

APRA

Capital stress testing

In December 2016 APRA advised insurers of revised expectations in relation to capital stress testing. In this d'finitive we take a look at APRA's expectations and provide our thoughts on implementation considerations for small to medium insurers.

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APRA industry stress tests

APRA recently wrote to all general insurers providing information about the general insurance industry stress testing that was performed by the larger insurers and reinsurers in 2016. In particular, APRA provided detailed specifics of two hypothetical scenarios and suggested that it *expects* all insurers to consider including the scenarios within their internal capital stress testing (and ICAAP).

Our overall impression is that the suggestion has some merit, although the complexity of the scenarios will make implementation challenging for some smaller insurers, and a degree of modification will be needed. In particular, insurers with geographically concentrated exposures outside of Sydney or those who don't write CTP may need to determine their own alternative, but broadly comparable scenarios.

The remainder of this update comments on the scenarios and some of the considerations for small to medium and niche general insurers.

Summary of the scenarios

Scenario	A	B
Common Market Shock	Weakening in China's economy leads to a capital outflow from the Australian economy. This causes reductions in GDP, government bond yields and AUD exchange rates. Unemployment and credit spreads increase and asset returns are poor across most types of investment. Insurance claims increase due to shareholder class actions and for credit related insurance classes.	
Scenario Specific Shock	An earthquake occurs near Sydney airport causing deaths, injuries and significant property damage. Post event demand surge increases reconstruction costs and there is significant business interruption in surrounding areas. Reinsurance premiums increase in subsequent periods.	In an environment with declining household wealth the incentive to seek insurance compensation for minor injuries increases. This leads to increased plaintiff lawyer utilisation and claim frequencies for CTP. Higher demand for medical and attendant care services also increases the cost of claims across CTP, workers compensation and liability classes. Premium increases to offset the cost changes are either not possible or delayed.



Our assessment

We are broadly supportive of APRA's intention and believe that the consideration and possible adoption of comparable scenarios by small to medium insurers would result in greater consistency across the industry in capital stress testing.

The scenarios themselves - how they are described and then mapped to parameters - also provide guidance on APRA's views of "best practice" in this area. In our experience, very few insurers are currently adopting scenarios with the level of detail and correlations, both multi-class and multi-year, that are present within the APRA examples. The scenarios are also described by APRA as intended to be "severe but plausible". This description, along with the underlying parameters, may also help improve the consistency of modelling of lesser severity outcomes (such as "modest" or "moderate" scenarios).

Another interesting feature of the scenarios is their multi-year nature, noting that APRA's specification to date has been around one year outcomes. Many stress tests actually work better as multi-year scenarios, which also allows consideration of possible management responses to the stress.

Implementation

Smaller insurers can expect some implementation issues in applying these stresses to their own books. The specific scenarios are particularly relevant to insurers with Sydney property and CTP exposures and other insurers will need to adapt the scenarios to be comparable for their own portfolio. Some initial thoughts on scenario modification include:

- Non Sydney Property insurers may wish to relocate the Property damage scenario to the location of their own peak exposure. In some cases this may even involve consideration of differing types of Property events, for example, it may make more sense for insurers underwriting solely in the northern states and territories to consider a severe Cyclone event. Care will also be needed to select an appropriate alternative location for the event. APRA's choice of Botany Bay appears to reflect the unique range of risks specific to this site. These include post-earthquake liquefaction risks, plus significant property damage and associated interruption risks spanning insurance classes such as domestic and commercial property, liability, travel, trade, aviation and marine.
- The granularity of the scenario specifications is limited for non CTP personal injury classes and refers only to Liability and Workers Compensation. Those insurers who don't write material volumes of CTP may therefore need to give further thought to the flow-on impacts for other personal injury classes, including classes such as Medical Indemnity, which is not referenced at all within APRA's specifications.
- Insurers will need to analyse industry statistics or their own historical experience to understand how claim costs, for differing classes, correlate with past economic downturns (such as the GFC). For classes such as D&O, Professional Indemnity and credit related classes, detailed parameters have not been specified, although APRA expects insurers to allow for the impacts on these classes.

Conclusion

On the whole, with the level of regulatory change having reduced over the past year or so, now may be an opportune time for insurers to take stock and “upgrade” those elements of their internal processes that need a refresh. In light of the detailed specification of APRA's industry stresses and their clear message that all insurers should consider something comparable, we expect many insurers will be looking to refine their own capital stress testing over the year ahead.

Finity & Stress Testing

Finity Consulting is the largest independent general insurance actuarial consultancy in Australia. Our expertise in general insurance is highly regarded and has been developed working in the industry since the early 1980's.

Through our industry publications we seek to share our insights into the key drivers of industry trends and to help our clients stay abreast of the latest issues that are important to their business.

The Finity team specialises in helping insurers understand, quantify and manage risk. We are experts in the development of risk-based, decision-making frameworks and have supported many of our clients in designing their own ICAAP stress and scenario tests. We have also assisted clients in understanding previous industry wide issues such as the changes to APRA's regulatory capital requirements.

If you have any questions about modifying the APRA stresses for your own business, please contact one of our consultants.

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