d'finitive
[APRA regulation]
Keeping you informed. FEBRUARY 2012

APRA Capital – Are we there yet? ... Almost.

In December 2011, APRA released its second response paper to industry submissions on the proposed changes to capital requirements.

As most people expected, changes to the general insurance proposals were minor. The focus now clearly moves to implementation, with APRA working on detailed standards and guides.

For insurers, while there is still an opportunity for submissions, the priority is now to be ready for the 2013 start date.

In this newsletter we:

- Outline the changes made to the proposed capital standards for general insurers
- Revisit our overall impact assessment
- Discuss the new ICAAP requirement, and how it might be used to implement the new capital standards.

Our Assessment

Time to get on with implementation.

APRA has fine tuned a small number of the capital charges (to reduce the impact) and clarified treatment of some items, but the main elements of the proposals are unchanged from QIS2.

Any further change is likely to be limited to any unintended consequences and minor details.

www.finity.com.au

Sydney +61 2 8252 3300
Melbourne +61 3 8080 0900
Auckland +64 9 363 2894
Wellington +64 4 460 5213

What's in this newsletter?

If you are reading this on screen, you can use the links to jump to items of interest:

>> Detail of changes to proposed capital rules

>> Measuring the capital base

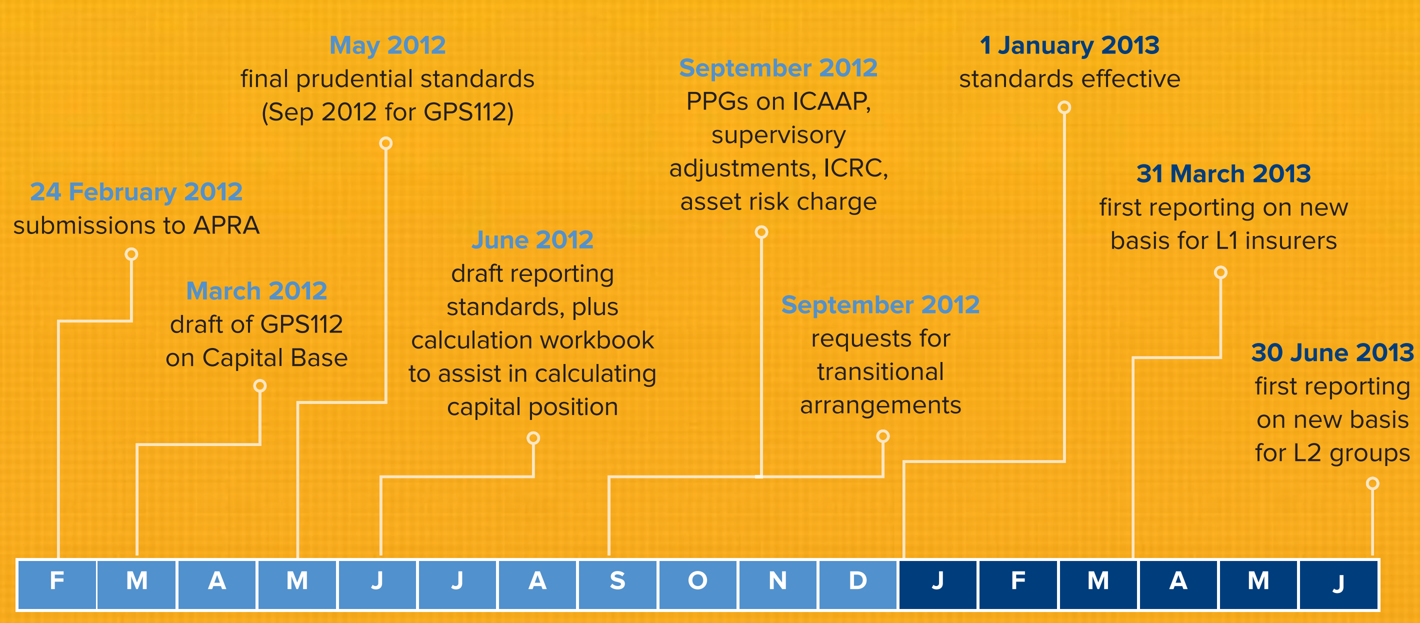
>> Industry-wide impact assessment

>> The ICAAP (Internal Capital Adequacy Assessment Process) proposals.

The story so far with LAGIC

When	What	Impact
May to September 2010	APRA released first proposals. No specific intention to increase industry-wide minimum capital requirements. QIS1 submitted November 2010.	Finity's analysis of QIS1 showed APRA's proposals would increase industry minimum capital by around 40%.
March 2011	APRA released its first response paper to insurer submissions. QIS2 submitted July 2011.	Analysis of QIS2 showed an increase in industry minimum capital of around 15%.
December 2011	APRA released its second response paper and draft prudential standards (capital base standard is due March 2012). Submissions due 24 February 2012.	Refinements will further moderate the impact, resulting in around a 10% increase in industry minimum capital.

Timetable from here...



The Changes to the Capital Elements

This section summarises the changes APRA have made in the latest response paper, the results of our QIS2 analysis, and our assessment of the likely impact of the latest round of changes.

Charge	Changes to Proposals	QIS2 Impact on Minimum Capital	Current Assessment of Impact
Asset risk	Changes to three of the seven modules – 1. Real interest rates – stresses reduced so that upwards stress is 25% of the nominal yield, downward stress is 20% of the nominal yield 2. Equity assets – stress on unlisted equities is now a fall equivalent to a 3% increase in the AXS200 dividend (was a 45% fall in value) 3. Credit spreads – default factors reduced for lowest quality counterparties and spread factors reduced for most grades of structured/securitised and re-securitised assets. For term deposits with guaranteed early redemption values, the stressed value cannot fall below the guaranteed value. Assets may be omitted from the stress calculations on the grounds of materiality.	Increased minimum capital by 11%.	We estimate the impact will reduce a little; to around a 9% increase.
Asset concentration risk	Insurers can apply for relief from asset concentration charges on transient exposures (such as a large premium receivable). Insurers may choose to apply either the reinsurance concentration limits or the counterparty limits to collateralised reinsurance recoveries at each reporting date (rather than making a one-off election).	Increased minimum capital by 7%, due to a small number of insurers who are heavily impacted by related party exposures.	The changes are sensible, but are minor overall (although they could be significant for individual insurers). We continue to expect a 7% increase from this source.
Insurance risk	No changes to the proposals.	Reduced minimum capital by 3% due to the reductions in the charges on long tail classes.	Reduce minimum capital by 3%.
ICRC	APRA has clarified how the Premium Liability offset (formerly the 'C' factor) should be calculated: >> Catastrophe losses are defined as those with a return period of 3 months or more >> The Appointed Actuary determines the central estimate of the premium liability that accounts for these losses >> This amount is annualised, allowing for both seasonality and exposure changes >> Risk margins and insurance risk charges are added. Insurers can allow for stop loss covers in determining the vertical requirement if losses have reached their attachment point.	Increased minimum capital by 5%, mainly from the horizontal requirement for property insurers.	We are unsure what return period insurers used in calculating the PL offset for QIS2, so we are unsure whether the new definition will increase/decrease the PL offset (thus decreasing/increasing the ICRC).
Operational risk	No changes to the proposals.	Increased minimum capital by 12%.	Increase minimum capital by 12%.
Aggregation benefit	Correlation factor reduced to 0.2 (from 0.3) for all insurers except LMIs (LMIs remain at 0.5).	Reduced minimum capital by 19%.	Reduce minimum capital by 22%.

Measuring the Capital Base

For some time APRA has flagged that it will adopt the Basel III capital reforms for insurers and the response paper provides the first details. These are:

>> Capital base will continue to be made up of Tier 1 and Tier 2

>> Tier 1 capital will comprise 'Common Equity Tier 1' (CET1) plus' Additional Tier 1'. CET1 replaces Fundamental Tier 1 but with a similar definition, noting that CET1 will have more detailed criteria for paid up ordinary shares.

>> Some changes to capital adjustments applied in the calculation of CET1:

> Capital held in subsidiaries and joint ventures – the prescribed capital amount of the subsidiary/JV (excluding any supervisory adjustment) will be deducted from CET1

> Netting of deferred tax liabilities and assets before deduction from the capital base will only be allowed when the tax amounts are levied by the same authority and that authority allows netting

> Rather than assets subject to a fixed or floating charge being subject to a 100% asset risk charge, these assets will be deducted from CET1

> Expected dividends will no longer be deducted from capital.

>> Upper and Lower categories of Tier 2 capital will be removed

>> The limits on the capital base are:

> CET1 must be greater than 70% of the prudential capital requirement (PCR) (currently 37.5%)

> Tier 1 must be greater than 80% of PCR (currently 50%)

> Capital base must be greater than PCR.

The detailed criteria for each element of the capital base are included in the response paper. Very few insurers have capital that is not CET1, but those that do will need to scrutinise the new rules carefully.

While the major insurers typically utilise hybrid capital, the amounts are not so large that the reduced limits are likely to be a significant problem.

Supervisory Adjustments

The possible addition of a supervisory adjustment has been an area of concern to insurers. In the response paper, APRA have set out more information regarding the form a supervisory adjustment may take, the circumstances in which a supervisory adjustment may be made, and the process APRA will follow. These comments could be read as formalising the powers that APRA has at present, but the discussion in the paper will not give any real comfort to those insurers who are concerned about supervisory adjustments.

A Prudential Practice Guide on this area will be released in September 2012. APRA will need to be in discussion much earlier with any insurer likely to have a supervisory adjustment from 2013, given that transition applications are due in September 2012.

Other minor changes

>> Draft GPS110 states that insurers will need to disclose the components making up minimum capital (excluding any supervisory adjustment). Previously only the total needed to be disclosed

>> GPS310 will be split into two new standards – one covering actuarial matters and one covering auditor matters

>> The new standards will combine the Level 1 and Level 2 group standards, with the aim of simplifying compliance for Level 2 groups.

Our Assessment of the Impact

For the insurers who participated in our QIS2 survey (covering 90% of the market excluding Lenders Mortgage Insurers), the following diagram shows:

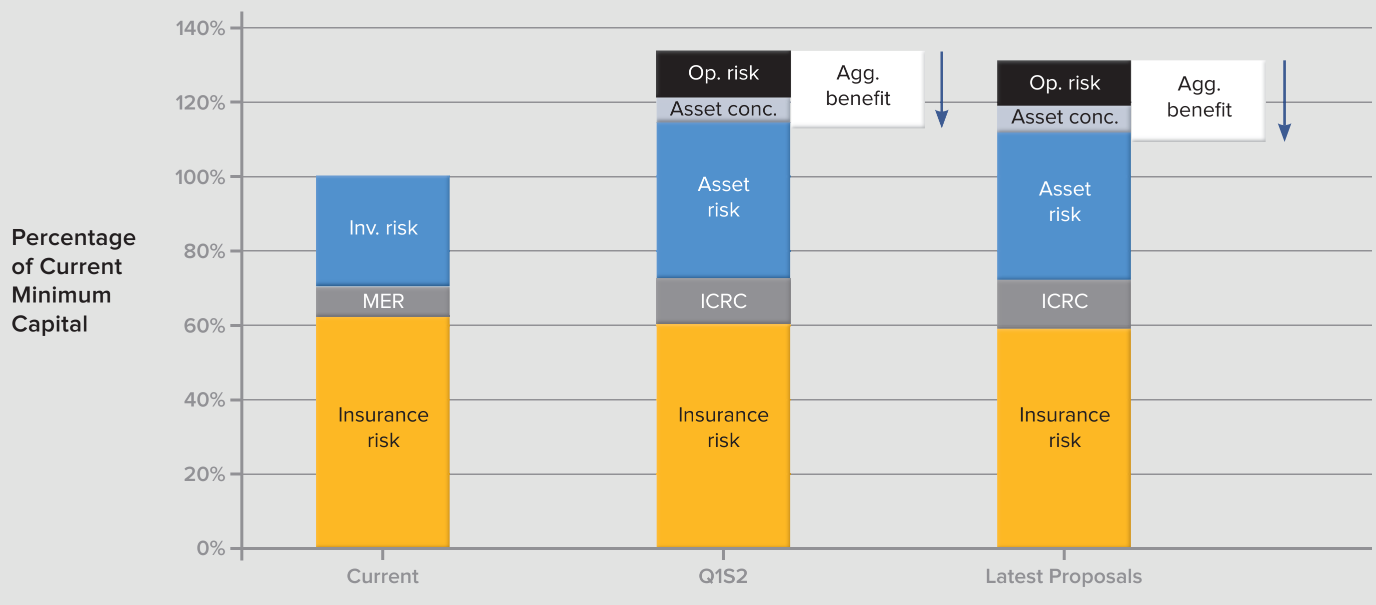
>> the current (approximately December 2010) aggregate minimum capital requirement broken down into each of its components

>> the minimum capital requirement as calculated for QIS2

>> our assessment of the impact of this latest round of changes. Note that the figures shown here do not include any impact of the latest changes to the ICRC or to the measurement of capital base.

"Finity expects the revisions to the proposals will result in around a 10% increase in minimum capital across the industry."

FIGURE 1 – MINIMUM CAPITAL



QIS2 showed that the proposals would result in around a 15% increase in minimum capital. Our assessment of the latest revisions is that the impact would be slightly lower at around a 10% increase in minimum capital.

This increase in minimum capital is, of course, an average impact over the whole of the general insurance market. Our QIS2 survey revealed that while many insurers will have either a reduction or a modest increase in their minimum capital, a number of insurers will have very sizeable increases in their minimum capital requirement.

The causes of increased minimum capital requirements are different for different insurers. Most increases are driven by asset risk charges, the asset concentration risk charge, the ICRC, or a combination.

> "We think APRA may have overstated the likely impacts of insurers changing business and capital strategies."

Can a business change avoid higher minimum capital?

In the response paper, APRA has said that it expects insurers will revise their business and capital management strategies in response to the revised capital standards. We are doubtful that insurers will be able to make changes that will have a meaningful impact on required capital, as discussed below.

Charge	Business Change to Reduce Capital Charge	Comment
Asset risk	Shift investment mix to a higher proportion of Commonwealth government bonds with a duration shorter than the liability cashflows.	While this investment strategy will reduce APRA capital charges, it is not clear that this is the optimal strategy from a risk/return perspective.
Asset concentration risk	Unwind related party transactions.	An issue for bank owned insurers as they face related-party concentration limits on cash holdings, forcing them to place assets with competitors of their parent. The small number of insurers that face asset concentration charges due to other related party exposures may find them difficult to unwind (at least in the short term).
	Spread assets among ADIs.	A small component of the asset concentration risk charge can be avoided quite easily in this way. However we question whether spreading assets among the ADI's really lowers risk, given the systemic risks of the banking industry.
ICRC	Purchase additional/ different reinsurance.	The market for sideways reinsurance cover has contracted greatly as a result of heavy event losses suffered by the market in recent years. Nevertheless, the greatly increased contribution of the ICRC to capital requirements will encourage insurers to seek out reinsurance arrangements that are effective at reducing capital requirements.

We did not identify any business changes available to reduce insurance or operational risk charges, or to increase the aggregation benefit.

A technical note on ICRC

After discussions with APRA, we have a better understanding of the basis upon which APRA have calibrated the horizontal requirement. We have previously said that we believe three 1 in 10 year events (or four 1 in 6 year events) is a more severe scenario than the 1 in 200 year scenario that APRA claims to be targeting. Our view on this has not changed and we believe APRA would agree with us. However, we now understand that APRA's underlying intention is to identify the 1 in 200 year outcome for the aggregate of catastrophe event costs for a full 12 month period. APRA's view is that three 1 in 10 year events (or four 1 in 6 year events) is a reasonable proxy for the 1 in 200 year 'aggregate annual event cost' that they are targeting. APRA is using a single point on the event loss distribution (or two points actually – 1 in 6 and 1 in 10) to approximate a single point on the aggregate annual event loss distribution. The analysis we have undertaken suggests that in most cases the approximation APRA is making is a reasonable one, although circumstances for individual insurers could clearly vary.

Nevertheless, in our view there is still a double count, due to APRA including events that might be termed 'attritional' i.e. with a return period of one every three months (4 per annum). The Insurance Risk Charge already makes allowance for variability in future claims costs, and includes allowance for variability arising from attritional events. Hence, capital to cover this variability is arguably being generated by both the Insurance Risk Charge and the ICRC.

ICAAP – a key process change

The response paper sets out what APRA expects in terms of the Internal Capital Adequacy Assessment Process, the 'ICAAP' (and further guidance is coming via a Prudential Practice Guide in September 2012). The key elements are –

- The Board is responsible for the ICAAP. APRA expects that the ICAAP will be developed by senior management, with the Board actively engaged in its development, implementation and approval
- Capital Management Plans will be subsumed into the ICAAP. Business Plans are still required, but do not need to include anything specific on capital management
- There needs to be a clear link between risk appetite and the risk and capital management framework, including capital levels, considering the insurer's own risk profile
- The ICAAP needs to include appropriate stress and scenario testing, and is expected to include trigger points for managing capital, including reporting to APRA
- APRA proposes that the ICAAP be subject to independent review at least every three years
- Documentation of the ICAAP is in two main parts –
    - An 'ICAAP Summary Statement' which is a policy statement of the capital management processes
    - The annual 'ICAAP Report' which will describe the outcomes of applying the ICAAP over the previous year. This will include assessing actual capital levels and capital management actions against the ICAAP, projections of capital levels against targets for the next three years, plus details of any changes to the ICAAP

      The ICAAP Report is distinct from the ILVR and the FCR which remain independent reports of the Appointed Actuary. However, in some circumstances, APRA may permit the ICAAP Report to be included within the FCR.
- The annual ICAAP Report is due within four months of the insurer's balance date while APRA proposes to bring forward the due date for ILVR's (and accompanying EPR's) and FCR's to three months after the balance date

OUR VIEW: Introducing the ICAAP is a good development. The existing capital management requirements are a little fragmented, and the ICAAP will result in a more cohesive framework.

We think the first Summary Statement will need to be completed in advance of 1 January 2013, as APRA could request it at any time from then. Insurers will probably need to discuss draft versions of the Summary Statement with APRA prior to finalisation, so the process will need to commence well in advance of that date.

A last word

We expect that any changes to APRA's proposals from here will be minor in nature. We encourage all insurers to have a good think about whether the draft standards have any unintended consequences for their unique circumstances.

More importantly, starting ICAAP now will make sure that you are ready for 2013 implementation.

If you are a branch, the practicalities of ICAAP will be a little different. We are currently preparing some material specifically for branches – please contact Steve Curley for more information (see contact details on back page).

We do not agree with two of the ICAAP proposals –

- >> The proposed timing of the ILVR, FCR and ICAAP reports raises issues in practice as it will be very difficult to complete both the ILVR and FCR within the three month window that APRA is proposing. We will be arguing against this proposal in our submission to APRA.
- >> The requirement for an independent review puzzles us. We are not sure what the review will achieve, and believe it will be counter to APRA's objective of 'Board ownership'.

Using ICAAP to implement the changes

Insurers can 'kill two birds with one stone' in the way they introduce ICAAP and adapt to the new capital rules. The plan could look something like this:

1. Q2 2012 – draft the ICAAP Summary Statement, and hold Board workshop on ICAAP
2. Q3 2012 – implement the new capital model (perhaps using APRA's calculation workbook):
   (a) For quarterly returns
   (b) Develop monthly estimation process
   (c) Develop forecasting approach for future capital requirements
   (d) Decide whether an application for transition is needed
3. Q4 2012 – use the results of 2 to:
   (a) Come to a final view of the impact of the new capital rules
   (b) Implement any desired business changes
   (c) Update the draft ICAAP Summary Statement
   (d) Develop a detailed plan for the first ICAAP Report
   (e) Hold second Board workshop.

The detail and timing of this plan will vary depending on the circumstances of the company, and the current stage of development of the insurer's capital and risk management. However, by integrating ICAAP with implementation of all the other changes, the Board involvement and understanding will evolve quickly over 2012 and 2013.

www.finity.com.au

d'finitive

[APRA regulation]

Not sure what your risk appetite statement should look like? Need some help with your risk analysis? Having trouble defining your capital strategy?

We have the expertise to help you answer these and related questions. For more information, please contact Scott Collings (+61 2 8252 3378) or Brett Riley (+61 2 8252 3382).

Finity & APRA Regulation

Finity is a firm of experienced consultants and actuaries specialising in general insurance. We are Appointed Actuaries to around 30 APRA-licensed insurers. We strive to keep our clients and contacts up to date with developments in the regulatory environment.

Contacts

Karen Cutter	karen.cutter@finity.com.au	02 8252 3386
Geoff Atkins	geoff.atkins@finity.com.au	02 8252 3337
Steve Curley	steve.curley@finity.com.au	02 8252 3326

Would you like to find out more about ICAAP, and what you need to be doing?

Please call Steve Curley on +61 2 8252 3326

This newsletter is based on Finity's current understanding of APRA's proposals. It does not constitute either actuarial or investment advice. While Finity has taken reasonable care in compiling the information presented, Finity does not warrant that the information is correct. We refer the reader to the response paper and draft prudential standards on APRA's website (www.apra.gov.au) for further detail.

Further clarification can be sought from our consultants.

Copyright© 2012 Finity Consulting Pty Limited.

Australia & New Zealand Insurance Industy Award
'Service Provider of the Year' 2006, 2007, 2008, 2009 and 2011.

Australia

Sydney
Tel +61 2 8252 3300
Level 7, 155 George St
The Rocks, NSW 2000

Melbourne
Tel +61 3 8080 0900
Level 3, 30 Collins Street
Melbourne, VIC 3000

New Zealand

Auckland
Tel +64 9 363 2894
Level 27, 188 Quay St
Auckland 1010

Wellington
Tel +64 4 460 5213
Level 16, 157 Lambton Quay
Wellington 6140

Contact the Author

Karen Cutter
Tel + 61 2 8252 3386
karen.cutter@finity.com.au
Sydney Office