



Institute of Actuaries of Australia

APRA – Current Developments

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INSTITUTE OF ACTUARIES OF AUSTRALIA CONFERENCE 10TH NOVEMBER 2003.

Thank you for the opportunity to talk to you today.

The Australian General Insurance Industry

In APRA's regulatory role with the general insurance industry, we need to be cognisant of the position that the industry holds in the overall Australian economy. It is important to bear in mind some of the key elements of the industry, in particular its size, complexity and the impacts it has (or can have) on other sectors of the economy. The Australian general insurance industry has an annual premium income in excess of \$20 billion, assets greater than \$14 billion, is a major player in the investor market, an employer of Australian labour resources and is charged with the protection of Australian assets for future economic benefit. The finance and insurance sector (which includes the general insurance industry), is the third largest sector in terms of contribution to Australia's GDP and is one of the major growing sectors of the Australian economy. See:

http://www.axiss.com.au/content/attractions/financial_markets.asp

The Australian general insurance industry is highly concentrated with the major five direct insurers accounting for 75% of the direct insurance industry premium and accounting for 60% of total industry assets. For these insurers, 75% of their premium is short tail business, and 25% long tail. All of the top five are listed : four are listed Australian insurers (IAG, Promina, Suncorp Metway and QBE) with Allianz being listed on the German stock exchange.

The reinsurance market within Australia is much further concentrated with the two largest reinsurers, Munich and Swiss Re, accounting for 63% of the reinsurance industry premium.

Before we address the current position at APRA, developments that are currently underway and future directions, it is important that we take a brief look back at where APRA has come from and some of the key issues that APRA has faced in its relatively short life.

The Origin of APRA.

The Wallis Report¹ recommended a restructure of the financial system regulatory framework in Australia and this resulted in the creation of a single prudential regulator – APRA. APRA was formed under the *Australian Prudential Regulation Authority Act 1998* on 1 July 1998 through the integration of the prudential supervisory functions of the Insurance and Superannuation Commission (ISC) and the Reserve Bank of Australia (RBA). The State-based Financial Institutions Scheme regulators integrated with APRA slightly later. The ISC was responsible for the prudential supervision of the life insurance, general insurance and superannuation sectors, the RBA regulated banks and the Financial Institutions Scheme regulators had responsibility for building societies, credit unions and friendly societies. The new framework moved from regulation based on institutional lines to one based on functional lines with the two main functional regulators being APRA and ASIC.

Reasons for establishing APRA:

APRA's formation was driven by the belief that a single integrated prudential supervisory agency would produce results superior to several stand-alone industry specialist agencies. This belief was based on the observation that many financial groups would arbitrage among regulators if regulation was not integrated. There was also a view that financial conglomerates were likely to move their own internal risk assessment and management processes and controls towards a group basis. It was also expected that an integrated supervisor would be more able to attract staff with strong supervisory skills and be more efficient.

Since formation APRA has witnessed a number of the large financial groups taking more of a group-wide rather than an entity approach to a number of major policies, processes and controls, in

¹ Financial System Inquiry, March 1997.

particular risk management. However, we have sometimes been surprised at the time it has taken for this to occur and also at the continuation in a number of cases, of distinct risk management approaches and processes even under the one 'Group wide umbrella'.

APRA has demonstrated that an integrated supervisor will generate consistency advantages in areas such as risk analysis and assessment and the approach to 'generic' financial industry matters such as capital issues. Our more sophisticated system for risk-rating supervised financial entities has also been rolled out and as of last week over 1090 ratings have been completed. APRA is also satisfied that integration has improved outcomes in supervisory support areas, such as statistical collections, risk consulting, training, and supervision policy formulation.

An integrated supervisory agency, however, need not be comprised of supervisors who individually supervise across the four industry groups. While supervisors play an important role in the protection of the interests of beneficiaries the primary responsibility for this lies on the board of the entity. APRA's supervisory strategy for large institutions from 1999 to 2001 relied upon the entity board, senior management, auditor and actuary to perform primary risk analysis, with a broader overview role being played by APRA. Our supervisory strategy has evolved to a more intense examination of the appropriateness and effectiveness of internal entity processes and, where necessary, a more interventionist approach. This approach requires both a strong supervisory framework and experienced supervisors supported by strong skill sets in industry and risk skills within APRA.

The General Insurance Prudential Supervisory Framework

APRA's mission is to: **"Establish and enforce prudential standards and practices that are designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system."**

APRA's concern is the financial promises that are made to 'beneficiaries' which are the policyholders in respect to the general insurance industry (as opposed to other stakeholders such as shareholders).

APRA's supervision of the general insurance industry has been assisted by the introduction of a new prudential regulatory framework that became effective on 1 July 2002 after several years of policy development and industry consultation. The new framework comprises a three-layered system of regulation:

- the *Insurance Act 1973* (substantially amended by the *General Insurance Reform Act 2001*);
- Prudential Standards; and
- Guidance Notes.

The *Insurance Act 1973* contains high-level principles and powers necessary for effective prudential supervision; the Prudential Standards, being disallowable instruments issued by APRA, set out the main requirements with which companies authorised under the *Insurance Act 1973* must comply; and Guidance Notes, also issued by APRA, set out interpretive detail. This framework is supported by a new regulatory reporting regime set out in Reporting Standards made under the *Financial Sector (Collection of Data) Act 2001*.

The new framework substantially strengthened and modernised the prudential requirements applying to general insurers in Australia. By strengthening the requirements in relation to both financial soundness (liability valuation and capital adequacy) and risk management (particularly in relation to governance and reinsurance), and coupling these with new legislative provisions that strengthen APRA's capacity to intervene in the affairs of an ailing insurer, the Australian general

insurance industry is now subject to much more effective regulatory standards than was the case in the past.

The Prudential Standards significantly upgrade the consistency and rigour with which insurers value their insurance liabilities (provisions must be set at least at the 75th percentile of expected losses) and assess their capital adequacy (with capital factors aligned to risk), and impose much higher standards of governance on an insurer's Board and management. The standards also require insurers to have in place sound risk management and reinsurance practices, broaden the role of the insurer's auditor and introduce a role for the insurer's actuary. These measures aim to ensure an insurer is well managed, has access to appropriate independent expertise and has in place systems for identifying, managing and monitoring risks that may reduce the ability of the insurer to meet its obligations to policyholders.

These prudential standards are supported by a strengthened reporting framework – implemented via APRA's D2A (Direct to APRA) reporting system. This framework requires reporting on a prospective basis which differs from the approach adopted under AASB 1023 Financial Reporting of General Insurance Activities. Details of the areas of contrast between the two approaches can be found on the APRA website at:

<http://www.apra.gov.au/Statistics/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=475>

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The quarterly reporting requirements for general insurers, while including more detail than under the previous regime, also ensures that more timely information is submitted to APRA.

There were some initial teething problems with the new reporting framework, both from industry dealing with the additional complexity of the new reporting forms and APRA's framework requiring additional fine tuning and further checking mechanisms such as increased validation checking. However these have been largely resolved and remaining issues are being worked

through with industry utilising enhanced instructions and an increased Q & A database of common occurring errors. APRA continues to focus on data quality issues to improve the integrity of the information being submitted by insurers.

The first audited annual reporting forms submitted to APRA under this new framework highlighted the need for improved communication between insurers, their approved auditors and APRA. To this end, tripartite meetings have been held, where applicable, to provide a forum for the discussion and resolution of any issues that arise out of the insurer's annual reports and quarterly reporting requirements.

This new prudential and reporting framework improves the ability of APRA supervisors to examine the financial position of insurers and also consider other non financial indicators that impact upon the ability of insurers to meet their financial obligations to policyholders.

APRA Supervision

While APRA, and predecessor agencies, has always had a risk based approach to supervision there was no formalised and structured assessment process in place across all entities. During 2002 APRA introduced a more formalised risk assessment model comprising the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight And Response System (SOARS) system. PAIRS is APRA's central risk assessment model - SOARS provides the supervisory stance that is to be adopted by responsible supervisors. These models are applied to all APRA-regulated institutions. Additional information on the PAIRS model and the rationale behind the methodology can be found at the APRA website :

<http://www.apra.gov.au/PAIRS/home.cfm>

Our supervisors are required to perform three tasks well:

- achieve accurate PAIRS grid positioning for each regulated entity,
- act accordingly on the SOARS model, and
- report the position to APRA senior management and Members on a risk based schedule.

This model ensures that supervisors focus on assessing risks against a consistent framework and responding effectively to impending difficulties in a regulated entity.

APRA supervisors populate these models using information supplied to APRA via financial and non-financial reporting requirements and other mechanisms, and also from on site visits and consultations with regulated institutions. Using both on-site and off-site information provides a check and balance on assessments made off-site through the verification of practices on-site. This is important since on-site visits often bring to light other factors which affect assessments as well as enabling supervisors to ask questions to clarify 'grey' issues.

Another element of APRA's on-site visit program is to ensure that the reporting methods adopted by the institution and the data that being reported actually provide APRA with the necessary, and accurate, information to adequately assess an institution. These visits provide APRA with the opportunity to review the systems institutions have in place and to assess whether they are operational as reported to APRA and have the functionality required of them.

Recent Developments

The findings of the HIH Royal Commission would be well known to the Australian general insurance industry. APRA accepts the Commission's findings that the way in which it exercised its powers and responsibilities in relation to HIH fell short of community expectations. Since the

failure of HIH, APRA has taken substantial steps to improve its supervisory capacity and processes and it has become a much stronger and more effective supervisor as a consequence.

The HIH Commission Report recommendations directly relevant to APRA have already been implemented or are in the process of being implemented or evaluated by myself and the other new Members. Many actions were taken by APRA in response to the Palmer Report² that was commissioned by APRA prior to the release of the HIH Commission Report. We have recently responded to the Government following the Government's release of its response to the HIH Royal Commission Report in September 2003.

In line with the HIH Royal Commission Report Recommendation Number 18, as at 1 July 2003 the Government replaced APRA's Board structure with a new APRA Member structure comprising three members - Chair Dr John Laker, Deputy Chair Ross Jones and myself as Member. To strengthen APRA's industry focus APRA members have divided their day-to-day responsibilities along industry lines; I have specific responsibility for insurance matters (both life and general), John Laker has responsibility for ADIs and Ross Jones for Superannuation.

A substantial step to further improve APRA's ability to function as an effective integrated prudential regulator has been the strengthening of APRA's skill base in insurance. Since its formation, APRA has had in place dedicated specialist teams for the analysis of key risk areas, namely credit risk, balance sheet and market risk, and operational risk. The Insurance Risk Consulting team was established in 2002 and includes a number of staff with many years of experience in the general insurance and reinsurance industries. Additional supervisors with industry experience have also been recruited.

² Report by John Palmer, FCA: Review of the Role Played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the Collapse of the HIH Group of Companies

As well as having the skills of these specialist teams to available to assist them, APRA's direct supervision teams also have access to the Technical Advice & Support (TAS) teams which are structured along industry lines. The TAS team for general insurance also includes industry recruits. This team provides supervisors with technical advice and also access to policy, legal, actuarial and other specialist resources from within APRA to support and enhance supervision.

APRA continues to strengthen its general insurance expertise through the recruitment of industry experienced staff and the provision of training and development programs.

In terms of our supervisory strategy, following an initial PAIRS assessment for each insurer, we have undertaken a process of refinement of the assigned ratings through peer group analysis both between general insurers and across other APRA-regulated industries. While this process has resulted in some ratings in particular risk categories being revised, it has not indicated any significant shortcomings in the overall risk rating approach. The SOARS ratings have also been refined and slight modifications have been made to the model.

Future APRA Developments

1. General Insurance Reforms Stage 2

As mentioned in APRA's 2003 Annual Report (which is available from our website), we will shortly be releasing a discussion paper 'Prudential Supervision of General Insurance Stage 2 Reforms'. The discussion paper will outline proposals to revise the existing prudential standards and guidance notes in light of experience and market developments; and increase disclosure about the activities of general insurers in order to promote market discipline.

The paper will canvass proposed changes in prudential standards to strengthen the capital adequacy requirements and governance requirements applying to general insurers. There will be proposals that clarify the minimum requirements relating to Reinsurance Management Strategies (REMS) and Risk Management Strategies (RMS) with further detailed guidance on the data and information required in these documents and an emphasis on the need for these to be updated and reviewed.

Proposals in relation to disclosure aim to improve the transparency and usefulness of information disclosed by both general insurers and APRA. APRA is of the view that policyholders and other users of this information will directly benefit from increased public disclosure as the additional information will allow more accurate assessment of the financial position and risk management practices of general insurers

The paper will seek comments from all interested parties and further consultation on these proposals will be conducted over 2004. We had anticipated releasing this paper earlier this year but as you can appreciate we needed to be mindful of the Government's response to the HIH Royal Commission Recommendations and ensure these were taken into account in the development of APRA's proposals.

2. Conglomerates (Consolidation) Policy

APRA considers that the development of a regime of consolidated supervision to minimise the risk that adverse developments in other parts of the group could damage the soundness of a general insurer is also required. This policy will be the subject of a separate consultation paper to be issued in early 2004.

3. International Accounting Standards

It is expected that the new International Financial Reporting Standards ('IFRS') of the IASB (operative from 1st January 2005) will be issued by 31 March 2004 and will impact upon

disclosure and reporting undertaken directly by APRA-regulated entities. The AASB has followed suit by announcing that as part of its international convergence and harmonisation strategy, it will make and issue Australian equivalents to IFRS, as soon as practicable after the IASB issues them.

APRA has gathered feedback from insurers and auditors that indicate that some insurers are not very far advanced in having the infrastructure in place to meet the new requirements. In order to undertake a comparative analysis, insurers need to be able to process their 2004 accounts on the basis of IAS. This means that for entities with December balance dates, systems need to be in place by 31st December 2003. Entities that have 30 June year ends will need to have the systems in place by 1 July 2004.

So APRA can gain a fuller appreciation of where insurers are up to in their planning processes, we will be asking all insurers (and ADIs) to complete an “Accounting Standards Survey” later this year. APRA will consider the responses and determine if further regulatory requirements need to be developed. In any case, we will be monitoring the progress of the industry on this issue.

Other developments

Recommendation 42 of the HIH Royal Commission proposed that the Insurance Act be extended to capture all discretionary insurance-like products. The Government has commissioned a review to examine the role of discretionary mutual funds and direct offshore foreign insurers in the Australian insurance market to be headed by Mr Gary Potts.³ APRA will be providing a submission to this review.

In response to HIH Royal Commission Recommendation 61, a proposal to introduce a policyholder support scheme in the event of failure of an insurance company, the Government has

³ Details of the review, including the terms of reference, can be found at <http://dmfreview.treasury.gov.au>.

commissioned a comprehensive study to be followed by a public consultation process, to be undertaken by Treasury, on possible policy options.⁴ APRA is participating in this study.

The Government has also commenced consultation on its Corporate Law Economic Reform Program No. 9 (CLERP 9).⁵ A number of proposals in CLERP9 are directly relevant to some of the governance issues which will be covered in our forthcoming discussion paper. APRA will consider the necessity of providing a submission to the Government on those CLERP9 issues particularly relevant to APRA-regulated institutions and prudential supervision. As a matter of policy, APRA is keen to ensure the consistent application of the principles in the draft legislation whenever possible. In some instances, however, balancing the interests of depositors and policy holders versus shareholders may be difficult to achieve in practice.

Thank you for your attention and I now await your questions before handing you back to Tony Coleman.

⁴ Details of the study, including the terms of reference, can be found at <http://fsgstudy.treasury.gov.au>.

⁵ In October 2003, the Government released for consultation the draft *CLERP (Audit Reform and Disclosure) Bill* and *Commentary on the Draft Provisions*. The draft Bill gives legislative form to the policy proposals contained in the September 2002 CLERP 9 policy proposal paper: *Corporate disclosure: Strengthening the financial reporting framework*. The draft Bill is available at <http://www.treasury.gov.au>.