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APRA review of capital standards for insurers

APRA's response to submissions

April 2011

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What would you like to grow?

APRA review of capital standards for insurers

APRA's response to submissions

APRA has just concluded its first round of consultations on the review of capital standards for general insurers and life insurers, and has released a paper to industry outlining its response and revised proposals.

APRA's original proposals are described in its May 2010 discussion paper and subsequent technical papers. APRA's objectives in conducting the review were to improve the risk sensitivity of required capital and to harmonise the approach across industries.

The majority of insurers participated in APRA's quantitative impact study (QIS), which indicated significant increases in required capital for both industries.

APRA has refined its proposals to reflect feedback received and in the light of the results of the QIS. They will run a second round of consultation and quantitative impact study from April to July 2011, and have indicated that further revisions to its proposals may be considered.

Whilst steps have been taken to address concerns raised by industry around complexity, pro-cyclicality and impact on aggregate industry capital levels, the key aspects to APRA's original proposals remain.

What are the implications of the proposed changes to your business?

General Insurers

For general insurers the composition of required capital remains relatively unchanged, however there would be significant changes to the method used to determine some components of required capital.

Key development	Areas for consideration
Focus on a more risk sensitive approach	• Replacement of investment risk charge with an asset risk charge based on stress tests to the balance sheet. • This will require more calculations and will have implications for balance sheet composition. • The revised proposals simplify the approach and specify lower stresses
Limits on asset exposures	• Limits on exposures to single counterparties or groups of counterparties • Insurers may need to diversify bank exposures and limit exposures to parents • Bank exposure limits more generous than original proposals
A new capital charge for operational risk, and explicit recognition of diversification	• Introduction of an explicit charge for operational risk. The proposed formula has been modified but it remains a relatively blunt size based measure. • Recognition of diversification across asset and insurance risks through the introduction of the 'aggregation benefit'. • APRA has indicated it will not place limits on diversification benefits implicit in risk margins, although it will be closely monitoring levels adopted by insurers
Significant changes to charges for catastrophe risk	• Move to 1 in 200 whole of portfolio requirement for vertical reinsurance cover • New capital requirement to address the risk of multiple events in a year • A requirement for one full reinstatement of cover to be prepaid or contractually agreed at the commencement of the treaty year

Life Insurers

The overall approach for life insurance will substantially change. How it will impact on your capital requirements will depend on your asset/liability relationship, risk drivers and exposures. Some of the key changes in the proposal include:

Key development	Areas for consideration
A significant change to the capital framework	• Dual requirements of solvency and capital adequacy to be replaced with a single measure. • Required capital will consist of a prescribed capital amount and a supervisory adjustment determined by APRA. • Prescribed capital to cover insurance risk, asset risk, asset concentration risk and operational risk. • Insurance risk to include a specific allowance for losses from extreme events such as a pandemic.
The risk-free discount rate set at the spot yield curve of Commonwealth Government Securities	• The risk free discount rate will be consistent across all insurers. • This will have implications for the value of policyholder liabilities for those insurers currently using alternative measures in their capital reporting. • This definition may also be amended for financial statement reporting.
A new capital charge for operational risk	• Introduction of an explicit charge for operational risk. • The effective management of operational risk will also be considered by APRA in determining any supervisory adjustment. • There may be lessons to be learned from the experience of ADIs.
Individual asset risk assessments and a standardised correlation matrix	• Surplus capital will now be exposed to asset risk capital charges. • Separate asset stress tests may uncover correlations and offsets previously hidden in the resilience reserve calculation providing greater transparency • A standardised correlation matrix may result in a substantial difference from the current resilience reserve.

What should you be considering in response to these changes?

APRA's proposals are firming up. There remains one last round of consultation and a final quantitative impact study before final proposals will be released. Insurers should pay particular attention to the detail outlined in the response paper and prior materials and make an assessment of what the proposals mean for their organisation. Insurers should consider:

- making a further submission to APRA for comments or clarifications, where necessary
- participation in QIS2 will give a good indication of expected impact on required capital
- revisiting insurer investment, reinsurance and capital management and overall business strategy to ensure they remain optimal in the post capital review environment.

There is no doubt that the adoption of a new, more risk sensitive capital framework will impact each insurer differently and that there will be some winners and some losers. APRA has indicated the new capital framework will take effect from 1 January 2013.

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