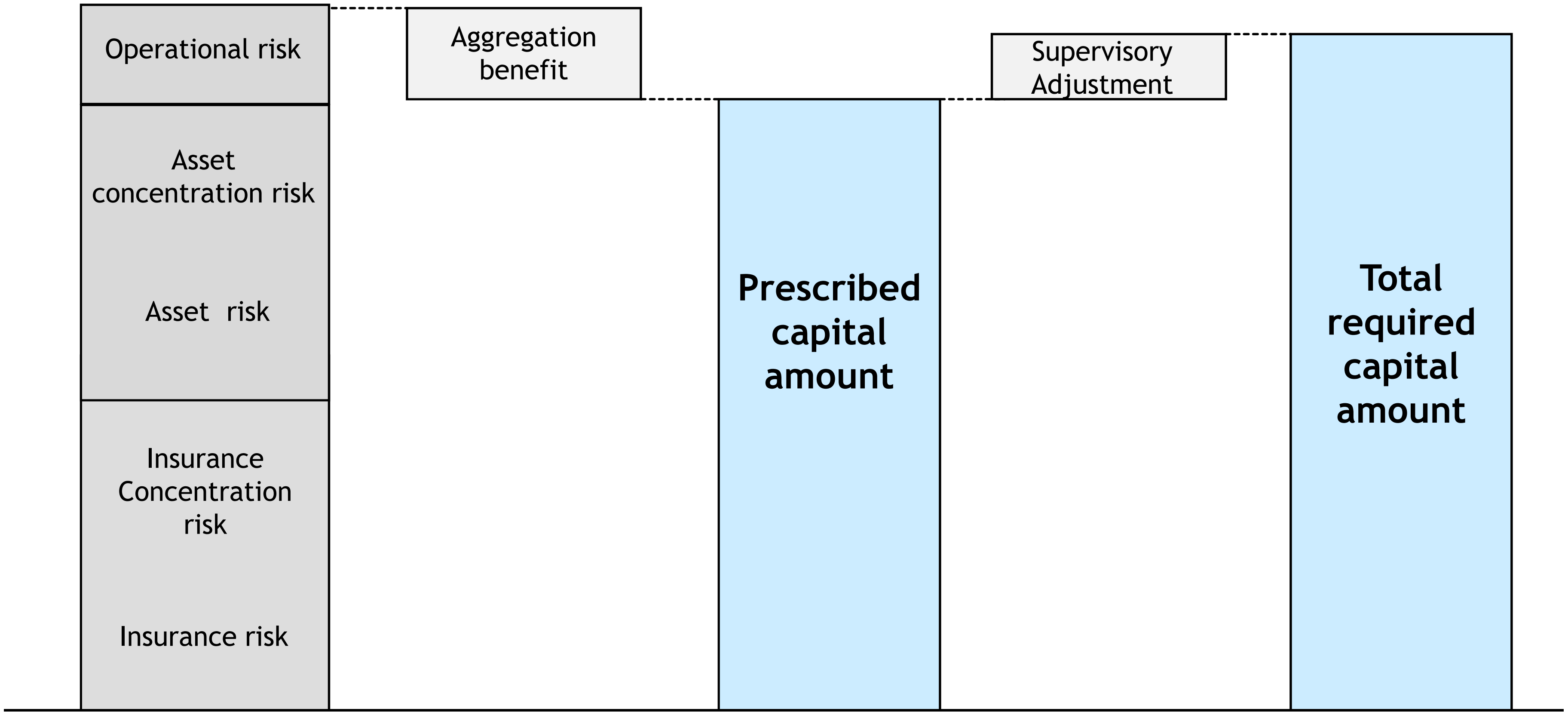
Agenda

- Timeline
- Summary of APRA proposals
- Industry responses to the Discussion Paper

Timeline

- Nov 2009 Informal industry consultation
- May 2010 First discussion paper issued
- Jul 2010 First two technical papers issued
- Aug 2010 QIS begins
- Aug 2010 First discussion paper comments due
- Sept 2010 QIS training sessions
- Sept 2010 Release of Third technical paper
- Oct 2010 QIS and tech paper comments by 29 Oct
- Dec 2010 Draft standards and response paper
- 2011 Final standards and reporting forms
- 2012 Implementation

Components of required capital



Asset risk capital charge

- Current charge makes no allowance for duration mismatch between assets and liabilities
- The new charge will be more risk sensitive – based on a series of stresses to the balance sheet
- Common approach across Life and General
- Materiality – simplify calculations
- Inflation risk – need to ensure no double counting

Asset risk capital charge

- 8 separate asset risk modules:
  - real interest rates
  - expected inflation
  - currency
  - volatility
  - equity
  - property
  - credit spreads
  - default

- Aggregation of capital charges using a correlation matrix

- Stress tests applied to the whole balance sheet (assets and liabilities)

Asset concentration risk capital charge

- Maintain 100% capital charge for excess of assets over limits
- Base limit of 25% of capital base
- No limit for govt exposures with grade 1 or 2
- 50% of capital base for exposures to APRA regulated parties
- 100% of capital base for exposures to related entities which are also APRA regulated
- Dollar minimum thresholds for exposures to strong counterparties (eg. Banks)
- No change to limits for reinsurance exposures.

Insurance risk capital charge

No change in overall approach, some changes to factors

Direct Business

- Travel 9%→11% for OSC (13.5%→16.5% for PL)
- Mortgage 11%→15% for OSC (16.5%→22.5% for PL)
- Actuary to choose charge most appropriate for ‘other classes’

Reinsurance business

- Align class groupings to match direct
- Remove distinction between facultative & treaty
- Collapse number of risk charge groups from 12 to 6

Insurance concentration risk capital charge

Current Approach

- Assuming Limit of cover equals PML, current capital charge = MER plus cost of one reinstatement.
- Aim to maintain adequate capital to withstand one large event
- BUT:
  - Ambiguity around definition of large event (single site vs WoP)
  - Does not address capital impact of unexpected losses from multiple small or medium sized events in a year
  - More clarity required for non property insurers
- Proposals not yet finalised – Technical paper expected in September

Insurance concentration risk capital charge

APRA

Likely content of proposals – Exposures to natural catastrophes:

- Proposed modification to Pillar 1 rules based requirement
- Separately address limit of vertical cover and amount of capital required for exposure to multiple events.
- For limit of cover, adopt Whole of Portfolio approach at 1 in 200 level. Maintain existing need for one full reinstatement of cover.
- For capital required for exposure to multiple events, consider impact on retention and reinsurance reinstatements from several scenarios of multiple events of varying size.
- Allow diversification between ICRC and remainder of framework. (Asset risk to diversify with sum of Insurance Risk and Insurance Concentration Risk).

Insurance concentration risk capital charge

Proposed formula – exposures to natural catastrophes:

Where: $$ICRC = \sqrt{A^2 + B^2 + 0.4AB}$$

A = the net loss (after reinsurance recoveries) from the occurrence of a single event with size equal to the 1 in 200 whole of portfolio loss, plus the cost of one full reinstatement of cover (changes dynamically through year).

B = max [B(3), B(4)] – 1.2C (set at start of year and held constant)

B(3) = Capital impact (expected retained losses plus cost of reinstatement cover) from the occurrence of three losses of a size equal to the 1 in 10 year event

B(4) = Capital impact (expected retained losses plus cost of reinstatement cover) from the occurrence of four losses of a size equal to the 1 in 6 year event

C = the average annual catastrophe cost included in the insurance premium.

Insurance concentration risk capital charge

<u>Likely content of proposals – Other accumulations of exposure:</u>

- Only consider exposure to largest single loss at 1 in 200 level (ie. only A from previous slide) plus cost of reinstatement
- Need to consider risk of a series of dependent claims arising from a single event.
- Clarify methodology for netting reinsurance assets for insurers with aggregate or stop loss cover
- For classes such as trade credit, LMI – allow a deduction of a portion of premium liability provision (to eliminate double count)

Operational risk capital charge

ORCC = 3% x max {GWP + |Δ|, L + |Δ|}

where:

- GWP = Total written premium for the most recent year
- L = Total insurance liabilities
- |Δ| = Absolute value of the annual change in the relevant quantity (from previous year to current year) for changes which exceed ±10%.

Other items

- Risk margins
  - maintain 75% PoS approach
  - require risk margins on recovery assets
- Diversification
  - collect information on diversification benefit in risk margins
  - may limit overall level allowed
- Discount rates
  - maintain requirement to use yields from Commonwealth Government Bonds
- Capital base
  - no double counting of regulatory capital
  - may limit quantum of Tier 2 capital allowed

Supervisory review and ICAAP

- A supervisory adjustment may be added to required capital
- Any supervisory adjustment is non-disclosable
- Insurers must have a process to assess and manage capital (ICAAP)
- The ICAAP requirements will build on current requirements

Summary of Submissions Received

Total of 24 submissions received on GI related issues

- Overall level of capital – will it go up?
- Increase in complexity & regulatory burden – more cost, less transparency?
- Operational risk charge – feedback on components of proposed formula, formula creates no incentive for improvement
- Asset risk charge – too complex, especially for real interest rates, inflation and volatility
- Asset concentration – concern that 50% limit on ADIs is too low
- Insurance risk – objections to gross RM proposals & placing limits on diversification.
- Supervisory adjustment – general discomfort over transparency of process