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# *General Insurance*

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# Introduction

## Scott Hadfield

*The past 15 month period has seen an unprecedented level of catastrophic events in Australia and the wider Asia-Pacific region. The Melbourne and Perth hailstorms proved to be the start of a sequence of weather related events with the Queensland Floods and Cyclone Yasi proving to be some of the most expensive losses in Australian history.*

*Outside of Australia, the New Zealand and Japanese earthquakes have dominated press coverage with these tragedies creating a monumental human, environmental and economic impact.*

*The general insurance sector has emerged from this period shaken but largely unscathed with adequate reinsurance absorbing a substantial amount of the larger losses. These events are expected to have a significant impact on the short and medium term operating environment. Market sentiment indicates that the extended period of a soft reinsurance cycle may now be over and there is a general expectation of rate rises across key classes as excess capacity dries up and the reinsurers reassess their views on the region.*

*In addition to the challenges these events have put on claims handling departments, insurers will have to tread carefully through the public and political pressure to address flood insurance in the coming months.*

*2011 has also been a busy year on the regulatory and reporting front. Changes made by APRA to align their reporting requirements with Australian Accounting Standards were positively received by the industry due to the obvious simplification benefits provided. APRA also released their proposed amendments to the capital standards. The initial proposals were met with concern by the industry due to a perceived unilateral increase in capital required. APRA has listened and responded to the feedback from the market and the evidence provided by the empirical data but the extent of the changes will only emerge when the second QIS is completed.*

*The Insurance Contracts Project has received a substantial amount of focus from the IASB with regular meetings aimed at ensuring a standard is released by the target date of 30 June 2011. The level of debate on significant matters remains high and with a number of key decisions still remaining, the final shape of the standard is still an unknown commodity.*

*The variety of factors impacting the industry is arguably unprecedented and continues to demand the attention of the best and the brightest. As ever, how each player reacts to these changes will determine their success in the future.*



## Statistics

### Top 15 general insurers

Entity	Year end	Ranking Measure:					Performance:			
		Net earned premium					Underwriting result		Investment result	
		Current \$m	Current Rank	Prior \$m	Prior Rank	% Change	Current \$m	Prior \$m	Current \$m	Prior \$m
1 QBE Insurance Group	12/10	12,416	1	12,149	1	2%	1,276	1,262	483	1,237
2 Insurance Australia Group	06/10	7,065	2	7,233	2	-2%	(61)	(265)	774	739
3 Suncorp	06/10	6,310	3	5,980	3	6%	3	(270)	796	862
4 Allianz Australia	12/10	2,295	4	2,071	4	11%	91	326	286	96
5 Westfarmers <sup>1</sup>	06/10	1,089	5	1,061	5	3%	59	10	n/a	n/a
6 Zurich Australian Insurance	12/10	805	6	780	7	3%	(46)	56	112	95
7 Munich Reinsurance Company Australia	12/10	803	7	877	6	-8%	80	134	100	23
8 Swiss Re	12/10	398	8	414	9	-4%	151	249	102	47
9 Genworth Financial Mortgage Insurance	12/10	358	9	490	8	-27%	161	150	169	109
10 Commonwealth Insurance	06/10	344	10	292	11	18%	11	(20)	9	14
11 Westpac Insurance	09/10	335	11	299	10	12%	105	110	56	32
12 Chubb Insurance	12/10	286	12	265	12	8%	20	(1)	59	(10)
13 Chartist (formerly AHA)	12/10	264	13	249	13	6%	65	70	59	59
14 RAC Insurance	06/10	251	14	237	14	6%	43	36	19	15
15 ACE Insurance	12/10	201	15	191	15	5%	55	6	28	17
NR Lloyd's <sup>2</sup>	12/10	1,397	NR	1,182	NR	18%	n/a	n/a	n/a	n/a

Source: Published annual financial statements or APRA annual returns, including segment reporting for organisations with significant non-general insurance activities

Notes: World wide premium is included for those companies/groups based in Australia, while only premium under the control of the Australian operations are included for those with overseas parents.

Where a group has significant non-general insurance operations, only performance and position information relating to general insurance is disclosed (subject to availability). In some instances this involves estimating a notional tax charge for the result after tax. Outstanding claims are net of all reinsurance recoveries.

Where applicable, comparatives have been updated to be in line with updated comparatives in current year financial reports.

Performance:		Financial Position:							
Result after tax		Outstanding claims		Investment securities		Net assets		Total assets	
Current \$m	Prior \$m	Current \$m	Prior \$m	Current \$m	Prior \$m	Current \$m	Prior \$m	Current \$m	Prior \$m
1,396	1,970	14,673	14,350	23,012	23,420	10,155	10,298	41,222	40,964
190	247	7,182	6,406	11,734	10,563	4,656	4,836	20,446	19,360
557	416	6,335	6,161	11,151	9,482	8,376	8,357	21,891	21,009
302	335	4,365	4,452	4,277	4,362	1,833	1,808	8,210	7,986
85	64	502	513	1,065	1,003	1,377	1,371	3,641	3,561
35	106	1,061	1,010	1,668	1,643	611	643	3,404	3,024
207	67	1,255	1,166	1,999	1,525	765	531	2,928	2,922
160	175	1,073	1,264	1,606	2,039	595	808	2,725	2,830
191	152	260	282	2,929	2,790	1,799	1,987	3,275	3,170
10	(7)	105	88	208	163	107	98	561	521
112	100	89	71	1,126	682	771	824	1,561	1,554
55	(8)	472	490	938	868	415	359	1,294	1,219
35	49	411	305	1,360	1,193	446	420	2,925	2,589
18	16	48	39	194	196	234	216	572	430
60	16	204	223	395	349	262	199	1,137	1,154
n/a	n/a	1,536	920	2,016	1,162	n/a	n/a	2,016	1,612

- 1 Disclosure of investment result from insurance operations was not available in Wesfarmers' financial statements
- 2 Lloyd's Underwriters are authorised in Australia under special provisions contained in the Insurance Act 1973. Because of the unique structure of the Lloyd's market Lloyd's reports to APRA on a different basis from Australian general insurers. Lloyd's is required to maintain onshore assets in trust funds and as at 31 December 2010 its Australian assets comprised of \$2,014m in trust funds and a statutory deposit of \$2m.

# Top 10 government insurers

Entity	Year end	Ranking Measure:					Performance:	
		Net earned premium					Underwriting	
		Current \$m	Current Rank	Prior \$m	Prior Rank	% Change	Current '000	Prior '000
1 WorkCover NSW	06/10	2,395	1	2,572	1	-7%	-584	-665
2 Victorian WorkCover Authority (Work Safe Victoria)	06/10	1,712	2	1,608	2	6%	-502	-257
3 Transport Accident Commission (Vic)	06/10	1,257	3	1,195	3	5%	-817	-592
4 WorkCover Queensland	06/10	959	4	950	4	1%	-651	-624
5 NSW Self Insurance Corporation*	06/10	804	5	773	5	4%	-158	-108
6 WorkCover Corporation (SA)	06/10	610	6	646	6	-6%	-18	122
7 Motor Accident Commission (SA) (MAC)	06/10	471	7	430	7	10%	-44	-199
8 Insurance Commission of WA	06/10	406	8	381	8	7%	-79	-98
9 Comcare (Cwlth)*	06/10	213	9	207	9	3%	-88	-32
10 Victorian Managed Insurance Authority (VMIA)	06/10	139	10	121	10	15%	-43	-136

Source: Published annual financial statements

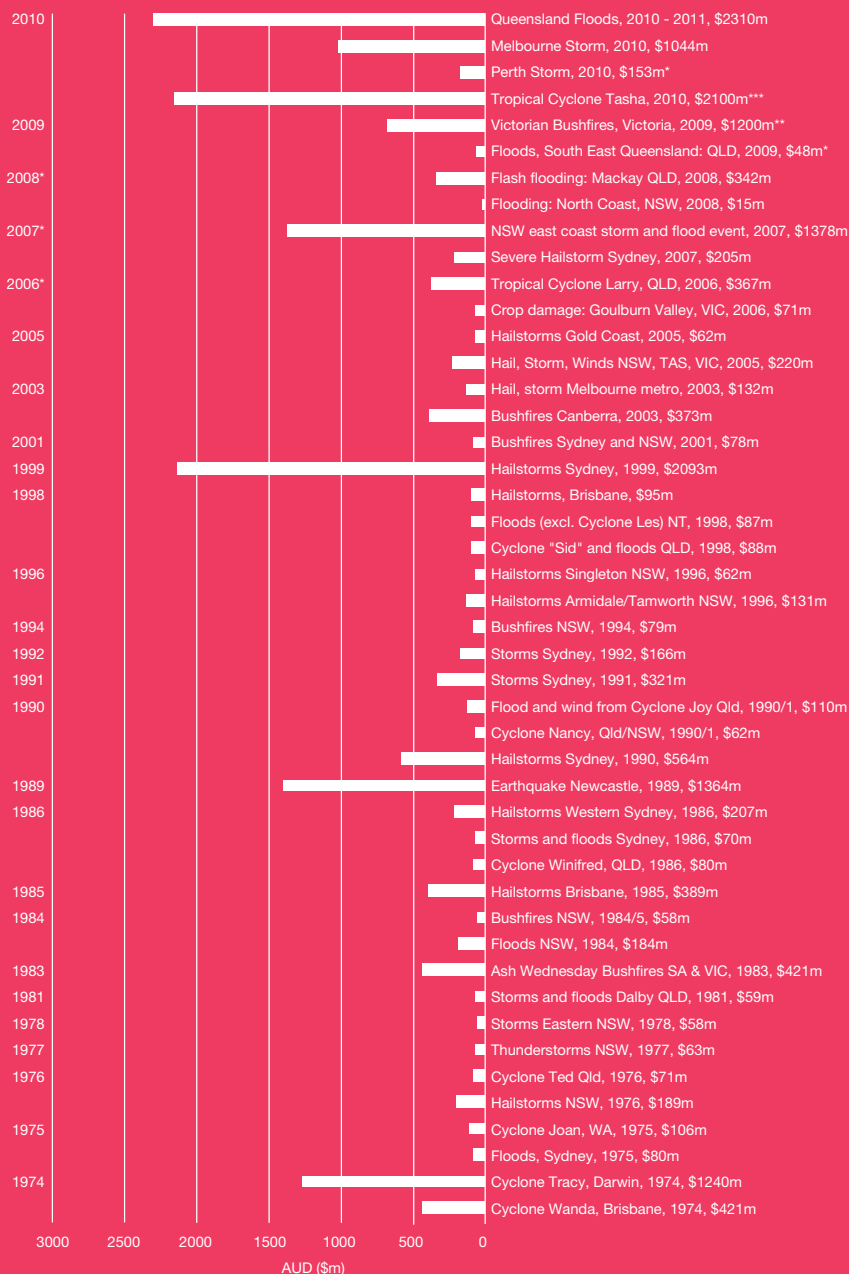
Notes: Outstanding claims are net of recoveries.

\* Underwriting result has not been disclosed in financial statements and has been recalculated as net earned premium less net claims incurred



# Major Australian catastrophes

Original cost adjusted to June 2006 CPI



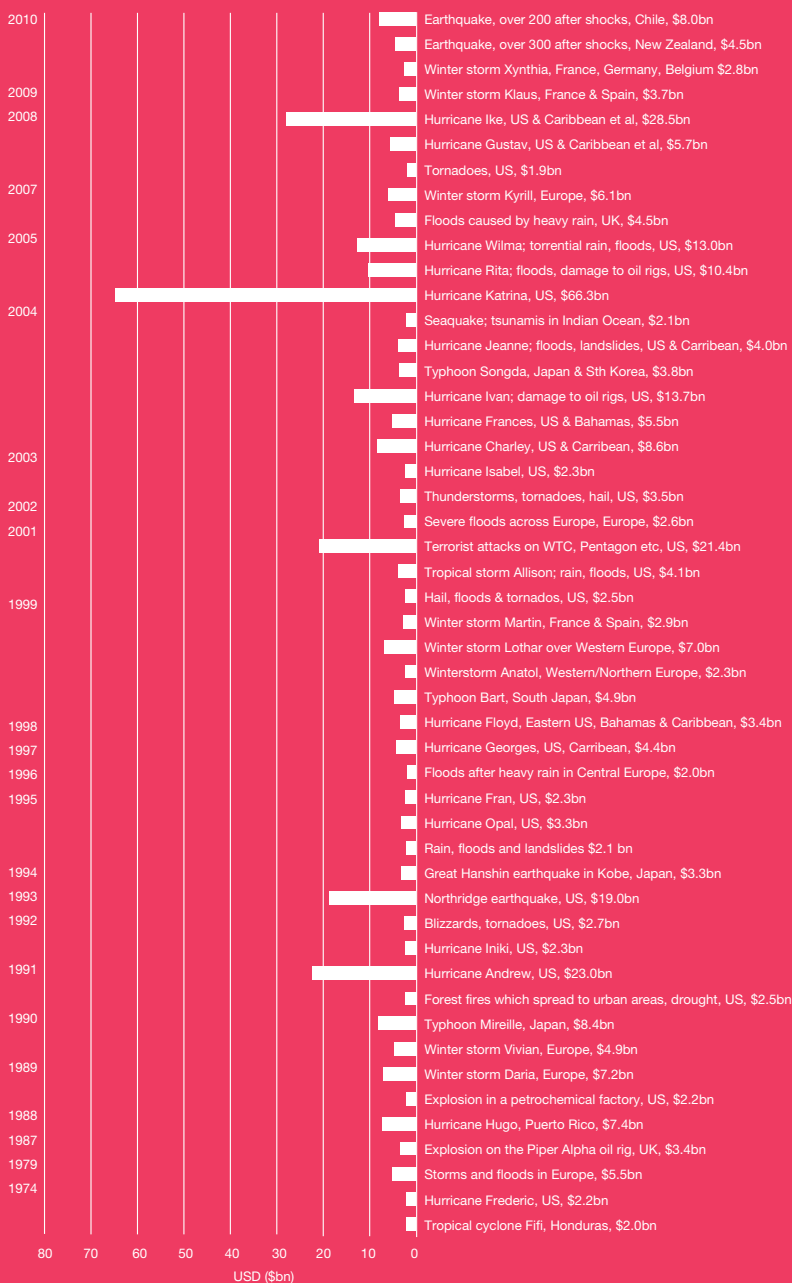
Source: Insurance Disaster Response Organisation, Major disaster event list since June 1967. Revised to March 2006.

\* Source: Emergency Management Australia, EMA Disasters Database.

\*\* Source: Figure not supplied by EMA. Figure comes from Swiss Re, "Natural catastrophes and man-made disasters in 2009: catastrophes claim fewer victims, insured losses fall", No 1/2010

\*\*\* Source: Figure not supplied by EMA. Figure comes from Swiss Re, "Natural catastrophes and man-made disasters in 2010", No 1/2011.

# World catastrophes



Source: Swiss Re, Natural catastrophes and man-made disasters. 1970 – 2005, Sigma no.2/2006; Natural catastrophes and man-made disasters in 2007, Sigma 1/2008; National catastrophes and man-made disasters in 2008: North America and Asia suffer heavy losses Swiss Re No. 2/2009; National catastrophes and man-made disasters in 2010, Sigma 1/2011.

## Key developments in 2010/11

### Key development

The Queensland floods  
Commission of Inquiry

### Summary of issue

The substantial rainfall across most of Queensland from December 2010 to January 2011 resulted in three catastrophic insurance events.

These catastrophes have raised the profile and level of debate on the definition of what constitutes a flood and also how to provide affordable protection for those properties that lie in flood prone regions.

The Queensland Floods Commission of Inquiry was launched on 17 January 2011 to examine the chain of events that lead to the floods and the response by relevant parties to the aftermath including the performance of private insurers in meeting their claims responsibilities.

Compounded by other flood events in Victoria, Tasmania and Western Australia this item remains a market and political hot topic. To address the financial impact faced by Queensland and in particular those property owners without adequate insurance cover the Federal Government has imposed a one-off levy to help fund the recovery. The impact of such intervention by the government further complicates the ability of the private market to adequately price risks in flood prone areas and may lead to a greater incentive for under-insurance in the future.

It was announced in March 2011 that there would be a review into natural disaster insurance in Australia and in April, a consultation paper was released by the Treasury titled "Reforming Flood Insurance: Clearing the Waters". This set out proposals for standard definitions relating to floods in insurance policies and makes references to other initiatives such as a flood mapping development framework.

There are many key factors being considered by the industry including the current availability, affordability and reliability of flood mapping across both urban and rural areas and the heightened risk of adverse selection for providers of insurance cover in flood prone regions.

The outcomes of these enquiries have the potential to impact the nature of insurance cover for flood related damages in the general insurance market.

### **Key development**

#### **Changes to General Insurance Prudential reporting**

### **Summary of issue**

Following a consultation process with the industry, APRA released amendments to a number of the Prudential Standards to align prudential reporting more closely with statutory reporting for general insurers, while maintaining the current capital framework. The changes are intended to deliver three important benefits:

- simplify reporting by general insurers to APRA;
- provide APRA with more effective information for assessing insurer performance; and
- enhance the dialogue between APRA and individual insurers on their performance.

The changes came into effect for reporting periods after 1 July 2010.

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#### **APRA's expectations regarding post reporting date events**

In early 2011 APRA issued two guidance letters to clarify their expectations for the impact of post reporting date events on the calculation of premium liabilities for prudential reporting purposes.

It is APRA's expectation that an insurer includes the impact of relevant post reporting date information on its solvency position in quarterly and annual reporting to APRA to the extent it is practical to do so.

In calculating premium liabilities a general insurer must make allowance in their Quarterly APRA return for all post reporting date events up to submission of the return. For the Annual APRA return the Prudential Standards require insurers to include updated information on only those events that were included in the Quarterly APRA return. New events subsequent to the submission of the Quarterly APRA return are not required to be included in the Annual APRA return calculations.

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## Key development

## Summary of issue

### Fire Services Levy

Based on the findings of the review conducted by the Bushfires Royal Commission the Victorian government has abolished its Fire Services Levy. With effect from 1 July 2012 fire services will be financed through a levy based on property rates. The change in financing method will help to address the inequities inherent in the previous system whereby those who are insured subsidise the cost of fire fighting for those who aren't insured. For the industry the move is seen as a positive tax reform as removing the levy reduces both the GST and stamp duty on premiums with no impact on the level of cover provided.

New South Wales and Tasmania are now the only states that maintain the levies on insurance premiums.

### Catastrophic events

2010 and early 2011 has seen a large number of severe catastrophe events in the Australasian and Asia-Pac regions.

The significant weather events in Australia and the earthquakes in New Zealand and Japan have again challenged the assumptions used by insurers and reinsurers as they factor in extreme weather events for their product pricing and modelling of catastrophic losses.

These events have also lead to a dramatic increase in the volume of claims reported to many general insurers and this has increased pressure on their day to day operations.

The combination of catastrophe losses in the region may well be a catalyst for a period of price strengthening in reinsurance and property and casualty lines in particular. The upcoming 1 July reinsurance renewal period will be an area of particular interest for the market.

### Risk Appetite

In speeches to the industry in early 2011, Ian Laughlin has outlined APRA's perspectives on risk appetite and its approach for assessing the board and management's adoption and implementation of risk appetite in execution of strategy. This is likely to be an area of focus in APRA supervising reviews of insurers in 2011.

### Change of APRA member

Effective 1 July 2010, Ian Laughlin replaced John Trowbridge as the APRA member responsible for the insurance sector. Ian Laughlin is a qualified actuary with extensive experience in the financial services industry, particularly in the insurance industry. John Trowbridge is currently chairing the National Disaster Insurance Review, which is a review into disaster insurance in Australia.

## **Key development**

## **Summary of issue**

### **National Injury Insurance Scheme**

The National Injury Insurance Scheme (NIIS) has been proposed by the Productivity Commission and would comprise a system of premium funded, nationally consistent minimum care and support arrangements for people suffering catastrophic injury.

This no fault system would be structured as a federation of separate, state-based injury insurance schemes and has obvious interactions with other compensation schemes currently in place (e.g. Workers' compensation). It is foreseeable that there could be a transfer of such claims into the NIIS, which would have implications on the nature of claims and associated costs on existing schemes.

It is intended that the scheme will ultimately cover all causes of catastrophic injuries, including motor vehicle accidents, medical treatment and general accidents occurring within the community or at home. Funding for the NIIS would come mainly from existing insurance premium sources but additional funding may come through state and territory governments.

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### **APRA capital standards**

Refer to Chapter 1 for details of the key developments and a summary of the potential impacts for general insurers.

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### **Insurance contracts exposure draft**

Refer to section Chapter 1 for details of the key developments and a summary of the potential impacts for general insurers.

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### **Level 3 Groups**

In March 2011 APRA issued its discussion paper on the proposed Level 3 supervision framework. The framework aims to ensure that prudential supervision adequately captures the risks to which APRA-regulated entities within a conglomerate group are exposed. APRA will determine on a case-by-case basis which groups will be subject to Level 3 supervision.

APRA is proposing two methods for the measurement of eligible capital at Level 3. A top-down approach based on the consolidated accounts of the Group and a 'building block' approach using the sum of eligible capital of blocks within the Level 3 Group.

Responses on the discussion paper should be submitted by 18 June 2011.

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# Regulation and Supervision

## The Australian Prudential Regulation Authority (APRA)

APRA is the single Commonwealth authority responsible for licensing and prudential regulation of all deposit-taking institutions, life and general insurance companies, superannuation funds and friendly societies. APRA is also empowered to appoint an administrator to provide investor or consumer protection in the event of financial difficulties experienced by life or general insurance companies.

APRA's powers to regulate and collect data from the general insurance industry stem principally from the following acts:

- Insurance Act 1973 (the Insurance Act);
- Financial Sector (Collection of Data) Act 2001;
- Financial Sector (Shareholdings) Act 1998;
- Insurance (Acquisitions and Takeovers) Act 1991; and
- Insurance Regulations 2002.

While licences to write most classes of insurance business are provided by APRA, state and territory governments issue licences to write certain compulsory classes of business, such as Workers compensation and Compulsory Third Party (CTP). The status of these lines of business varies between states.

As supervisor of general insurance companies, APRA administers the Insurance Act. APRA's stated objective in respect of general insurance is "to protect the interest of insurance policyholders, in particular, through the development of a well managed, competitive and financially sound general insurance industry".

APRA is responsible for the prudential regulation of insurers. APRA's aim is to apply similar principles across all prudential regulation and to ensure that similar financial risks are treated in a consistent manner whenever possible. It is not responsible for product disclosure standards, customer complaints or licensing of financial service providers (including authorised representatives and insurance brokers) as these responsibilities fall to the Australian Securities and Investments Commission (ASIC) under its Australian Financial Services Licence (AFSL) regime.

APRA co-operates with other regulators where responsibilities overlap. In particular, APRA works closely with ASIC and the Reserve Bank of Australia. It also liaises, when necessary, with the Federal Department of Treasury, the Australian Competition and Consumer Commission (ACCC) and the Australian Stock Exchange (ASX).

### ***Probability and Impact Rating System***

APRA's primary objective is to minimise the probability of regulated institutions failing and to ensure a stable, efficient and competitive financial system. APRA uses its Probability and Impact Rating System (PAIRS) to classify regulated financial institutions in two key areas:

- The probability that the institution may be unable to honour its financial promises to beneficiaries – depositors, policyholders and superannuation fund members; and
- The impact on the Australian financial system should the institution fail.

As part of its role as a prudential regulator, APRA uses PAIRS to assess risk and to determine where to focus supervisory effort, determine the appropriate supervisory actions to take with each regulated entity, define each supervisor's obligation to report on regulated entities to APRA's executive committee, board, and, in some circumstances, to the relevant government minister, and to ensure regulated entities are aware of how APRA determines the nature and intensity of their supervisory relationships.

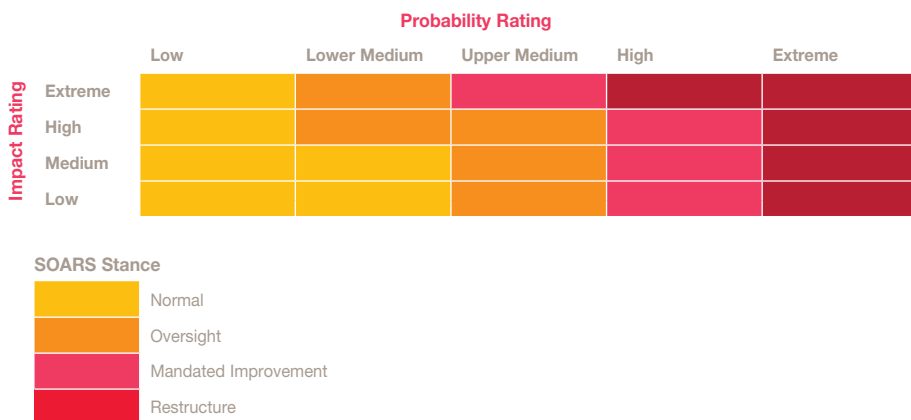
The PAIRS Supervisory Attention Index rises as the probability of failure and the potential impact of failure increase, ranging from "Low" to "Extreme". These ratings are not publicly available, and are used only to identify potential issues and seek remediation before serious problems develop.

### ***Supervisory Oversight and Response System***

Supervisory Oversight and Response System (SOARS) is used to determine how supervisory concerns based on PAIRS risk assessments should be acted upon. It is intended to ensure that supervisory interventions are targeted and timely. All APRA-regulated entities that are subject to PAIRS assessment are assigned a SOARS stance. Supervisory strategies vary according to an entity's supervision stance.

The supervision stance of a regulated entity is derived from the combination of the Probability Rating and Impact Rating of the PAIRS process, as illustrated in figure 1.1 on the following page.

**Figure 1.1 – PAIRS and SOARS**



## Regulatory framework

The General Insurance Reform Act 2001 (amendment to the Insurance Act) created a three-tier regulatory system for general insurers:

- Tier 1 – The Insurance Act contains the high-level principles necessary for prudential regulation;
- Tier 2 – Prudential standards detail compliance requirements for companies authorised under the Insurance Act. This has been updated to include more high-level and principles-based requirements.
- Tier 3 – Guidance notes accompany each prudential standard, providing details of how APRA expects them to be interpreted in practice. This has been updated to provide non-binding guidance on prudential good practice and on how best to meet the requirements of the new standards.

## Categories of general insurer

The different categories of insurers referred to in the GI Prudential Standards are defined in GPS 001 Definitions as follows:

Category	Description
A	<ul style="list-style-type: none"><li>• Insurers incorporated in Australia, excluding all insurers falling within any other categories below.</li><li>• Wholly owned subsidiaries of corporate groups that are not insurance groups fall into this category where they do not already fall into another category below.</li></ul>
B	<ul style="list-style-type: none"><li>• Insurers incorporated in Australia <b>and</b> a subsidiary of a local or foreign insurance group.</li><li>• An insurance group captive is not a Category B insurer.</li></ul>
C	<ul style="list-style-type: none"><li>• A foreign insurer operating as a foreign branch in Australia; could be a branch of a foreign mutual or shareholder company.</li></ul>
D	<ul style="list-style-type: none"><li>• Often referred to as 'association captives'; an insurer incorporated in Australia that:<ul style="list-style-type: none"><li>– is owned by an industry or a professional association, or by the members of the industry or professional association or a combination of both; and</li><li>– only underwrites business risks of the members of the association or those who are eligible, under the articles of the association or constitution of the association, to become members of the association; but</li><li>– is not a medical indemnity insurer as defined under the <i>Medical Indemnity Act 2002</i>.</li></ul></li></ul>
E	<ul style="list-style-type: none"><li>• Often referred to as 'sole parent captives'; an insurer incorporated in Australia that is a corporate captive or partnership captive.</li></ul>

## Licensing

Private sector general insurance companies may conduct insurance business in Australia only if authorised under the Insurance Act. APRA can impose and vary licence conditions of an insurer under Section 13 and exempt an insurer from complying with all or part of the Insurance Act under Section 7.

In addition to requiring compliance with prudential standards, APRA may request additional information as it sees fit. The information expected to be provided includes:

- Details of the ownership structure, board and management (including resumes and the company's constitution);
- Applications for the proposed appointed auditor and actuary;
- A three-year business plan with financial and capital adequacy projections, including sensitivity analysis;
- Systems and controls documentation (risk management strategy, reinsurance management strategy, business continuity plan and details of accounting and reporting systems);

- Details of subsidiaries and associates and any proposed relationships;
- An auditor's certificate verifying the level of capital and capital ratios of the applicant;
- Written undertakings to comply with prudential standards at all times, consult and be guided by APRA on prudential matters and new business initiatives and provide;
- relevant information required for the prudential supervision of the applicant; and
- For foreign-owned insurers, approval of foreign parent's home supervisor and details of the foreign parent's operations and an acknowledgement that APRA may discuss the conduct of the applicant with its head office and home supervisor.

In order to underwrite workers compensation or CTP insurance, additional approval from state and territory government regulators is required under the relevant state or territory legislation.

## *Restructure of operations*

The Insurance Act provides for the restructuring of insurance operations. Sections 17A to 17I of the Act allow for the assignment of insurance liabilities between insurers subject to the satisfaction of several steps, including approval of APRA, informing affected policyholders; and obtaining confirmation of the assignment from the Federal Court of Australia.

GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers sets out more detailed information on the requirements for transferring insurance portfolios between registered insurers. In the event of revocation of an insurer's authorisation, APRA can stipulate the assignment of liabilities immediately prior to the revocation. It should be noted that APRA can revoke a licence only with the Federal Treasurer's approval, unless it is a request from an insurer with no remaining Australian insurance liabilities.

Section 116 addresses the issue of winding up an insurer and stipulates that assets in Australia can be applied only to settle liabilities in Australia (unless these are nil). For the purpose of this and the Section 28 solvency requirement, a reinsurance receivable from an overseas party is considered to be an asset in Australia if:

- the reinsurance contract relates to Australian liabilities; and
- reinsurance payments are made in Australia.

The definition of liability in Australia is complex, but in general terms it is if the risk is in Australia or if the insurer has undertaken to satisfy the liability in Australia.

## *Prudential Standards*

APRA's supervision currently spans two levels:

- Level 1 – applicable to individual APRA-authorised general insurers on a stand-alone basis.
- Level 2 – applicable to consolidated general insurance groups incorporating all general insurers (both domestic and international within the group. The group may be headed by an APRA-authorised insurer or an APRA authorised non-operating holding company).

Level 3 supervision is currently being developed by APRA and will be intended to cover the supervision of conglomerates, spanning more than one APRA regulated industry.

The Prudential Standards are discussed in more detail in the sections below.

# Australian Securities and Investments Commission

ASIC is the single Commonwealth regulator responsible for market integrity and consumer protection functions across the financial system. It is responsible for:

- Corporate regulation, securities and futures markets;
- Market integrity and consumer protection in connection with life and general insurance and superannuation products, including the licensing of financial service providers; and
- Consumer protection functions for the finance sector.

Most insurers require an AFSL, and as such, a dual licensing system exists with overlapping requirements under both ASIC and APRA.

## *Australian Financial Services Licence*

The Corporations Act requires all sellers of insurance products to retail clients, including registered insurers and brokers, to obtain an Australian Financial Services Licence (AFSL).

Insurers that are regulated by APRA are exempted from the financial obligations of an AFSL as their financial position is separately monitored by APRA.

## *Ownership restrictions*

The Financial Sector (Shareholdings) Act limits shareholdings to 15 per cent of an insurer, unless otherwise approved by the Federal Treasurer. The Insurance (Acquisitions and Takeovers) Act complements this legislation by requiring government approval for offers to buy more than 15 per cent of an insurer.

# *Solvency and capital adequacy*

## **Overview**

Under Section 28 of the Insurance Act, authorised insurers are required to hold eligible assets in Australia that exceed liabilities in Australia, unless otherwise approved by APRA. Section 116A of the Insurance Act and GPS 120 Assets in Australia provide further details of excluded assets and liabilities.

The prudential standards aim to ensure the security of policyholder obligations of all insurers is established at an appropriate level by requiring that each insurer maintains at least a minimum amount of capital.

The following sections give an overview of the various Prudential Standards for Capital Adequacy and Assets in Australia.

APRA is undertaking a process to review the prudential framework around capital requirements. The proposals from this review are intended to improve risk sensitivity in capital requirements and align standards across APRA regulated industries. These changes are likely to present new challenges for insurers and these are discussed in more detail in Chapter 1.

## **Capital adequacy standards**

GPS 110 to GPS 116 form part of a comprehensive set of prudential standards that deal with the measurement of a general insurer's capital adequacy. These standards were updated in July 2010 to better align APRA reporting with Australian Accounting Standards (AAS). Two further Prudential Standards (GPS 120 Assets in Australia and GPS 310 Audit and Actuarial Reporting and Valuation) were also updated as part of this process and are discussed below.

### ***Capital adequacy***

GPS 110 Capital Adequacy aims to ensure that the general insurers maintain adequate capital to act as buffer against the risk associated with their activities and sets out the overall framework adopted by APRA to assess the capital adequacy of a general insurer.

The key requirements of this Prudential Standard are that a general insurer must:

- maintain minimum levels of capital determined according to the Internal Model Based Method or the Prescribed Method;
- determine its Minimum Capital Requirement having regard to a range of risk factors (discussed below) that may threaten its ability to meet policyholder obligations;
- make certain public disclosures about its capital adequacy position; and
- seek APRA's consent for reductions in capital.

### *Capital base and MCR*

GPS 110 specifies that the capital base for Category A to C insurers must exceed the greater of \$5 million and the MCR. In case of Category D or Category E insurer the MCR cannot be less than \$2 million. Where APRA is not satisfied as to the margin by which the capital base exceeds the minimum capital requirement, it can require the insurer to submit a capital plan detailing the proposed actions to improve solvency.

By the nature of its Australian balance sheet, a Category C insurer will not typically have capital instruments of the type specified in GPS 112 Capital Adequacy: Measurement of Capital. Category C insurers are nevertheless required to meet a variant of the MCR. Specifically, Category C insurers are required to maintain assets in Australia (where the assets are the ones that are recognised by GPS 120 as assets in Australia) that exceed their liabilities in Australia (less technical provisions in excess of those required by Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation) by an amount that is greater than the MCR determined by this Prudential Standard.

The capital base is calculated by measuring available capital taking into account the quality of the support provided by various types of capital instruments and the extent to which each instrument:

- provides a permanent and unrestricted commitment of funds;
- is freely available to absorb losses;
- does not impose unavoidable servicing charges against earnings; or
- ranks behind policyholders and creditors in the event of wind-up.

The MCR represents an allowance for the following risks:

- Insurance risk – The possibility that the actual value of premium and claims liabilities will be greater than the value determined under prudential standards (GPS 310);
- Investment risk – The risk that on-balance sheet assets and off-balance exposures will be realised at a different value to their reported amounts; and
- Concentration risk – The largest loss to which an insurer will be exposed (taking into account the probability of that loss) due to the concentration of policies, after netting out any reinsurance recoveries and allowing for the cost of one reinstatement premium for the insurer's catastrophe reinsurance.

## Capital buffer

Capital buffer is the excess capital provided to cater for the possibility of unusual or extreme economic shocks that would otherwise damage policyholder interests. The following table gives the capital buffer by the category/type of the insurer.

**Table 1.3 – Capital buffer requirement**

<i>Category / Type of Insurer</i>	<i>Capital buffer</i>	<i>where MCR is</i>
A, B & C	20% of MCR	not specified
D & E	50% of MCR	MCR < \$4m
D & E	at least \$6m (after deductions)	\$4m < MCR < \$5m
D & E	20% of MCR	MCR > \$5m
Medical Indemnity	50% of MCR	not specified

Source: APRA, GPG 110

## Capital adequacy: measurement of capital

GPS 112 Capital Adequacy: Measurement of Capital sets out the essential characteristics that an instrument must have to qualify as Tier 1 or Tier 2 capital for inclusion in the capital base that is used to assess the capital adequacy of an insurer. Tier 1 capital comprises the highest quality capital components. Tier 2 capital includes those instruments which fall short of the quality of Tier 1 capital but nonetheless contribute to the overall strength of an institution as a going concern.

The key requirements of this standard are that a general insurer must:

- include only eligible capital as a component of capital for regulatory capital purposes;
- make certain deductions from capital; and
- meet certain limitations with respect to Tier 1 capital and Tier 2 capital.

## ***Capital adequacy: internal model-based method***

GPS 113 Capital Adequacy: Internal Model-based method sets out the requirements that a general insurer or an insurance group must follow in order to use the Internal Model-based method to calculate their MCR. A general insurer using the Internal Model-based method is expected to include the three risks covered in the Prescribed Method (insurance, investment and concentration risks) as well as other relevant risk factors, within its method of calculation.

The key requirements to obtain and maintain approval for the use of an Internal Model-based method are:

- the insurer or insurance group must have an advanced approach to risk management and capital management which includes an appropriate Economic Capital Model (ECM);
- governance arrangements for the development and use of the ECM must be suitable;
- the ECM must be used by the insurer or insurance group for its own purposes or the purposes of the group and be embedded in management, operations and decision making processes; and
- the ECM must be technically sufficient to produce a reliable estimate of the capital required by the insurer or insurance group.

## ***Capital adequacy: investment risk capital charge***

GPS 114 Capital Adequacy: Investment Risk Capital Charge sets out the calculation of Investment Risk Capital Charge under the Prescribed Method of calculating the MCR. Credit risk, market or mismatch risk and liquidity risk may all cause adverse movements in the value of assets recorded by a general insurer.

The investment risk capital charge is calculated by classifying each asset according to its quality and multiplying it by an investment capital factor as determined by APRA. Adjustments are made for off-balance sheet exposures and assets subject to charges or guarantees. Where a significant exposure to a single asset (e.g. property) or counterparty (e.g. single reinsurer) exists, the insurer may have to hold additional capital depending on the credit rating of the counterparty. The higher the risk of the investment, the higher the investment capital factor that needs to be applied, essentially recognising the need for a higher level of capital to support the business.

Investment capital factors also exist for reinsurance recoverables. Those with poorer counterparty grades (higher counterparty risk and thus lower ratings from ratings agencies) attract a higher investment capital factor.

Wholly owned subsidiaries that meet certain requirements may be consolidated in determining the investment risk capital charge.

## ***Capital adequacy: insurance risk capital charge***

GPS 115 sets out the calculation of the Insurance Risk Capital Charge under the Prescribed Method of calculating MCR.

Insurance risk comprises two components: outstanding claims risk and premium liability risk. Both must be valued to allow for a margin that results in a 75 per cent probability of sufficiency. The method for valuing liabilities is detailed in GPS 310 Audit and Actuarial Reporting and Valuation. It should be noted that premium liabilities are not brought to account for financial statements purposes and that it is possible for directors to decide that a different outstanding claims liability is more appropriate for statutory reporting purposes.

For capital adequacy purposes, any excess risk margin over the 75 per cent sufficiency level, net of tax, can be included as part of the capital base. The actual capital charge is calculated using different capital factors for each class of business and for direct and inwards reinsurance business.

For direct insurance, long-tailed insurance classes such as CTP are subject to greater uncertainty and therefore attract a higher insurance risk capital factor than short-tailed classes such as Domestic Motor. For inwards reinsurance, non-proportional reinsurance treaties attract a higher risk capital factor than proportional treaties.

## ***Capital adequacy: concentration risk capital charge***

The concentration risk capital charge takes into account the highest aggregation risk of an insurer. GPS 116 Capital Adequacy: Concentration Risk Capital Charge sets out the calculation of the concentration risk capital charge under the Prescribed Method of calculating MCR to a General Insurer. It is calculated as the insurer's Maximum Event Retention after taking into account acceptable reinsurance arrangements, plus the cost of one reinstatement of those reinsurance arrangements. This Prudential Standard sets out issues that affect an insurer's Maximum Event Retention that must be taken into account in the calculation of the Maximum Event Retention and therefore the Concentration Risk Capital Charge.

There are specific requirements for this calculation for lenders mortgage insurers (LMI), due to the nature of the risks which gives rise to insurance claims. Attachment A of GPS116 sets out the method of calculating MER for LMIs.

## ***Capital adequacy: Level 2 Insurance Groups***

Under GPS111 "Capital Adequacy: Level 2 Insurance Groups", the MCR and capital base of the group is determined on a consolidated group basis using requirements similar to those that apply to Level 1 general insurers. The Board of the group is responsible for capital management of the group and of non-consolidated subsidiaries.

The impact of intra-group transactions is assessed at the group level and may result in eligible capital instruments of entities within the group being excluded from the capital base of the group as a whole.

The value of non-consolidated subsidiaries is deducted from the group's capital base and thus any deficiency in an undercapitalised non-consolidated subsidiary may result in a reduction in the group's eligible capital.

The following also apply to the capital requirements of the group:

- Level 1 insurers within the group are required to meet the MCR on an individual basis;
- The concentration risk capital charge is to be calculated in a manner consistent with the requirements for Level 1 insurers;
- The MER calculation may take into account inwards reinstatement premiums if the group has contractually binding netting arrangements in place;
- APRA will not prescribe where the surplus capital of the group can be held; and
- APRA's assessment of capital instruments will not affect any foreign subsidiaries that have issued capital instruments.

## Assets in Australia

GPS 120 Assets in Australia, effective 1 July 2010, sets out requirements applying to general insurers in relation to when assets are eligible to be counted as assets in Australia. Section 28 of the Insurance Act requires that all insurers are to maintain assets in Australia of a value that equals or exceeds the total amount of the general insurer's liabilities in Australia.

The list of assets that cannot be included as assets in Australia includes:

- Goodwill;
- Other intangible assets;
- Net deferred tax assets; and
- Assets under charge or mortgage (to the extent of the indebtedness).

## Investment policy

There are no absolute restrictions on investments that may be held by insurance companies except the trust account requirements of the Financial Services Reform (FSR) Act 2001. Under Section 1017E of the FSR Act where monies received cannot be applied to the issue of a product within one business day of receipt (i.e. unmatched cash), the monies must be held in a trust account. However, in calculating the minimum capital requirement of an insurer under GPS 110, the capital charge assigned to each asset type is given a different weighting, taking into account its nature and the credit rating of any counterparties. Significant individual exposures may require an additional capital charge. APRA also has the power under Section 49N to direct an insurer to record an asset at a specified value, subject to approval of the Federal Treasurer.

# Management of risk and reinsurance

## Risk management

GPS 220 Risk Management aims to ensure that a general insurer has systems for identifying, assessing, mitigating and monitoring the risks that may affect its ability to meet its obligations to policyholders. These systems – together with the structures, processes, policies and roles supporting them – are referred to as a general insurer’s risk management framework.

The prudential standard requires that a general insurer:

- includes a documented Risk Management Strategy (RMS) in its risk management framework;
- has sound risk management policies and procedures and clearly defined managerial responsibilities and controls;
- submits its RMS to APRA when any material changes are made;
- has a dedicated risk management function (or role) responsible for assisting in the development and maintenance of the risk management framework;
- submits a three-year rolling Business Plan to APRA and re-submits after each annual review or when any material changes are made;
- submits a Risk Management Declaration (RMD) to APRA on an annual basis; and
- submits a Financial Information Declaration (FID) to APRA on an annual basis.

### *Risk Management Framework*

The risk management framework of a general insurer should consider, at a minimum, the following risks:

- Balance sheet and market risk;
- Credit risk;
- Operational risk;
- Insurance risk;
- Reinsurance risk;
- Concentration risk; and
- Risks arising from the business plan.

The framework should also cover other elements such as the interaction between the risk management role and the board; the processes used to identify, monitor and mitigate risks; and the mechanisms for monitoring the minimum capital requirements (MCR).

The general insurer is also required to have this risk management framework reviewed by operationally independent, appropriately trained and competent members of staff. The frequency and scope of this review will depend on the size, business mix, complexity of the insurer's operations and the extent of any change in the business mix or risk profile. The review must cover the RMS, the risk management role and the system of internal control.

To assist general insurers in developing their own risk management framework, APRA released non-binding prudential practice guides GPG200 – GPG520.

### ***Risk Management Strategy (RMS)***

An insurer's RMS must set out the following (among other requirements):

- The risk governance relationship between the Board, Board committees and senior management;
- The insurer's risk appetite;
- Describe processes for identifying, assessing, mitigating, controlling, monitoring and reporting risk issues;
- The roles and responsibilities of the persons with managerial responsibility for the risk management framework; and
- An overview of mechanisms for ensuring continued compliance with the minimum capital requirements and all other prudential requirements.

### ***Risk Management: Level 2 Insurance Groups***

The prudential standard GPS 221 Risk Management: Level 2 insurance Groups, sets out the risk management requirements for Level 2 general insurance groups. The requirements of GPS 221 are based on the principles applying to Level 1 general insurers.

The group is required to maintain a group-wide risk management framework, including the following:

- a documented, group-wide Reinsurance Management Strategy, setting out sound reinsurance management policies and procedures and clearly defined managerial responsibilities and controls;
- policies relating to outsourcing arrangements for material business activities, setting out appropriate procedures for due diligence, approval and on-going monitoring of such arrangements; and
- business continuity management appropriate to the nature and scale of the operations.

The requirements for documentation of reinsurance arrangements do not apply to foreign entities within the group, however APRA must be provided with details of the effects of any limited risk transfer arrangements entered into by foreign entities within the group.

Level 1 insurers within the group do not have to comply with risk management requirements on an individual basis if the Level 2 group can satisfy these requirements in relation to each Level 1 insurer within the group.

The group must submit the following to APRA on an annual basis:

- Risk Management Declaration;
- Financial Information Declaration; and
- Reinsurance Arrangements Statement.

## Business continuity management

The prudential standard GPS 222 Business Continuity Management and associated guidance note on business continuity management (BCM) GGN 222.1 Risk Assessment and Business Continuity Management, aim to ensure that general insurers have a holistic approach to BCM. It is intended that BCM will increase resilience to business disruption arising from internal and external events and reduce the impact on the insurer's business operations, reputation, profitability, policyholders and stakeholders.

Key requirements of the prudential standards include:

- The board of directors and senior management of a general insurer must consider business continuity risks and controls as part of the company's overall risk management systems when completing Board Declaration submitted to APRA annually;
- A general insurer must identify critical business functions, resources and infrastructure which, if disrupted, would have a material impact on the company's business operations, reputation or profitability;
- A general insurer must assess the impact of plausible disruption scenarios on critical business functions, resources and infrastructure and have in place appropriate recovery strategies to ensure all necessary resources are readily available to withstand the impact of the disruption;
- A general insurer must develop, implement and maintain through review and testing procedures, a Business Continuity Plan (BCP) that documents procedures and information which enable the company to respond to disruptions and recover critical business functions;
- The BCP must be reviewed at least annually by responsible senior management and periodically through insurer's internal audit function or an external expert; and
- An insurer must notify APRA as soon as possible and no later than 24 hours after experiencing a major disruption that has the potential to materially impact policy holders.

# Reinsurance Management

GPS 230 Reinsurance Management aims to ensure that a general insurer, as part of its overall risk management framework, has a specific reinsurance management framework to manage the selection, implementation, monitoring, review, control and documentation of reinsurance arrangements. There must be a clear link between the insurer's risk management framework and the insurer's Reinsurance Management Strategy (REMS), clearly defining management responsibilities and controls, policies and procedures to manage the reinsurance arrangements of the general insurer, including the risk appetite of the general insurer. This REMS should be approved by the Board.

The general insurer is also required to have the reinsurance management framework reviewed by operationally independent, appropriately trained and competent members of staff. The frequency and scope of this review will depend on the size, business mix, complexity of the insurer's operations and the extent of any change in the reinsurance program or risk appetite. As with the risk management strategy, the REMS is subject to an annual review by the Appointed Auditor, providing limited assurance to APRA that the insurer has complied with the REMS at all times during the reporting period.

In summary, GPS 230 requires that a general insurer:

- has in its reinsurance management framework a documented REMS, sound reinsurance management policies and procedures and clearly defined managerial responsibilities and controls;
- submits its REMS to APRA when any material changes are made;
- submits a Reinsurance Arrangements Statement (RAS) detailing its reinsurance arrangements to APRA at least annually; and
- makes an annual reinsurance declaration (RD) based on the "two-month rule" and "six-month rule" specified in the standard and submits the declaration to APRA.

# Outsourcing

GPS 231 Outsourcing aims to ensure that all outsourcing arrangements involving material business activities entered into by a general insurer are subject to appropriate due diligence, approval and on-going monitoring.

The key requirements of the standard are:

- A general insurer must have a policy relating to outsourcing of material business activities;
- A general insurer must have sufficient monitoring processes in place to manage the outsourcing of material business activities;
- A general insurer must have a legally binding agreement in place for all material outsourcing arrangements with third parties, unless otherwise agreed by APRA;
- A general insurer must consult with APRA prior to entering agreements to outsource material business activities to service providers who conduct their activities outside Australia; and
- A general insurer must notify APRA after entering into agreements to outsource material business activities.

# Transfer and amalgamation of insurance business for general insurers

GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers aims to ensure that affected policyholders, and other interested members of the public, are informed and given accurate information about the transfer or amalgamation of an insurer's insurance business.

The key requirements of GPS 410 are as follows:

- Prior to making an application to the Court for a transfer or amalgamation of its insurance business, an insurer must:
  - provide a copy of the scheme and any relevant actuarial reports to APRA;
  - publish a notice of intention to make the application in the Government Gazette and relevant newspapers; and
  - send a summary of the scheme (approved by APRA) to every affected policyholder and make a copy available for public inspection.
- After gaining Court approval, the insurer must give APRA a statement of the nature and terms of the transfer or amalgamation, and the Court order confirming the scheme.

## ***Governance and assurance***

### **Audit and Actuarial Reporting and Valuation**

GPS 310 outlines the roles and responsibilities of a general insurer's Appointed Auditor and Appointed Actuary. It also outlines the obligations of a general insurer to make arrangements to enable its Appointed Auditor and Appointed Actuary to fulfill their responsibilities. In addition, the Prudential Standard establishes a set of principles and practices for the consistent measurement and reporting of insurance liabilities for all general insurers.

The key requirements of GPS 310 Audit and Actuarial Reporting and Valuation are:

- an insurer must make arrangements to enable its Appointed Auditor and Appointed Actuary to undertake their roles and responsibilities;
- an insurer is exempt from the requirement to have an Appointed Actuary in certain circumstances;
- the Appointed Auditor must audit, and provide an opinion to the board on, the yearly APRA statutory accounts of the general insurer;
- the Appointed Auditor must review other aspects of the general insurer's operations on an annual basis and prepare a report on these matters to the board;
- the Appointed Auditor may also be required to undertake other functions, such as a special purpose review (see "APRA targeted reviews" below);
- the Appointed Actuary must prepare a Financial Condition Report (FCR) and an Insurance Liability Valuation Report (ILVR) and provide these reports to the board;
- the Appointed Actuary must apply GPS 310 when valuing the general insurance liabilities for the purposes of GPS 110 Capital Adequacy for General Insurers and for the purpose of reporting requirements under the Financial Sector (Collection of Data) Act;
- a general insurer must arrange to have the ILVR of its Appointed Actuary peer-reviewed by another actuary; and
- a general insurer must submit all certificates and reports required to be prepared by its Appointed Auditor and Appointed Actuary to APRA.

## ***Audit and Actuarial Reporting and Valuation: Level 2 Insurance groups***

The prudential standard GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance groups requires a Level 2 insurance group to:

- appoint a Group Auditor and Group Actuary;
- make arrangements to enable its Group Auditor and Group Actuary to undertake their roles and responsibilities;
- ensure that on an annual basis its Group Auditor conducts a limited assurance review of the annual accounts of the group and reviews other aspects of the group's operations;
- ensure that its Group Actuary prepares an Insurance Liability Valuation Report annually which is addressed to the Board of the parent entity of the group;
- ensure that its Group Auditor and Group Actuary undertake other functions such as special purpose reviews where required;
- for the purposes of the capital standards and reporting requirements under the Financial Sector (Collection of Data) Act 2001, ensure that the group's insurance liabilities are valued in accordance with this Prudential Standard; and
- submit to APRA all reports required under this Prudential Standard prepared by its Group Auditor and Group Actuary.

## ***APRA targeted reviews***

Both the Insurance Act and the prudential standards stipulate that the Appointed Auditor (or Appointed Actuary) may be required to undertake other functions specified by APRA in consultation with the general insurer.

APRA periodically carries out "targeted reviews" of general insurers. These reviews highlight a particular area that APRA is interested in and require the general insurer to engage the Appointed Auditor to prepare a report in respect of that selected area of operation. Apart from highlighting areas where further improvement could be sought, these reviews provide APRA with an industry snapshot that helps to identify and promote best practices.

## Governance

GPS 510 Governance sets out what APRA consider being the minimum requirements which must be met to achieve good governance. A sound governance framework is important in helping maintain public confidence in regulated entities. The actual governance arrangement in place will vary from entity to entity depending on the size complexity and risk profile of each entity.

The key requirements stipulated in GPS 510 are:

- specific requirements with respect to Board size and composition;
- the chairperson of the Board must be an independent director;
- a Board Audit Committee must be established;
- regulated institutions must have a dedicated internal audit function;
- certain provisions dealing with independence requirements for auditors consistent with those in the Corporations Act 2001;
- the Board must have a Remuneration Policy that aligns remuneration and risk management;
- a Board Remuneration Committee must be established; and
- the Board must have a policy on Board renewal and procedures for assessing Board performance.

All insurers, except Category C insurers, have to comply with this prudential standard in its entirety. Category C insurers only have to comply with those provisions of this Prudential Standard specific to Category C insurers.

## Fit and proper

GPS 520 Fit and Proper applies to all general insurers and authorised non-operating holding companies and sets out minimum requirements for those institutions in determining the fitness and propriety of individuals to hold positions of responsibility.

The key requirements of this standard are that:

- an institution must have and implement a written fit and proper policy that meets the requirements of the standard;
- the fitness and propriety of a responsible person must generally be assessed prior to their initial appointment and then re-assessed annually (or as close to annually as practicable);
- an institution must take all prudent steps to ensure that a person is not appointed to, or does not continue to hold, a responsible person position for which they are not fit and proper; and
- information must be provided to APRA regarding responsible persons and the institution's assessment of their fitness and propriety.

The standard stipulates who are regarded as responsible people at different types of institutions and sets out additional restrictions on the Appointed Actuary and Appointed Auditor roles. However, it leaves the determination of what is an appropriate fit and proper policy in the hands of the general insurer.

# Financial reporting

## Accounting standards

Australian general insurers are required to prepare financial statements that comply with Australian Accounting Standards (AASB). Specific AASB's relevant to general insurance include:

- AASB 4 Insurance Contracts defines what constitutes an insurance contract.
- AASB 1023 General Insurance Contracts defines a general insurance contract (i.e. an insurance contract that is not a life insurance contract as defined in the Life Act), and a non-insurance contract (a contract regulated by the Insurance Act that does not meet the AASB 4 Insurance Contracts definition of insurance).

AASB 1023 prescribes accounting treatment for:

- General insurance contracts (including reinsurance contracts) that a general insurer issues and to reinsurance contracts that it holds;
- Certain assets backing general insurance liabilities;
- Financial liabilities and financial assets that arise under non-insurance contracts; and
- Certain assets backing financial liabilities that arise under non-insurance contracts. The treatment of the remaining balances, transactions and operations of a general insurer are prescribed by the AASB applicable to these transactions or balances.

The International Accounting Standards Board (IASB) released exposure draft ED/2010/8 (ED) on accounting for insurance contracts in July 2010. The draft covers life, health and general insurance as well as reinsurance. Once finalised and adopted by the AASB, it will replace AASB 1023. Refer to Chapter 1 for further information.

### *Definition of an insurance contract*

An insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

### *Definition of insurance risk*

Insurance risk is risk other than financial risk transferred from the holder of a contract to the issuer. Financial risk is defined as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance.

A contract that transfers financial risk alone, or only insignificant amounts of insurance risk, is accounted for under AASB 139, to the extent that it gives rise to a financial asset or financial liability.

### *Definition of premium revenue and earning pattern*

Premium revenue comprises premiums from direct business and premiums from reinsurance. Premium revenue is intended to cover actual and anticipated claims, reinsurance premiums, administrative, acquisition and other costs, and a profit component.

Premium revenue includes fire service levies collected from policyholders as there is no direct nexus between fire brigade charges and the levy that insurers charge policyholders. The fire brigade expense is brought to account in accordance with the earning of the premium to which it relates.

In contrast, stamp duty and Goods and Services Tax (GST) in relation to premium revenue effectively represent the collection of tax on behalf of the government and are therefore not included as revenue of the insurer.

Premium revenue is recognised from the risk attachment date in accordance with the pattern of the incidence of risk. AASB 1023 provides additional guidance on how the pattern of the incidence of risk is determined. Premiums received in advance are recognised as part of the unearned premium liability. Unclosed business is estimated and the premium relating to unclosed business is included in premium revenue. Premium revenue is only recognised as income when it has been earned, which is in proportion to the incidence of the risk covered over the life of the insurance contract.

Measuring premium revenue involves:

- estimating the total amount of premium revenue;
- estimating when claims are expected to occur, and hence estimating the pattern of risk exposure, which provides the earning pattern; and
- recognising the premium when it is earned.

For most contracts the period of the contract is one year and the exposure pattern of the incidence of the risk will be linear. For some reinsurance contracts written on a “risk attaching” basis, a 12 month contract may result in up to 24 months of exposure.

The insurer must also recognise a liability item on the balance sheet for the unearned premium, where this exists.

## *Measurement of outstanding claims*

AASB 1023 requires that the liability for outstanding claims shall be measured as the central estimate of the present value of expected future payments for claims incurred with an additional risk margin to allow for the inherent uncertainty in the central estimate.

Expected future payments include amounts related to:

- Unpaid reported claims;
- Claims incurred but not reported (IBNR);
- Adjustments in light of the most recently available information for claims development and claims incurred but not enough reported (IBNER); and
- Claims handling costs.

The liability for outstanding claims reflects the amount that, if set aside at balance date, would be sufficient to enable an insurer to pay claims as they fall due. The standard requires that outstanding claims should be discounted to net present value unless the claims are to be settled within a year and the discounting would not have a material impact. While it does require outstanding claims in all classes of business to be discounted, it recognises that such discounting will have significant application to “long tail” classes of business (mainly liability, compulsory third party and workers compensation) where a high proportion of such claims are settled outside a 12 month period.

Discount rates selected are required to be risk-free rates that are based on current observable, objective rates that relate to the nature, structure and term of the outstanding claims liabilities typically government bond rates.

Expected future payments must account for future claim cost escalation created by inflation and superimposed inflation. Superimposed inflation is defined as the level of inflation in excess of normal economic inflation indices. The disclosure of superimposed inflation assumptions differs between companies. Some companies make explicit disclosures while others include superimposed inflation within composite inflation assumptions.

## *Explicit risk margins*

An additional explicit risk margin is required to be included as part of the outstanding claims liability. The margins are set with regard to the robustness of the valuation models, available data, past experience and the characteristics of the classes of business written. The risk margin should also allow for uncertainty in reinsurance and other recoveries due.

Similar to the APRA requirements, risk margins can allow for diversification. The risk margin for the entire company can then be allocated to individual classes of business.

## *Assets backing general insurance liabilities*

The fair value approach is used to measure assets backing general insurance liabilities or financial liabilities that arise under non-insurance contracts as required by AASB 1023. Where assets are not backing general insurance liabilities or financial liabilities that arise under non-insurance contracts, the applicable accounting standards should be applied by general insurers.

Under AASB 139 Financial Instruments: Recognition and Measurement, financial investments may only be designated as at fair value through profit and loss when doing so results in more relevant information. General Insurers apply fair value through profit or loss because the financial instruments typically form part of a group of financial assets that are managed on a fair value basis in accordance with a documented risk management or investment strategy and information about the group is provided internally on that basis to the entity's key management personnel.

### ***Deferral of acquisition costs and liability adequacy testing for unearned premium***

Acquisition costs, including commission and brokerage paid, incurred in obtaining and recording insurance policies shall be deferred and recognised as an asset if it is probable that they will give rise to premium revenue that will be recognised in the income statement in subsequent reporting periods.

AASB 1023 also requires the application of a liability adequacy test (LAT) to the unearned premium liability. If the present value of the expected future cash flows relating to future claims arising from the current contracts plus an additional risk margin exceeds the unearned premium liability less related intangible assets and related deferred acquisition costs (DAC), then the entire deficiency shall be recognised, first by writing down any intangible assets, then the associated DAC, and then by recognizing a separate unexpired risk liability.

In applying the LAT, general insurers are permitted to use a probability of adequacy that is different to that to be used for outstanding claims, provided that the reasons for using a different rate are disclosed. The LAT shall be performed at the level of a portfolio of contracts that are subject to broadly similar risks and are managed together as a single portfolio.

### ***Accounting for inwards reinsurance***

Inwards reinsurance business should be accounted for in line with the general principles established for direct business. AASB 1023 requires companies underwriting inwards reinsurance to estimate and bring to account "unclosed premiums" and to recognise such premiums as earned, having regard to the spread of risk of underlying policies ceded under inwards reinsurance treaties. On the claims side, the standard requires inwards reinsurance business to be accounted for in a similar manner to direct business.

Outstanding claims should have regard to IBNRs and future claims development, and also be discounted to their net present value. The standard allows reinsurers some latitude. It requires compliance only when the information received is reasonably reliable.

### ***Non-insurance contracts***

Contracts that are regulated under the Insurance Act that fail to meet the definition of insurance risk are referred to as non-insurance contracts. These contracts are accounted for under AASB 139 to the extent that they give rise to financial assets and financial liabilities. The financial assets and the financial liabilities that arise under these contracts are designated as "at fair value through profit or loss" where this is permitted.

## *Financial Statement disclosure principles and requirements*

AASB 1023 incorporates extensive disclosure requirements in respect of the accounting policies, balances, sensitivities to key assumptions, risk exposures and risk management associated with the insurer's insurance contracts.

GPS 110 Capital Adequacy for General Insurers also requires additional disclosure to be made in the financial statements in respect of the capital base, minimum capital requirements (MCR) of the insurer and its capital adequacy.

## **Regulatory Reporting**

In addition to the compliance declarations and statements described above, the general insurer must also provide APRA with:

- a set of annual statutory accounts prepared in accordance with APRA General Insurance Reporting Standards and forms (GRSs and GRFs);
- a financial information declaration (FID);
- the Appointed Auditor's opinion on the annual statutory accounts;
- the Appointed Actuary's Insurance Liability Valuation Report (ILVR);
- the Appointed Actuary's financial condition report (FCR); and
- quarterly statistical and financial returns.

The general insurer must also arrange for an independent peer review of the Appointed Actuary's ILVR.

### *External peer review*

Under GPS 310, the general insurer must arrange for an independent external peer review of the Appointed Actuary's ILVR. This peer review must provide an assessment of the reasonableness of the Appointed Actuary's investigations and reports including the results contained within.

Copies of the report must be provided to the Appointed Actuary, the Appointed Auditor, the board and the management of the insurer before the yearly lodgment of statutory accounts. The review report is not required to be provided to APRA, but must be made available to APRA upon request.

IAA Professional Standard 100 External Peer Review for General Insurance and Life Insurance details the responsibilities of the reviewing actuary and the reviewing requirements.

# Key dates

## *Corporations Act 2001*

Audited annual financial statements – Within four months of the year-end.

## *Financial Sector (Collection of Data) Act 2001*

- Annual APRA statutory accounts  
*Within four months of the year-end.*
- Quarterly forms (GRF 110.0 – 310.3)  
*Within 20 business days of the end of each quarter.*
- Directors' certification in respect of the Risk Management Strategy (RMS) or Reinsurance Management Strategy (REMS), FID, Appointed Actuary's ILVR and FCR, Appointed Auditor's certificate on the annual statutory accounts and APRA prudential compliance review report  
*Within four months of the year-end.*
- Business plan  
*Annually (when appointed by the Board) and when material changes are made.*
- Changes in reinsurance and risk management strategies  
*Within 10 days of board approval. The revised REMS must be submitted to APRA.*
- Changes to details in original application for licence, including appointment of senior staff, appointed actuary and Appointed Auditor  
*Must be approved by APRA prior to the change taking effect.*
- National Claims and Policies Database data (GRF 800.1 – 800.3 and LOLRF 800.1 – 800.3)  
*Within two months from the end of the half year.*

## *National Claims and Policies Database*

The National Claims and Policies Database requires insurers to submit claims and policies at three different levels of aggregation and analysis. Classes covered by this database include public and product liability and professional indemnity. This database, managed by APRA, supplements databases on CTP and workers compensation in several states and aims to provide transparency in the industry. The data may also help to reduce the volatility through the insurance cycle, as insurers will have access to more information to assess the risks more precisely.

# General insurance taxation

## General developments

As in the previous income year, the Government has continued with numerous initiatives for significant tax reform across a wide range of topics from corporate tax rates to controlled foreign company rules.

Some other key tax developments during the year relevant to general insurance activities are summarised below.

- In the past year, the Australian Taxation Office has continued to be very active in the general insurance sector, undertaking both risk reviews and full audits. Areas of focus include:
  - Extent of claims reserve prudential margins, including documentation supporting the setting of these;
  - Adjustments for prudential margins built into internal claims handling reserves;
  - Adjustments for liability adequacy testing;
  - Reinsurance with non-residents;
  - Security arrangements relating to reinsurance (such as loans)
  - Transfer pricing;
  - Restructures;
  - Increases in debt levels; and
  - Acquisitions and divestments.
- A rewrite of the existing general insurance provisions within Schedule 2J of the Income Tax Assessment Act 1936 has been enacted, by repealing the existing provisions and reproducing its effect in Division 321 of the Income Tax Assessment Act 1997. Treasury has confirmed that the policy intentions of the previous provisions will remain the same in the new legislation.
- The Taxation of Financial Arrangements (TOFA) measures which provide a comprehensive regime for the tax treatment of gains and losses arising from financial arrangements now apply to eligible taxpayers for the income year beginning on or after 1 July 2010. Taxpayers have a choice as to how TOFA will apply to their financial arrangements. Additionally, the ATO continues to work through the extensive list of issues raised in connection with the practical application of the legislation to various arrangements, such as swaps and hedges, as well as grapple with some base level issues relevant to the application of the tax-timing methods.

From 1 July 2010 GST rulings are included in the general rulings regime. This has resulted in rulings obtained by industry associations and the Insurance Industry Partnership issues register, (both which are extensively relied upon by insurers), no longer having the status of a ruling in many cases. As a result, insurers no longer have tax certainty for those issues on the former issues register that have not been confirmed by the ATO unless they have obtained a private ruling.

## Taxation of general insurers

In Australia, general insurance companies are assessed under Division 321 of the Income Tax Assessment Act (ITAA) 1936. Tax is payable on the profits of a general insurer at the corporate tax rate, currently 30 per cent.

### *Premium income*

Division 321 of the ITAA legislates the manner in which premium income is earned by an insurer for taxation purposes.

An insurance premium has a number of components. The gross premium, including components referable to fire services levies, stamp duty and other statutory charges must be included as assessable income. Insurers must recognise premium income from the date of attachment of risk. As a result, unclosed business will be brought to account in calculating tax liability.

Subject to the following comments on unearned premium reserve, all premiums received or receivable in that year are included in assessable income.

### *Unearned premium reserve*

Where part of the premium relates to risk in a future year, an unearned premium reserve (UPR) is established. When the UPR is greater at year-end than it was at the beginning, a deduction is allowed for the increase. Where it decreases over the year, the decrease is included in assessable income.

The legislation prescribes the way UPR is to be calculated. In particular, expenses relating to the issuing of policies, as well as reinsurance, reduce the amount of the UPR.

### *Liability adequacy testing*

Under the accounting standards, an insurer is required to assess at each reporting date whether its UPR is adequate, by considering current estimates of future cash flows under its insurance contracts. If the assessment shows that the carrying amount of its UPR is inadequate, the entire deficiency must be recognised in profit or loss by first writing off related intangibles and deferred acquisition costs and then recognising an unexpired risk liability. This process is known as Liability Adequacy Testing or “LAT”.

For tax purposes, the LAT adjustment is not deductible and generates a temporary difference.

## *Apportionable issue costs (acquisition costs)*

Costs incurred in obtaining and recording premiums are allowable deductions in the year of income in which they are incurred. These costs include commissions and brokerage fees, processing costs, risk assessment fees, fire brigade charges, stamp duty and other government charges and levies (excluding GST).

The benefit of an immediate deduction for apportionable issue costs incurred during a year of income is effectively restricted, as these costs are taken into account in the determination of the unearned premium reserve. This is achieved by determining the UPR based on premiums net of apportionable issue costs.

## *Prepayments*

The prepayment legislation would normally apply to apportionable issue costs and reinsurance expense. However, as the methodology for calculating the unearned premium reserve includes a reduction component for these expenses, the legislation excludes these expenses from the prepayment rules.

Treaty non-proportional reinsurance, which is not taken into account in determining the UPR, remains subject to the prepayment rules.

## *Outstanding claims*

A deduction is allowed for any increase in the outstanding claims reserve during the year, while decreases in the outstanding claims reserve are assessable. In addition, claims paid during the year are deductible. This effectively mandates a balance sheet approach for determining the claims expense for the year, and with the exception of indirect claims settlement costs, should align with the current accounting treatment of claims.

This means that a deduction is allowed for the estimated cost of settling reported claims and claims incurred but not reported (IBNR) during the year of income. The deduction is based on the costs of claims incurred and paid during the year of income, an estimate of costs to be paid in respect of claims incurred during the year and a revision of previously estimated costs of claims incurred in prior years. These estimates must be soundly based but may take prudential margins into account.

The following factors may be taken into account in determining the quantum of the allowable deduction for outstanding claims and IBNR provisions:

- direct policy costs;
- claims investigation and assessment costs;
- direct claims settlement expenses;
- estimated increased costs of litigation and other factors, such as superimposed inflation; and
- recoverables, including reinsurances, excesses and salvage and subrogation.

These factors allow for the effects of inflation. However, only the present value (i.e. the value after discounting) of costs associated with long-term claims is an allowable deduction. A deduction is not allowed for estimated indirect claims settlement costs (e.g. future claims department costs), until those expenses are paid.

### ***Profits or losses on realisation of investments***

The purchase and sale of investments are regarded as part of the income-producing activities of a general insurer. As a consequence, profits or losses on the sale of investments are generally considered to be of a revenue nature. Profits will be assessable as ordinary income, while losses will be allowable deductions. However, a profit or loss arising on the sale of a capital asset that is not part of the insurance business may be treated as a capital gain or loss. It is generally accepted that a building used as a head office or permanent place of business by an insurer is a capital asset.

Unrealised profits and losses on investments are not currently brought to account as assessable income or allowable deductions for tax purposes. However, this may change where a general insurer makes certain elections under the TOFA regime.

### ***Reinsurance***

Generally, a premium paid for reinsurance will be an allowable deduction in the year in which the premium is incurred. Because such premiums (other than treaty non-proportional reinsurance premiums) reduce gross premiums in calculating the unearned premium reserve, the benefit of the deduction allowed in any year is effectively limited to the proportion of risk covered by the premium that has expired during the year.

Reinsurance recoveries are assessable income and future recoveries must be taken into account in determining outstanding claims reserves (unless the reinsurance is with a non-resident and a section 148(2) election has not been made).

### ***Reinsurance with non-residents***

Where a general insurer reinsures the whole or part of any risk with a non-resident, a deduction will not be allowed in the first instance in respect of those premiums.

These reinsurance premiums will not reduce gross premiums in calculating the unearned premium reserve and reinsurance recoveries will not be assessable.

However, an insurer may elect that this principle does not apply in determining its taxable income (section 148(2) election), in which case the insurer becomes liable to furnish returns and to pay tax at the relevant rate (30 per cent) on 10 per cent of the gross premiums paid or credited to these non-resident reinsurers during the year. Where the election has been made, these reinsurance premiums should be included in the calculation of UPR, and recoveries under those reinsurance policies included in the calculation of the outstanding claims reserve.

## Financial reinsurance

The ATO considers (in TR96/2) that financial insurance and financial reinsurance arrangements should be treated as the provision and repayment of loans. In determining whether an arrangement constitutes financial insurance or reinsurance, reference is made to two criteria:

- The degree of insurance risk assumed; and
- The possibility of the insurer/reinsurer incurring a significant loss under the arrangement.

An insurer needs to prove both of these to support a claim for a deduction of a reinsurance premium.

## Goods and Services Tax

Under the Australian GST legislation, some classes of insurance are treated differently, leading to different implications for insurers and insured parties.

The provision of general insurance is, in most cases, a “taxable supply”. Insurers are required to account for GST of one-eleventh of the premium income collected (excluding stamp duty). In most cases, they are also entitled to claim input tax credits for the GST included in the price of expenses they incur that relate to making supplies of general insurance (with certain exclusions which apply to all businesses).

It should be noted that the GST classification of general insurance will be different if a supply is made in relation to a risk located outside of Australia, in which case the supply of these policies may be GST-free (known as “zero rated supplies” in other jurisdictions).

The GST legislation contains complex provisions in respect of general insurance businesses. The effect of the main provisions is summarised below.

- GST, where applicable, is chargeable on the stamp duty-exclusive amount of the premium. As GST forms part of the “price” of a supply, it constitutes one-eleventh of the price paid for the premium (based on the prevailing GST rate of 10 per cent). Stamp duty will be calculated on the GST-inclusive amount of the premium.
- At or before the time a claim on the policy is made, the insured must notify the insurer as to the extent of the input tax credit they are entitled to claim on the policy. Failure to do so could adversely affect the GST position for both the insurer and the insured.
- An insurer will not have to account for GST on supplies made in the course of settling a claim if it has received notification from the insured entity of its entitlement to claim input tax credits on the premium paid for the insurance. Furthermore, it can generally claim input tax credits when acquiring goods and services that are to be supplied in settlement of a claim, provided the policy was not initially a GST-free supply.
- Where the insured was not entitled to claim an input tax credit in respect of the premium, the insurer is entitled to make a decreasing adjustment mechanism (DAM) in respect of any settlement amount (in the form of cash and/or goods or services) paid out under that policy.
- Where the insured was entitled to claim a full input tax credit for GST included in the premium, there is no entitlement to a DAM for the insurer when they make a settlement under the policy.

- If the insured is entitled to partial input tax credits on the premium, the insurer is entitled to a partial DAM.
- The receipt of an excess payment can trigger a GST liability as an increasing adjustment for the insurer. The actual liability is based on a specific formula contained in the GST law.

Special rules also exist for a range of common insurance scenarios such as, excesses, insurance settlements and subrogated recoveries. In most cases, the rules and the practical impact on business systems and processes can be complicated.

Further, there are special GST rules dealing with the various state and territory-based compulsory third party (CTP) insurance schemes. These laws are complicated and generally require careful consideration.

## Stamp duty

Stamp duty is generally chargeable on the amount of the premium paid in relation to an insurance policy (including any fire service levy where applicable). The amount of GST or reimbursement for GST is also generally included in the amount on which duty is calculated. The rates of general insurance duty vary in each state and territory and in some states, by class of insurance.

The liability for duty on general insurance policies usually falls on the general insurer.

## Other levies and taxes

### *Fire services levy*

Fire services levies are imposed on various classes of general insurance in New South Wales, Victoria and Tasmania to fund the cost of providing fire and emergency services (in August 2010 the Victorian government announced the abolishment of the levy with an effective date of 1 July 2012). The levies vary in each state with different rates applying to various classes of insurance.

### *Insurance protection tax (NSW)*

The Insurance Protection Tax Act (NSW) 2001 imposes a tax on the total annual amount of general insurance premiums received by insurers in New South Wales. The tax was introduced to establish a fund to assist builders' warranty and compulsory third-party policyholders affected by the collapse of HIH Insurance Limited. The tax is apportioned among general insurers according to their share of the total premium pool for the year.

### *General Insurance Levy*

This annual levy is based on a percentage of the value of assets of a general insurance company at a specified date. The unrestricted and restricted levy percentage, the specified date, and the minimum and maximum restricted levy amount for each financial year are determined by the Federal Treasurer (2010/2011: unrestricted levy of 0.007776 per cent of assets; restricted levy of 0.02023 per cent of assets; minimum restricted levy: \$4,700; maximum restricted levy: \$835,000).