



Insurance Capital Review

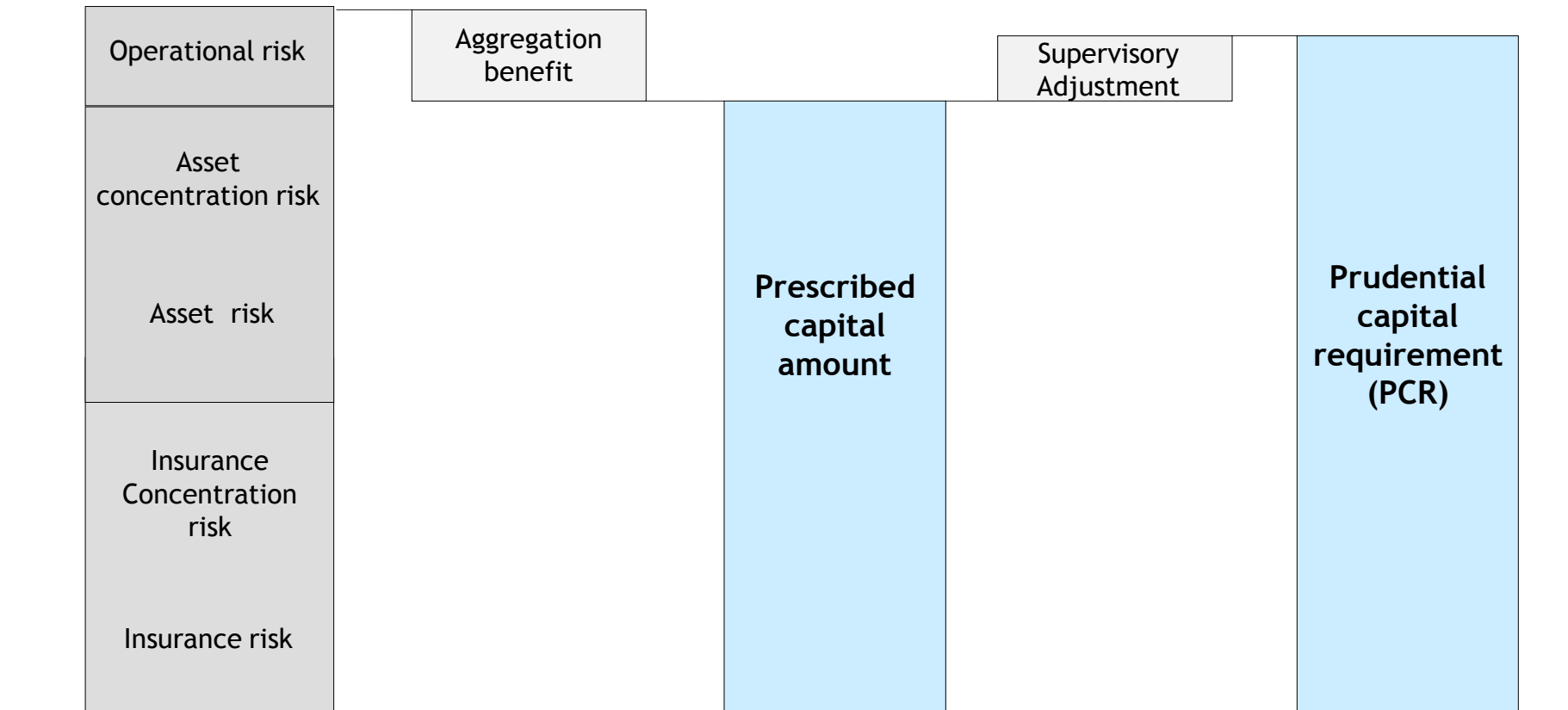
Seminar - General Insurance

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	<ul style="list-style-type: none">• Calculations considered complex• Some factors considered too high• Some factors overly pro-cyclical	<ul style="list-style-type: none">• Simplification of calculations• Factors revised to be less pro-cyclical and lower in magnitude
Asset concentration risk	<ul style="list-style-type: none">• Some limits considered too restrictive	<ul style="list-style-type: none">• Limit increased for short term investments in APRA regulated entities
Operational risk	<ul style="list-style-type: none">• Formula overly sensitive to normal insurance fluctuations	<ul style="list-style-type: none">• Revised formula
Insurance risk	<ul style="list-style-type: none">• Inflation risk accounted for in both asset risk and insurance risk	<ul style="list-style-type: none">• Reduction in insurance risk capital factors for long-tail classes
Insurance concentration risk	<ul style="list-style-type: none">• Whole of portfolio vs single site• Large capital impact and increased complexity	<ul style="list-style-type: none">• Whole of portfolio retained• Formula simplified and capital impact reduced
Level 2 groups	<ul style="list-style-type: none">• Further clarification required	<ul style="list-style-type: none">• Most Level 1 proposals implemented at Level 2 with some modifications

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

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

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

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

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

Revised proposals:

- 1 in 200 year whole of portfolio requirement for vertical cover
- Requirement for at least one contractually agreed reinstatement of vertical catastrophe 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



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

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

- **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

- **Insurance Concentration Risk Charge:**

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

where:

VR_{prop}	Vertical requirement for property risks
$VR_{\text{non-prop}}$	Vertical requirement for non-property risks
$ICRC_{\text{LMI}}$	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

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

$$\text{ICRC}_{\text{LMI}} = \text{PML} - \text{ALR} - \text{NPL (ED)},$$

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