

Navigating The APRA Capital Standards Review: Preparing now for what lies ahead

APRA has continued working on the new capital standards for insurers. Since our last APRA Update Special Edition in August 2010, APRA has released a new technical paper and the Quantitative Impact Study (QIS), considered the industry response and discussion of the results of the QIS, and released a new timetable for the review. In other words, APRA has been very busy.

Although the Capital Standards Review is not yet finalised, the QIS suggests that big changes lie ahead for most general insurers. The sooner you think through these changes and prepare for what lies ahead, the less you will be disrupted.

Here at Taylor Fry we've continued to follow these developments and their potential impacts on general insurers closely. In this second of our APRA Update special editions, we identify the potential impacts of the Capital Standards review on your business, and suggest a range of ideas to mitigate these impacts.

APRA
update



This newsletter at a glance

We've analysed the current state of the APRA Capital Standards Review according to the following breakdown. Click on the headings below to read our analysis of what is coming and what you can do to prepare.

OVERVIEW: A QUICK UPDATE ON THE APRA CAPITAL STANDARDS REVIEW	3
<i>Where Are We Now?</i>	3
<i>What did the QIS Tell Us?</i>	4
<i>Where are things headed?</i>	5
PREPARING FOR WHAT LIES AHEAD	6
<i>The Asset Concentration Risk Charge</i>	7
What lies ahead?	7
How can you prepare?	7
<i>The Insurance Concentration Risk Charge</i>	7
What lies ahead?	7
How can you prepare?	7
<i>The Operational Risk Charge</i>	8
What lies ahead?	8
How can you prepare?	8
<i>The Supervisory Adjustment</i>	8
What lies ahead?	8
How can you prepare?	8
SO, IN SHORT...	9
ANY QUESTIONS OR FEEDBACK? CONTACT US	9



Where Are We Now?

As we've mentioned, APRA has been quite busy. Since our last newsletter on the APRA Update ([Taylor Fry's August 2010 newsletter](#)), there have been a number of significant developments with the Capital Standards Review. APRA has released a technical paper on the new standard for the Insurance Concentration Risk Charge (ICRC). The QIS has been completed (including training sessions for insurers) and the results were discussed at the 2010 General Insurance Seminar of the Institute of Actuaries of Australia. APRA has responded to the feedback received in a letter to the industry. This letter included a revised timetable for the Review, which gives APRA time to refine the proposed standards and issue a new QIS.

Acronym Key

The table below is a guide to the acronyms used in this newsletter

ACRC	Asset concentration risk charge
ADI	Authorised deposit-taking institutions
APRA	Australian Prudential Regulatory Authority
ARC	Asset risk charge
ICAAP	Insurance capital adequacy assessment process
ICRC	Insurance concentration risk charge
MCR	Minimum capital requirement – i.e. the prudential capital requirement excluding any supervisory adjustment
ORC	Operational risk charge
PML	Probable maximum loss
QIS	Quantitative impact study

Before we look at the new timetable we'll give you a quick rundown on the results of the QIS.

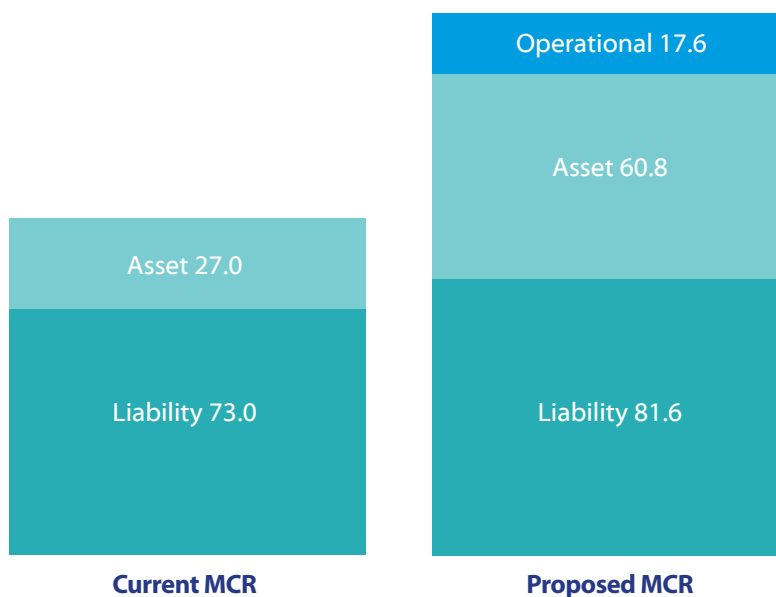


What did the QIS Tell Us?

The QIS revealed that the proposed changes will have a significant impact on both the size and the composition of the Minimum Capital Requirement (MCR) for most insurers. We've illustrated this impact for you in the graph below.

Impact of proposals on MCR of surveyed insurers¹

Scaled so that total Current MCR = 100 and Proposed MCR = 160



APRA received QIS responses from 67 general insurers, who together represent 88% of industry assets. A survey¹ of 33 of the insurers who undertook the QIS showed:

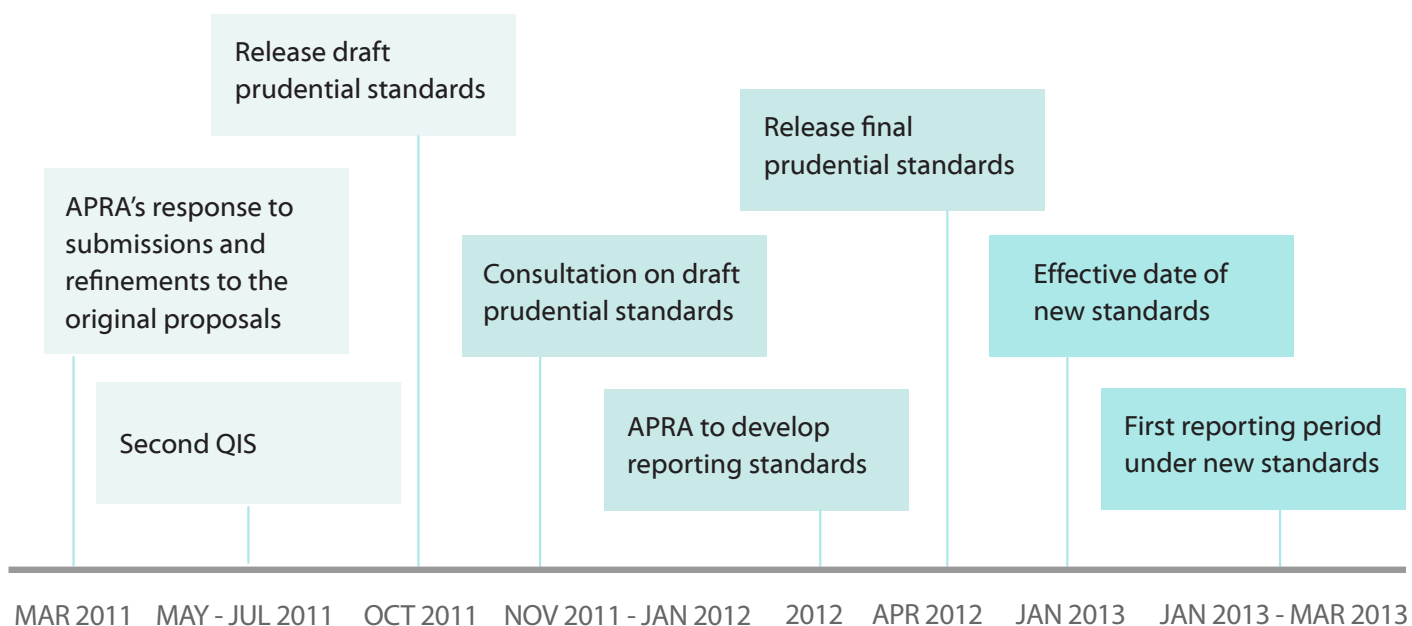
- An average increase in the MCR of 60%, with all 33 insurers showing an increase and six insurers having an increase in excess of 100%.
- An average reduction in solvency ratios of 70% of the MCR, with twelve insurers risking technical insolvency by falling below 120% of the MCR.
- An increase in the significance of the asset risk charge (ARC) and operational risk charges (ORC), rising from 27% and 0% of the current MCR to 38% and 11% of the proposed MCR respectively.
- A reduction in the insurance liability risk charge from 73% of the current MCR to 51% of the proposed MCR.
- The asset concentration risk charge (ACRC) impacts half of the insurers surveyed, mainly from exposure to the Big Four banks.
- The ICRC rises to 2.5 times the current equivalent, with the largest impact on property insurers.
- The ORC increases the MCR by 20%, but the Aggregation Benefit reduces the MCR by only 8%.

Clearly, the proposed changes are set to have a serious impact on your capital position!

¹ From: APRA Proposed Capital Changes – Impacts on small to medium insurers, by Estelle Pearson available at <http://www.actuaries.asn.au/Library/Events/GIS/2010/Plenary%204%201150%20Pearson.pdf>

Where are things headed

APRA's ultimate goal is to make prudential capital more risk sensitive, but not to change the overall capitalisation of the industry. The QIS showed that the overall capitalisation is likely to substantially increase. Consequently, APRA has extended the project timetable (as shown below) to give it time to address the issues raised by the QIS and other feedback received.



APRA also intends to have a second QIS. This means that we can expect further revisions to the proposed changes. We'll be keeping abreast of these future developments and will continue to send out updates as important news is released. For now, let's take a look at what you can do to prepare your business for the inevitable changes that lie ahead.

PREPARING FOR WHAT LIES AHEAD

Don't assume that the revised proposals in March will eliminate the changes to prudential capital seen in the QIS. There are several reasons why we believe that APRA may have limited room to reduce the MCR:

- First, the new ARC is intended to be consistent with similar charges for life insurers and ADIs. APRA cannot make large reductions in the ARC for general insurers without reducing the capital requirements for life insurers and ADIs.
- Second, the ORC is new to the prudential capital framework. And so, you will require additional capital even if APRA lower the ORC risk factor.
- Third, it's difficult to imagine APRA reducing the insurance liability related risk charges below 51% of the MCR - if they did so it would mean that insurance risk would no longer be the majority of an insurer's risk!

Consequently, we recommend that you start reviewing your business plans and capital management strategies in preparation for some inevitable changes to the MCR. In the rest of this newsletter we'll take a look at steps you can take now to reduce the impact of the proposed changes on your business.

What about Basel III?

The Basel III proposals contain significant changes to the level and quality of capital required by banks. APRA wants to apply similar changes to the capital standards for the insurance industry. You can expect to hear more from APRA on this issue. In other words, make sure you keep an eye on the Basel III reforms when reviewing your capital requirements.

Many analysts are suggesting that banks will need to raise additional capital over the next few years to meet Basel III requirements. So you can expect a crowded capital market if you need to raise capital to meet APRA revised standards in the same timeframe.

The Asset Concentration Risk Charge

What lies ahead?

The Asset Concentration Risk Charge (ACRC) forms a large part of the asset-related risk charges. You will be charged 100% of any investments with any single counterparty above 50% of the capital base. So if your investments are dominated by cash deposits with the Big Four banks, you'll be faced with a substantial ACRC. Although you can of course diversify these investments to other banks, this may reduce your credit quality and overall security. In either case, these cash assets will no longer give the lowest risk charge due to the proposed charge for mismatch risk.

How can you prepare?

We suggest that you take this opportunity to review your investment strategy. You should consider security limits for both your existing asset classes and the new asset classes to better match the duration of the insurance risk. You may find that you need additional investment expertise in these new asset classes. If you act early, changes to your strategy can be gradually introduced – this will minimise the risk of markets moving against you when you implement changes in investment strategy.

The Insurance Concentration Risk Charge

What lies ahead?

APRA's proposed Insurance Concentration Risk Charge (ICRC)² considers the capital required to support both the vertical component (a single very large loss) and the horizontal component (multiple small to medium losses) of the portfolio. The result is a more complicated formula than current standards.

Still, it's not surprising that APRA are proposing these changes to the ICRC. Last year many property insurers faced multiple large and medium size losses from major storms in Melbourne and Perth, earthquakes in Christchurch and floods in Queensland. For insurers without sufficient horizontal protection, the result was an adverse impact on their capital position.

How can you prepare?

Since PMLs are required for 1 in 200, 1 in 10, and 1 in 6 year events on a whole of portfolio basis, you can prepare for the ICRC by considering whether additional catastrophe modelling is needed. Be aware that you may well encounter difficulties when modelling catastrophes that do not have extensive models available, such as hail, especially for the longer return periods.

APRA have also proposed a new method of calculating the ICRC for non-property risks. You'll need to familiarise yourself with the increased complexity of the overall ICRC calculation as described in the technical paper.

You should also review your reinsurance program structure. In particular, consider the protection from multiple small and/or medium losses to reduce the horizontal component of this risk charge.

The new capital charges aren't all doom and gloom. For instance, the changes will create an opportunity for reinsurers and brokers to offer additional products better suited to reducing the net impact of multiple losses.

² APRA technical paper dated 30 September 2010 <http://www.apra.gov.au/Policy/upload/Insurance-Conc-Risk-charge.pdf>

The Operational Risk Charge

What lies ahead?

The Operational Risk Charge (ORC) is a new risk charge. It will be based on the gross written premium, the size of the change in the gross written premium over the last year (where this exceeds 10%), the gross insurance liabilities and the size of the change in the gross insurance liabilities over the previous year (where this exceeds 10%).

How can you prepare?

We suggest that you review your existing plans to enter or exit business lines as these will generate risk charges based on the size of changes in gross written premiums and gross insurance liabilities. Where feasible, it might be worth making these changes in your business lines prior to 2013 as this will help minimise the impacts of any additional capital requirements under the proposed regime.

The current proposals give no reduction in the ORC for any reinsurance. You may need to review any fronting arrangements you have as these will require additional capital under the proposed changes.

The Supervisory Adjustment

What lies ahead?

The supervisory adjustment is the great unknown in APRA's proposals. If APRA deems that the prescribed capital amount for an insurer is insufficient, it can require the insurer to hold additional capital. The supervisory adjustment will be based on all the relevant information at APRA's disposal, including the quality of each insurer's current capital management plan and its replacement – the Insurance Capital Adequacy Assessment Process (ICAAP). It will take the place of the previously informal higher multiple of the MCR that APRA required from some insurers.

How can you prepare?

We suggest that insurers review their capital management plans and start developing high quality ICAAPs. If you've only been operating for a short period of time, are in financial or operational difficulty, or have a disproportionate exposure to a particular type of risk, we recommend that you think about initiating private discussions with APRA. If you go down this path, make sure that you discuss what you can do to reduce any likely supervisory adjustments.



SO, IN SHORT...

The long and the short of it is that major changes to prudential capital appear inevitable. Even if the QIS suggests your company will be significantly and adversely impacted by the changes, careful planning may allow you to identify strategies to mitigate these impacts.

In the meantime, here at Taylor Fry we will keep our ears to the ground and keep you posted on any other strategies we come up with to meet the proposed changes head on.

Until next time,

The Taylor Fry Team

PS -

Please note our new Sydney office address. We have moved across the street to larger premises.

Any questions or Feedback? Contact us

Win-Li Toh

ph: + 61 2 9249 2904
e: winli.toh@taylorfry.com.au

Samantha Fuller

ph: + 61 2 9249 2925
e: samantha.fuller@taylorfry.com.au

Sharanjit Paddam

ph: + 61 2 9249 2914
e: sharanjit.paddam@taylorfry.com.au



Sydney office
Level 11
55 Clarence Street
Sydney NSW 2000
ph: + 61 2 9429 2900
fax: + 61 2 9249 2999
e: sydoffice@taylorfry.com.au

Melbourne office
Level 6
52 Collins Street
Melbourne VIC 3000
ph: +61 3 9658 2333
fax: + 61 3 9658 2344
e: melboffice@taylorfry.com.au



www.taylorfry.com.au
Consulting Actuaries &
Analytics Professionals

Disclaimer

This newsletter is general in nature and provided for information purposes only. It does not constitute actuarial or investment advice. In certain cases the discussion is based on incomplete information from APRA that is subject to change. We recommend that you refer to APRA (www.apra.gov.au) for updated information regarding the proposed changes, and discuss your specific circumstances with your Appointed Actuary, or the Taylor Fry contacts above.