

If you require advice on this topic, please contact your PwC representative or alternatively these experts:

Lisa Simpson

+61 (3) 8603 4489
lisa.simpson@au.pwc.com

Andrew Smith

+61 (2) 8266 4928
andrew.james.smith@au.pwc.com

Scott Fergusson

+61 (2) 8266 7857
scott.k.fergusson@au.pwc.com

Kim Smith

+61 (2) 8266 1100
k.smith@au.pwc.com

Christa Marjoribanks

+61 (2) 8266 5790
Christa.marjoribanks@au.pwc.com

Ask your representative about these other related PwC publications:

- Insurance Facts and Figures
- Sharpening the focus on risk management for Insurers
- Attracting and retaining top finance talent.

APRA review of capital standards for insurers

Insurance insights

APRA's Asset
Risk Charge for
General Insurers

April 2011

APRA review of capital standards for insurers

APRA's asset risk charge for General Insurers

At PwC, we have been closely following developments arising out of APRA's Insurance Capital Review. Key for general insurers are APRA's proposals for the asset risk capital charge. The charge is intended to capture the risk of net assets changing in value over time due to market movements and/or default, and replaces the existing investment risk capital charge.

APRA's proposals for the asset risk capital charge borrow heavily from the resilience reserve approach used in life insurance, and require the insurer to apply a series of defined stresses to the balance sheet. Both assets and liabilities are stressed against movements in real interest rates, inflation, equity, property, credit spreads, currency and the risk of default. This is a quantum change for general insurers and at first glance represents a reasonably significant increase in complexity but also risk sensitivity.

APRA has just concluded its first round of consultations on the Insurance Capital Review proposals, and has released a paper outlining its revised proposals. Whilst steps have been taken to reduce the complexity of the charge and the magnitude of the stresses applied, the essence of the asset risk capital charge proposals remains. APRA is undertaking a further round of consultation and impact study, however it seems likely that some form of stress test based asset risk charge will be a part of the regulatory capital framework going forward.

So how does it work?

The insurer is required to calculate the impact on net assets of a series of APRA defined stresses. A brief summary of the stresses follow:

Nature of risk	Size of upwards (downwards) stress
Real interest rates	<ul style="list-style-type: none"> 30% increase (25% decrease) in nominal risk free yields.
Inflation rates	<ul style="list-style-type: none"> 125 basis point increase (100 basis point decrease) in expected inflation.
Currency risk	<ul style="list-style-type: none"> 25% increase (25% decrease) in value of AUD against all foreign currencies.
Equity risk	<ul style="list-style-type: none"> Listed equity: 2.5 percentage point addition to ASX200 dividend yield. Unlisted equity, hedge funds and other assets: 45% fall in market value.
Property risk	<ul style="list-style-type: none"> 2.75 percentage point addition to rental yields.
Credit spreads and Default risk	<ul style="list-style-type: none"> Interest bearing assets: credit spread shock incorporating default risk. Factors vary depending on type of asset and counterparty grade. Reinsurance assets, premiums receivable: default factors vary by counterparty.

The net impact on the balance sheet of each of the above stresses are then combined, allowing for diversification, to arrive at the asset risk capital charge. APRA has specified the correlation matrix to be used and the workings can be found in APRA's QIS.

Insurers will need to examine their balance sheet and consider which stresses need to be applied for each asset and liability. The table overleaf provides a summary of the stresses which should be applied for items typically found on a general insurer balance sheet.

Balance sheet item	Real interest rates	Inflation rates	Equity risk	Property risk	Credit spreads	Default risk
Deposits with ADIs	×	×	×	×	✓	×
Cash Management Trusts, Bank Bills	✓	✓	×	×	✓	×
Commercial paper/promissory notes	✓	✓	×	×	✓	×
Short term govt paper	✓	✓	×	×	×	×
Govt bonds – Nominal	✓	✓	×	×	×	×
Govt bonds – Inflation linked	✓	×	×	×	×	×
Corporate bonds – Fixed rate	✓	✓	×	×	✓	×
Subordinated debt – Fixed rate	✓	✓	×	×	✓	×
Mortgage backed – Floating	×	×	×	×	✓	×
Mortgage backed – Fixed	✓	✓	×	×	✓	×
Listed and unlisted equity	×	×	✓	×	×	×
Direct property	×	×	×	✓	×	×
Listed property trusts	×	×	✓	×	×	×
Unlisted property trusts	×	×	×	✓	×	×
Loans (commercial terms) – Fixed rate	✓	✓	×	×	✓	×
Gross insurance liabilities	✓	×	×	×	×	×
Reinsurance recoveries	✓	×	×	×	×	✓
Non reinsurance recoveries	✓	×	×	×	×	✓
Govt recoveries (ITCs, HCCS)	✓	×	×	×	×	×
Unclosed premiums	×	×	×	×	×	✓

So, what does this mean for insurers?

Insurers should re-consider optimal investment strategy, balancing risk appetite and return objectives against the desire to optimise regulatory capital. Insurers should consider investment strategy for surplus assets versus those held to support the liabilities, along with the benefits of holding a diversified portfolio of assets.

Insurers should consider how well investments match the liability profile, both in currency and duration. There is now a capital cost for holding long duration assets where they exceed the average duration of the liabilities. The average duration of projected cash-flows in the insurance liability valuation will now have a direct influence on regulatory capital.

The investment strategy will need to be flexible in responding to changes in market conditions. The investment policy which minimises regulatory capital in good times when yields are high will not necessarily be the optimal position in times of low yields.

The calculation of the asset risk charge will be more complex than in the past. The challenge for insurers will be to develop effective means of communication of the implications of various investment strategies to enable informed decisions at the senior executive level. Scenario testing under varying market conditions will be necessary when considering forward capital projections.

For most general insurers, regulatory capital would be minimised through investment in index linked bonds. Given the absence of a liquid index linked bond market, regulatory capital will typically be minimised through investment in government fixed interest securities with duration somewhat less than that of the liabilities.

Please speak to your PwC contact to explore the implications for your business in more detail.