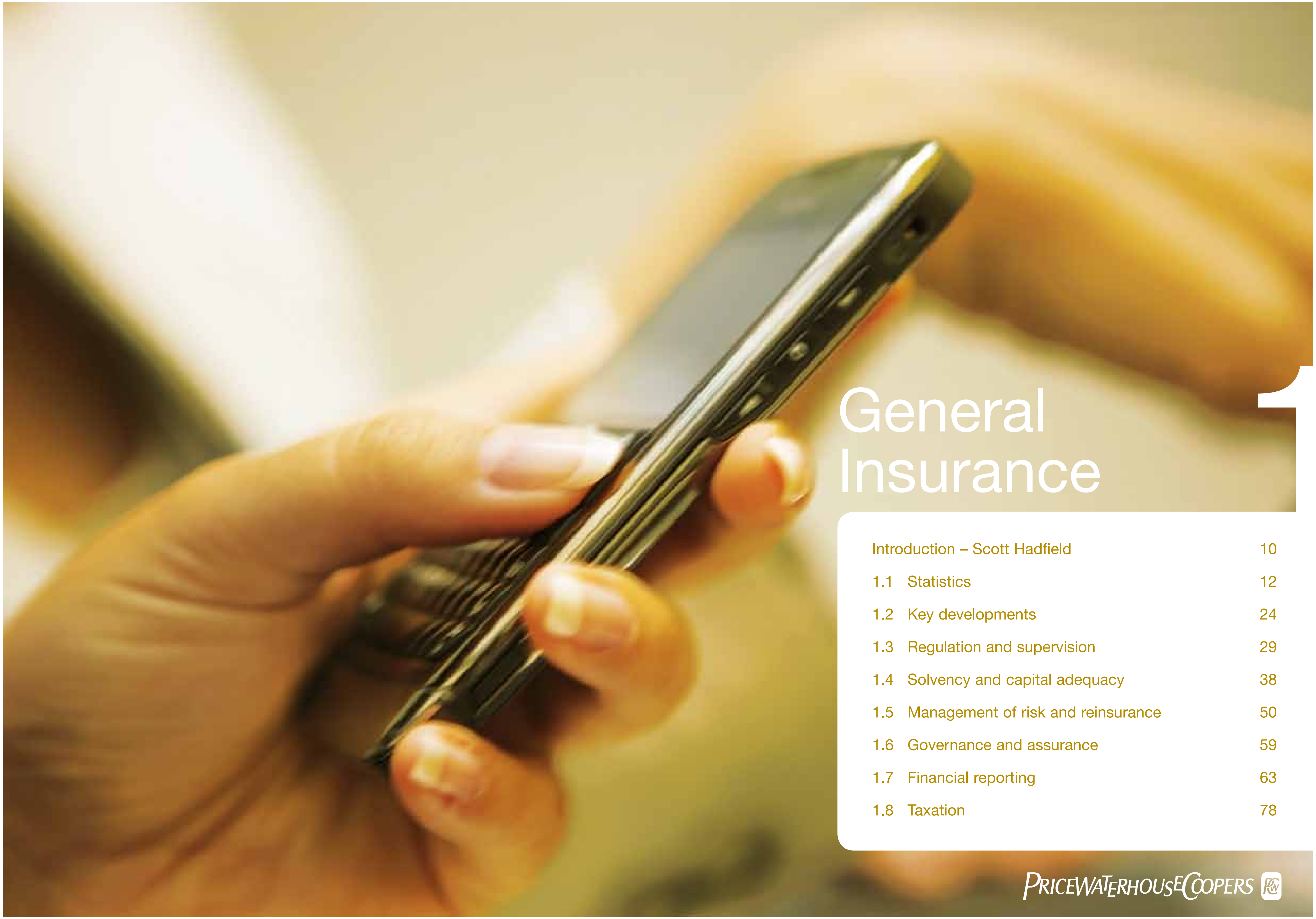


1 General Insurance

Introduction

Scott Hadfield

Last year it was all about the GFC and bushfires in Victoria. This year, the worst of the GFC has passed and business confidence has returned, albeit the markets are still a little edgy. Weather events however remain with hail being the talk of the town. Sydney's hail storm in 1998 remains the largest single event in Australia's history, but separate hail events in Melbourne and Perth have had a significant impact in the current year. Reinsurance appears to have contained the costs of those most affected, but the frequency of these 'infrequent' events raises questions about pricing and what event will be next.

In the direct market, the new entrants are growing in size and profile, however their overall impact is still relatively small. With players such as Coles, Australian Post and Progressive (one of the largest motor insurers in the US) the future will see more consumer choice and increased competition. Whether we see the commoditisation of insurance products that the UK has experienced in recent years is unknown, but if it were to happen, I believe it is still some way off.

On the reporting front, there is change coming:

- In the short term, general insurers will see revised reporting requirements to APRA, the output of a project that sought to align APRA reporting with that required under Australian Accounting Standards.
- In the medium term, APRA will be revising the capital standard as it seeks to align capital requirements across life and general insurers. We are not expecting the changes for general insurers to be significant.
- Over the horizon, the Insurance Contracts Project continues to develop. We can expect an exposure draft in mid 2010, but the final standard is still some way off. Although the project predates the IASB itself, there are still passionately debated topics that have yet to reach a conclusion. General insurers would do well to follow this debate as it nears completion, with hot topics to look out for including risk margins, diversification benefits and acquisition costs. The devil will be in the detail.

Overall, the industry continues to provide its challenges to CEOs, underwriters, and finance professionals. The mental stimulation is rewarding and those that respond to the changes with agility, innovation and speed will emerge the strongest.

1.1 Statistics

Top 15 general insurers

		Ranking Measure:						Performance:	
		Net earned premium revenue						Underwriting result	
	Entity / group	Year end	Current $m	Current Rank	Prior $m	Prior Rank	% Change	Current $m	Prior $m
1	QBE Insurance Group[1]	12/09	12,149	1	11,087	1	10%	1,262	1,275
2	Insurance Australia Group	06/09	7,233	2	7,295	2	-1%	-265	-40
3	Suncorp	06/09	5,980	3	5,867	3	2%	-270	170
4	Allianz Australia	12/09	2,071	4	1,983	4	4%	326	-255
5	Wesfarmers[2]	06/09	1,061	5	993	5	7%	10	78
6	Munich Reinsurance Company Australia	12/09	877	6	739	7	19%	134	-34
7	Zurich Australian Insurance	12/09	780	7	741	6	5%	56	-112
8	Genworth Financial Mortgage Insurance	12/09	490	8	367	8	34%	150	158
9	Swiss Re	12/09	414	9	325	9	27%	249	-11
10	Westpac Insurance[3]	09/09	299	10	217	13	38%	110	62
11	Commonwealth Insurance[4]	06/09	292	11	200	14	46%	-20	-33
12	Chubb Insurance	12/09	265	12	253	11	5%	-1	-12
13	AIG (American Home Assurance)	12/09	249	13	259	10	-4%	70	88
14	RAC Insurance[5]	06/09	237	14	221	12	7%	36	18
15	ACE Insurance	12/09	191	15	175	15	9%	6	-20
NR	Lloyd's*	12/09	1,182	NR	1,050	NR	13%	n/a	n/a

Performance:				Financial Position:							
Investment result		Result after tax		Net outstanding claims		Investments		Net assets		Total assets	
Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m
1,237	1,177	1,970	1,859	14,350	16,161	23,420	25,693	10,298	11,245	40,964	48,383
739	455	247	-226	6,406	6,416	10,563	10,034	4,836	4,351	19,315	19,380
732	437	394	189	6,059	5,881	9,482	9,634	8,019	7,333	20,791	19,701
96	500	335	209	3,406	3,626	4,362	4,176	1,808	1,652	7,986	7,932
n/a	n/a	64	92	513	448	1,003	871	1,371	1,320	3,561	3,321
23	189	67	84	1,166	1,207	1,525	1,783	531	498	2,922	2,817
95	72	106	-29	1,010	1,021	1,643	1,604	643	543	3,024	2,876
109	266	152	262	282	226	2,790	2,613	1,987	1,494	3,170	2,887
47	220	175	123	1,264	1,136	2,039	1,561	808	479	2,830	2,285
32	29	100	63	71	62	682	450	824	242	1,554	654
14	10	-7	-18	88	92	163	150	98	74	521	370
-10	133	-8	85	490	424	868	837	359	367	1,219	1,144
59	49	49	72	305	368	1,193	1,039	420	371	2,589	1,931
15	–	16	-4	39	41	196	178	216	200	430	393
17	47	16	17	223	219	349	341	199	186	1,154	1,083
n/a	n/a	n/a	n/a	920	945	1,162	1,401	n/a	n/a	1,612	1,401

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.

* 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 2009 its Australian assets comprised of $1,610m in trust funds and a statutory deposit of $2m.

1 QBE acquired Elders Insurance effective 30 September 2009. Comparative figures are for QBE only.

2 Disclosure of investment result from insurance operations was not available in Wesfarmers' financial statements.

3 Westpac acquired St George Insurance Australia on 1 December 2008. Comparative figures are for Westpac only.

4 The Commonwealth Bank acquired St Andrew's Insurance (Australia) on 19 December 2008. Due to inconsistencies in reporting dates, information for St Andrew's has not been included.

5 RAC Insurance changed its year end to June during the 2008 financial year resulting in accounts being prepared for the six months to 30 June 2008. Financial performance figures for the six months to 30 June 2008 have been extrapolated for comparative purposes.

Top 10 government insurers

			Ranking Measure:					Performance:	
			Net earned premium					Underwriting	
	Entity	Year end	Current $m	Current Rank	Prior $m	Prior Rank	% Change	Current $m	Prior $m
1	WorkCover NSW	06/09	2,572	1	2,440	1	5%	-665	352
2	Victorian WorkCover Authority	06/09	1,608	2	1,656	2	-3%	-257	292
3	Transport Accident Commission (Vic)	06/09	1,195	3	1,132	3	6%	-592	-268
4	WorkCover Queensland	06/09	950	4	865	4	10%	-624	-295
5	NSW Self Insurance Corporation *	06/09	773	5	766	5	1%	-108	529
6	WorkCover Corporation (SA)	06/09	646	6	621	6	4%	122	-21
7	Motor Accident Commission (SA)	06/09	430	7	397	7	8%	-199	-122
8	Insurance Commission of WA	06/09	381	8	357	8	7%	-98	-10
9	Comcare (Cwlth) *	06/09	207	9	222	9	-7%	-32	12
10	Victorian Managed Insurance Authority	06/09	121	10	111	–	9%	-136	-54

Performance:				Financial Position:							
Investment		Result after tax		Outstanding claims		Investments		Net assets		Total assets	
Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m	Current $m	Prior $m
-823	-76	-2,107	-187	11,508	9,993	9,480	13,114	-1,482	625	11,596	14,612
-1,330	-977	-1,254	-587	8,154	7,824	7,999	9,535	814	2,069	9,300	10,271
-803	-486	-971	-517	6,429	5,782	5,859	6,714	-338	772	7,100	7,503
-265	-80	-567	-259	2,166	1,720	2,341	2,788	648	1,218	2,982	3,127
-121	-357	-187	-518	4,612	3,927	3,799	4,136	108	330	5,199	4,566
-138	-73	-75	-140	2,286	2,374	1,182	1,337	-1,059	-984	1,390	1,528
-10	-22	-208	-146	1,811	1,617	2,060	2,041	70	278	2,104	2,093
-224	-95	-161	-34	1,426	1,328	1,948	2,138	704	880	2,516	2,745
20	18	14	70	1,601	1,242	186	179	199	189	2,475	2,436
-141	-84	-283	-144	1,039	858	848	992	-114	169	1,343	1,111

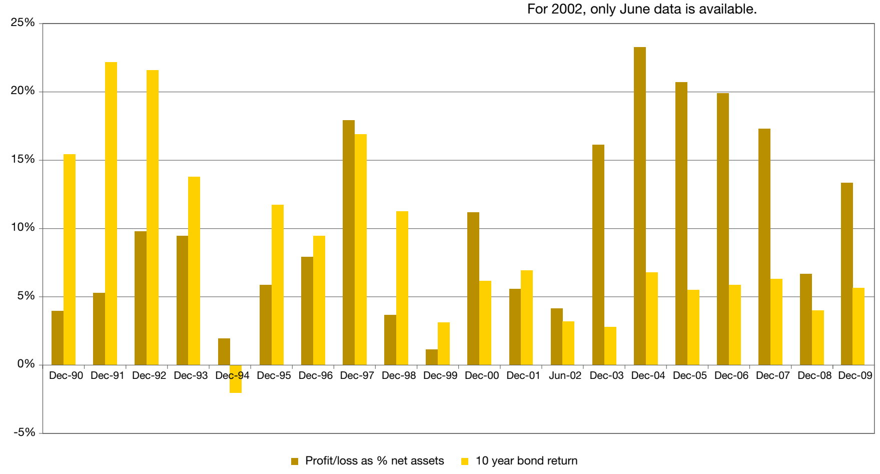
Source: Published annual financial statements

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

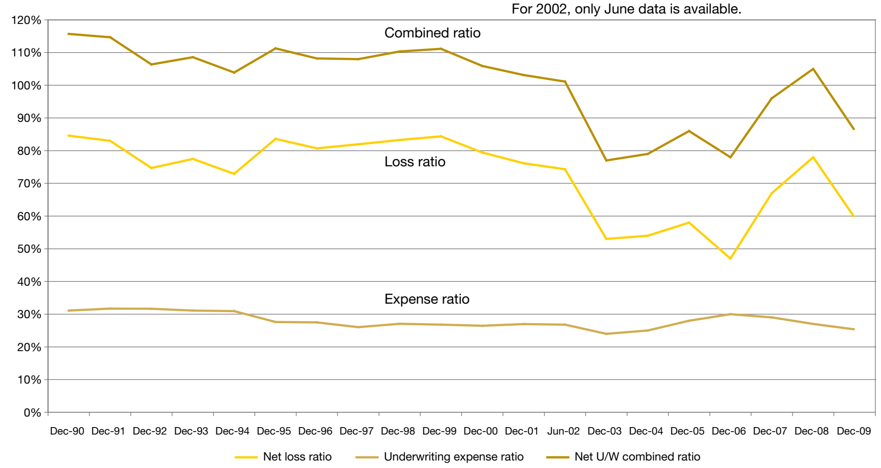
Direct insurers - comparison of profitability

We have not included 31 December 2002 data as APRA has not published statistics for this period. For 2002, only June data is available.

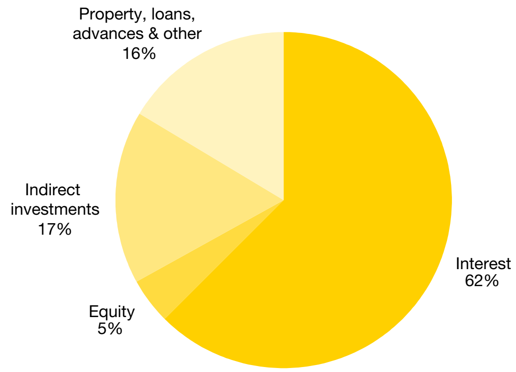


Direct insurer loss and expense ratios

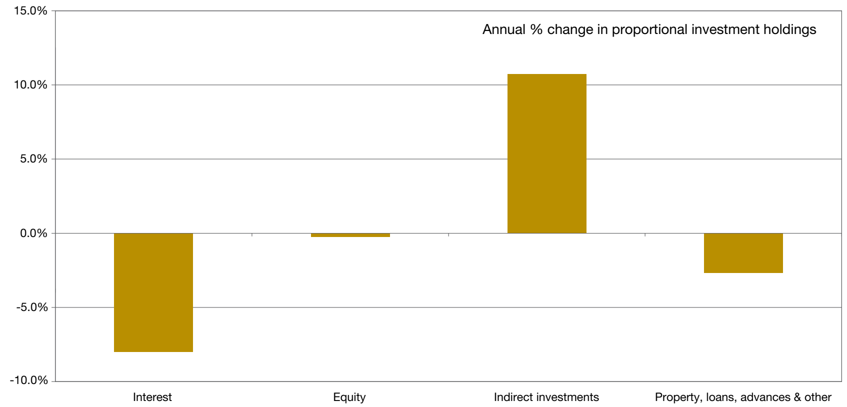
We have not included 31 December 2002 data as APRA has not published statistics for this period. For 2002, only June data is available.



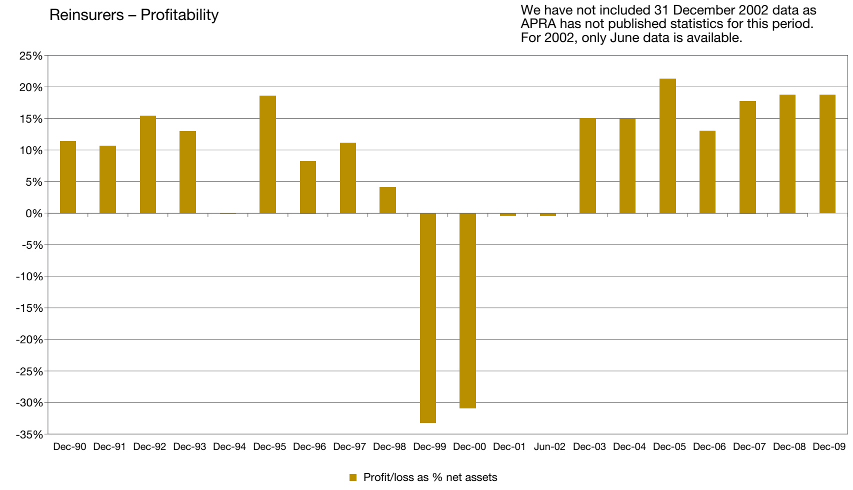
Direct insurers – Distribution of investments by type

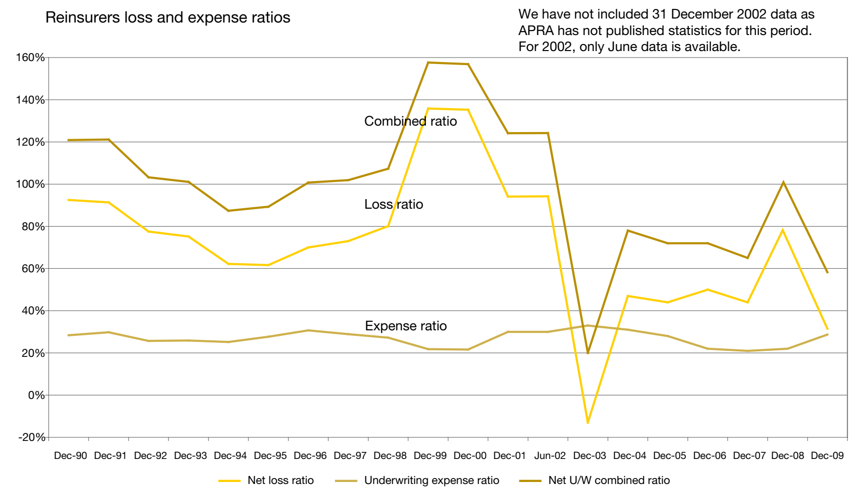


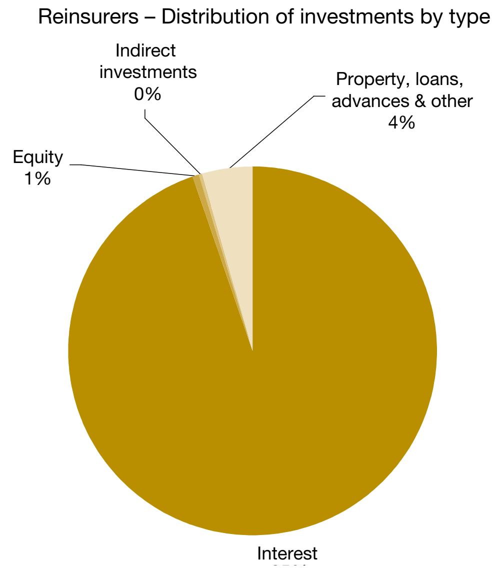
Direct insurers – Movement in investments

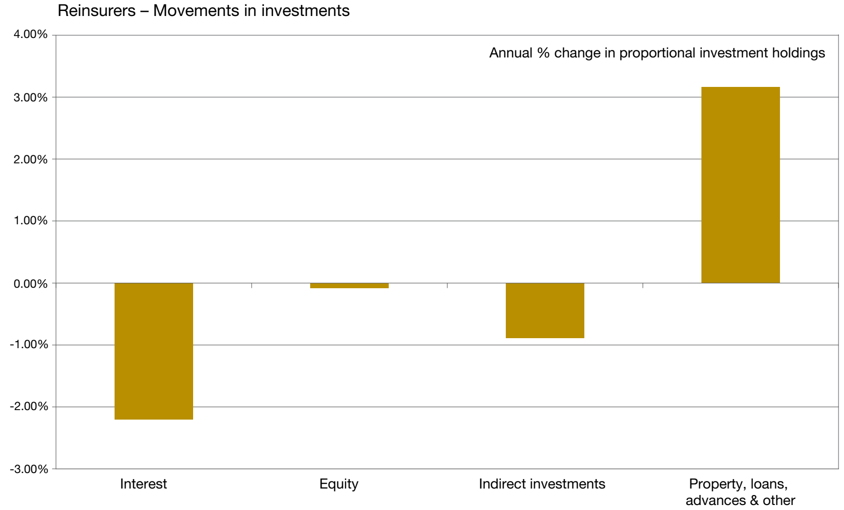


Source: Selected statistics on general insurance industry, APRA, December 2009





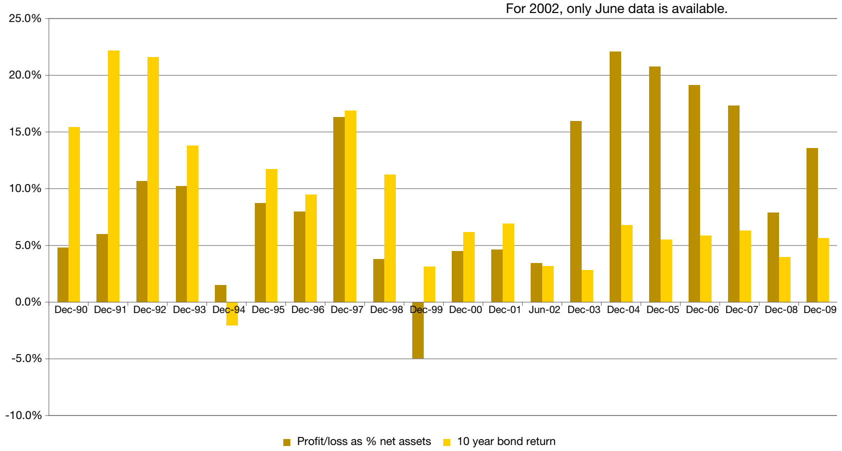




Source: Selected statistics on general insurance industry, APRA, December 2009

Total private sector – comparison of profitability

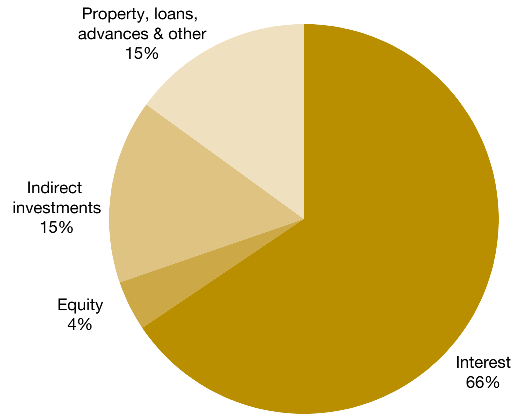
We have not included 31 December 2002 data as APRA has not published statistics for this period. For 2002, only June data is available.



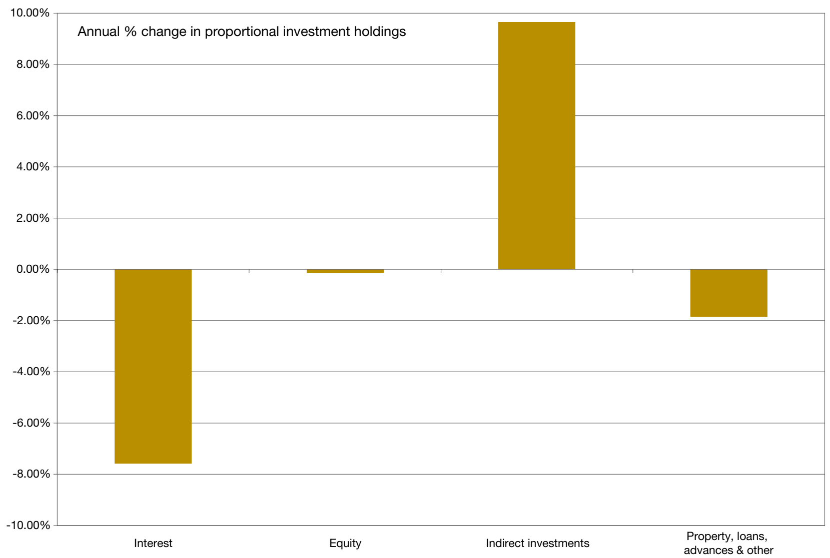
Total private sector loss and expense ratios

We have not included 31 December 2002 data as APRA has not published statistics for this period. For 2002, only June data is available.

Total private sector – Distribution of investments by type



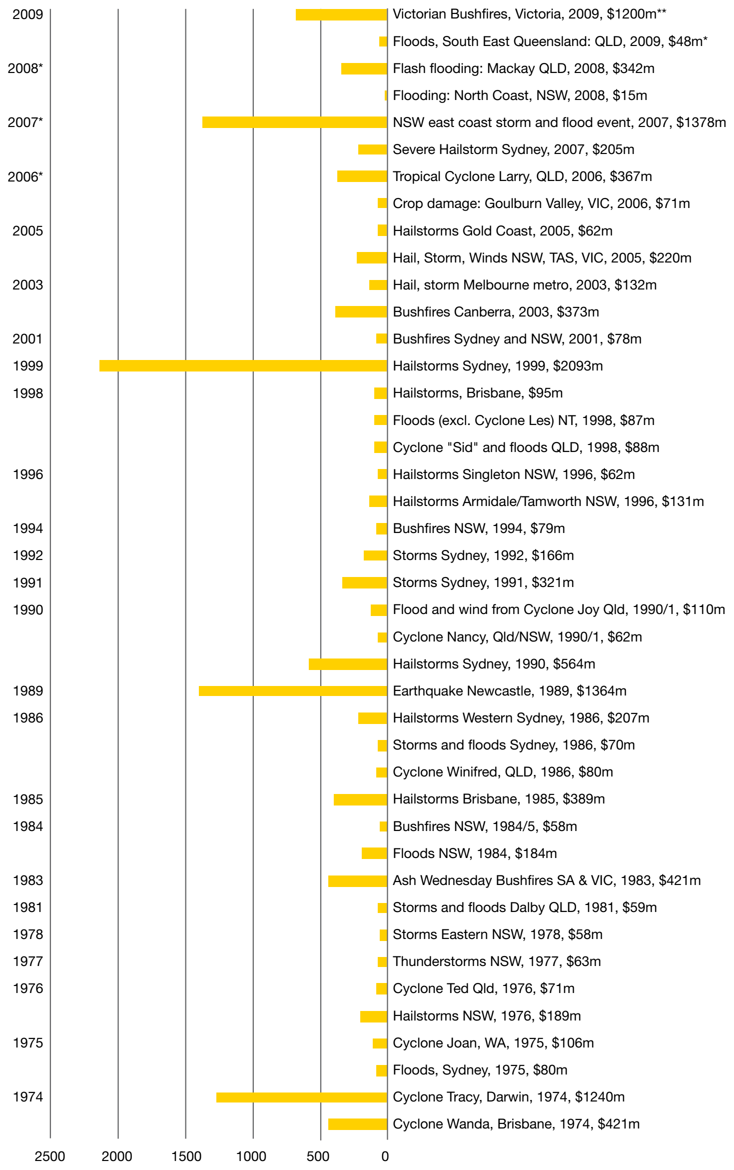
Total private sector – Movements in investments



Source: Selected statistics on general insurance industry, APRA, December 2009

Major Australian catastrophes

Original cost adjusted to June 2006 CPI

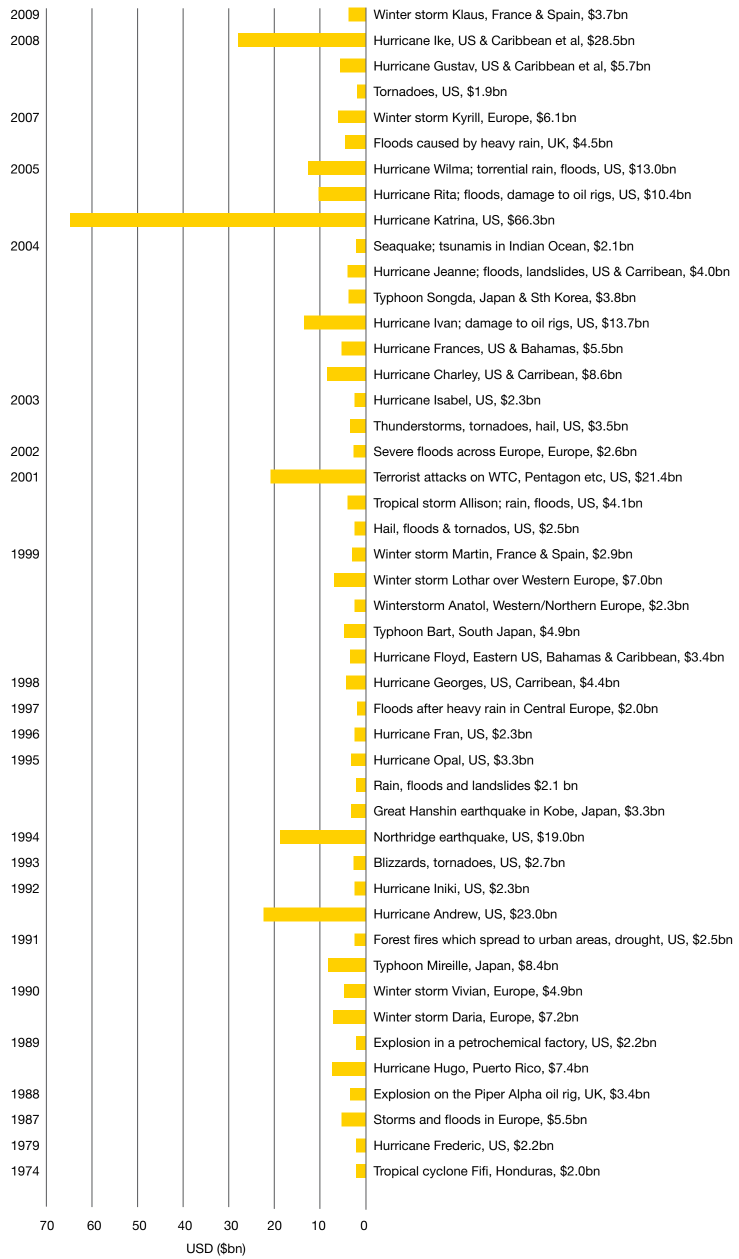


Source: Insurance Disaster Response Organisation, Major disaster event list since June 1967. Revised to March 2006.

* Source: Emergency Management Australia, EMA Disasters Database. 24 April 2009

** 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

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

1.2 Key developments

The general insurance sector has continued to evolve over the last twelve months, experiencing legislative regulatory and market change. In this section we discuss some of the developments that general insurers will need to be prepared for in the year ahead.

APRA regulatory changes

Capital adequacy

The Australian Prudential Regulation Authority (APRA) has undertaken a process to further review the prudential framework especially around capital requirements. The aim is to maintain a broadly consistent approach to the determination of regulatory capital for general insurers and authorised deposit-taking institutions as well as to achieve harmonisation of the regulatory framework between life and general insurers. A letter was issued by APRA in December 2009 to update local general insurers and authorised non-operating holding companies on the 2009 Basel proposals for regulatory capital requirements and that the definition of "eligible capital" for insurers is being considered as part of a broader review of general and life insurance capital standards. A discussion paper on the refined capital adequacy standards was released on 5 May 2010.

Level 3 supervision proposals

In March 2010, APRA released a discussion paper "Supervision of conglomerate groups" containing proposals on supervising conglomerate groups. Conglomerate groups are groups with APRA-regulated entities that have material operations in more than one APRA-regulated industry and/or have material unregulated entities.

APRA's proposed 'Level 3' supervision framework is designed to complement its existing industry-based supervision of stand-alone entities (Level 1 supervision) and its supervision of single industry groups (Level 2 supervision).

APRA's proposed Level 3 supervision framework aims to ensure that prudential supervision adequately captures the risks to which APRA-regulated entities within a conglomerate group are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing prudential frameworks at Level 1 and (where it applies) Level 2. The proposed framework is a flexible one intended to ensure that group structures are not unduly restricted by supervisory intervention whilst giving both APRA and the group itself a better understanding of the risks that arise from the group and its activities.

Lenders Mortgage Insurance capital

APRA has also amended the Attachment A of the prudential standard GPS 116, which sets out the calculation of concentration risk capital charge for lenders mortgage insurers (LMI). The corresponding reporting standard GRS 170.1 'Maximum Event Retention and Risk Charge for Lenders Mortgage Insurers' has also been changed and both of these are effective from 1 May 2010. The amendments aim to replace the prescriptive approach in GPS 116 Attachment A with a principles-based approach. Overall, the process will have minimal impact on the LMI industry. In March 2010, APRA released a paper titled "Maximum event retention for lenders mortgage insurers" discussing these changes. More details are given under "Capital adequacy: concentration risk capital charge" in Section 1.4.

Prudential reporting

In December 2009, APRA released a discussion paper "Proposed Changes to the General Insurance Prudential Reporting" on changes to the general insurance prudential reporting requirements. The changes seek to align the current reporting requirements with those of Australian Accounting Standards while retaining certain prudential elements for capital adequacy purposes. The proposed changes are discussed in detail in the Financial Reporting Section 1.7.

Management of security risk in information and information technology

The use of IT information and systems is becoming increasingly important for financial institutions. In February 2010, APRA issued PPG 234 Management of security risk in information and information technology, reflecting the need for these institutions to safeguard IT assets. It is designed for use by senior management, risk management and IT security specialists.

The PPG addresses IT security risks and related controls, covering IT security risk, user awareness, access control, IT asset life-cycle management controls, monitoring and incident management, IT security reporting and metrics, and IT security assurance.

Remuneration governance

In November 2009, APRA released a paper "Remuneration: Extensions to governance requirements for APRA – regulated institutions". The paper covers changes to the prudential standards on governance and the associated prudential guide on governance, dealing with remuneration. The revised governance standards came into effect on 1 April 2010. Details are discussed under "Governance" at Section 1.6.

Builder's Warranty

Builders' warranty insurance provides cover to consumers should the builder die, disappear, become insolvent or have their license cancelled. Builders are legally prevented from building without it. Builders' warranty cover is compulsory in all states except Queensland and Tasmania for all residential building works over $12,000.

Following the withdrawal of major builders' warranty providers Lumley Insurance, CGU and Vero, concerns were raised about the lack of available cover. The Victorian Government, taking into account the withdrawal of the three major providers – has established a new scheme to provide builders' warranty cover from 31 March 2010. This is run by the Victorian Managed Insurance Authority. Builders with recent insurance coverage will be automatically eligible for VMIA cover for at least 12 months on comparable terms and conditions.

The NSW Government also decided to replace the privatised builders' warranty insurance market with a government scheme to ensure the provision of adequate and affordable insurance. It will underwrite the scheme from July 2010, replacing existing providers. NSW Treasury will manage the new scheme through the Self Insurance Corporation.

National Disability Scheme

Care and support and related services in Australia for people with disabilities are currently provided predominantly by a combination of an insurance system which provides fully-funded lifetime care benefits for eligible claimants, and a social welfare system comprising a wide range of Commonwealth and State/Territory-based programs. Both systems are in urgent need of reform.

In the case of the insurance system, which covers a range of injuries, the most significant of which are traumatic spinal cord injury and brain injury, there are wide differences in coverage and entitlement across jurisdictions and across causes of injury. Moreover, because much of this insurance is paid in lump sum form, beneficiaries typically pursue further benefits from the wider disability welfare system when their available reserves are extinguished.

In the case of the disability welfare system, Australian governments commit a very large quantum of revenue – approximately $20 billion per annum in total, of which about $8 billion is on community care and support. In spite of this significant budget, there is a large and expanding unmet need for care and support, and also a large volume of unpaid care and support provided by family and other informal carers.

As discussed in the Australia 2020 Summit, there is a view that the most appropriate way to satisfy the requirements of planning, efficiency and positive outcome realisation is through a social insurance type approach.

An increasing number of European economies (where the ageing population is a greater issue) have been moving to this approach over the past decade or two, primarily to formalise the revenue requirements of the welfare system.

In Australia and New Zealand, however, the best indicators of potential success of this approach are available through the funded (partially or fully) accident compensation schemes (workers and motor accident compensation in particular).

The majority of these schemes continue on a path of reform that has been in process over the past twenty years. Characteristics of the reform with respect to care and support of people with major injuries typically include:

- Elimination or severe restriction in the availability of litigation as a pathway to compensation – and replacement with readier admission of eligibility on a "no fault" or "provisional liability" basis;
- Replacement of inappropriate mechanisms of assessing monetary entitlement with mechanisms based on functional need, attached to a personal plan and expectation of mutual obligation and personal outcomes;
- Far more sophisticated governance models, which increasingly consider both financial and service utilisation (prudential governance) but also rehabilitation, health, return to work and other social outcomes of beneficiaries.

It is proposed that a model that is developed from elements of schemes such as these could be applied to the system of care and support for people with disabilities, and could be implemented in a coordinated way as follows:

- Work towards developing a National Disability Scheme over a period of feasibility testing, which would include concept development, detailed analysis, stakeholder communication and structure and governance development;
- As part of this initiative, seek collaboration between the Commonwealth, States and Territories to work towards a comprehensive and national approach to providing care and support for people who sustain catastrophic traumatic injury. Such an approach would encourage modification of existing statutes of worker compensation, motor accident compensation, civil (public) liability (extended to general injury) and medical indemnity (extended to treatment injury).

QLD CTP Scheme review

A review of the QLD CTP scheme is currently being conducted. The scheme was last reviewed in 1999 and legislation requires a review of the scheme every ten years. The scheme review will focus on improving efficiency in the delivery of CTP insurance by ensuring administration and delivery costs are as low as possible, which will in turn benefit motor vehicle owners. The state government has indicated that this review will not examine claimant benefits given that substantial tort reforms have been introduced recently.

The government will be inviting consultation on this review, which is expected to be completed by mid 2010.

Fire Services Levy

The Victorian bushfire in 2009 has highlighted the proportion of properties that were not covered by fire insurance policies. Under the Metropolitan Fire Brigades Act 1958 and the Country Fire Authority Act 1958 (the Acts), insurers providing cover against fire risk in NSW, Victoria and Tasmania are, on a combined basis, required to contribute a set percentage of the annual budget for the states' fire services, called the Fire Services Levy (FSL). The amount payable by each insurer is determined based on the percentage of its premium compared to the premium of all other insurers. The cost of this is typically passed onto policyholders.

Since this levy is dependent on the level of fire risk in an area, insured properties located in the bush are likely to attract significantly higher levies than those in the city. This has discouraged the purchase of cover, causing inequities in the system where those who are insured subsidise the cost of firefighting for those who are uninsured. An estimated one-third of the properties involved in the Victorian Bushfires in 2009 were uninsured.

The Royal Commission into the Victorian Bushfires is considering alternatives to the fire services levy. For example, the removal of the levy in WA seven years ago has led to cheaper insurance and improved resources. In SA introduction of a property-based levy more than 10 years ago ensured all SA residents contribute an equal share to the emergency services.

As a result of the problems experienced in Victoria, the avenue for funding the cost of firefighting in Australia is being considered as part of the Henry review of Australia's tax system.

Catastrophic events

Following the Victorian bushfires in early 2009, the remainder of the year was a fairly benign period for catastrophic events in Australia. The first quarter of 2010 however has seen a number of significant events such as hailstorms in Perth and Melbourne as well as flooding in Queensland. These events have added immensely to the influx of claims and have challenged insurers and reinsurers to factor in the tendency of more extreme weather events in companies' product pricing and modelling of catastrophic losses.

Internet insurers

Over the last few years there have been new entrants to the Australian insurance market that operate purely over the internet, such as Budget Direct, Bingle and more recently Youi and Progressive Insurance. The cost advantage inherent in a business model built around the internet is likely to encourage more insurance providers to use the internet as a direct distribution channel in the future.

1.3 Regulation and supervision

Overview

The general insurance industry is primarily regulated by APRA and ASIC with additional regulation by a range of other bodies such as the ACCC and the ATO. This section provides an overview of the roles of APRA and ASIC. Further details around regulation and policyholder protection can be found at Chapter 6.

Australian Prudential Regulation Authority

APRA is the single Commonwealth authority responsible for licensing and prudential regulation for all general insurance companies. APRA is also empowered to appoint an administrator to provide investor or consumer protection in the event of financial difficulties experienced by general insurance companies.

APRA's powers to regulate and collect data from the 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

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".

Although APRA is responsible for the prudential regulation of insurers, 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).

Since its establishment in 1998, APRA has been working to harmonise the regulatory framework of regulated institutions. The 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.

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;
- provide a risk diagnostic tool; and
- ensure regulated entities are aware of how APRA determines the nature and intensity of their supervisory relationships.

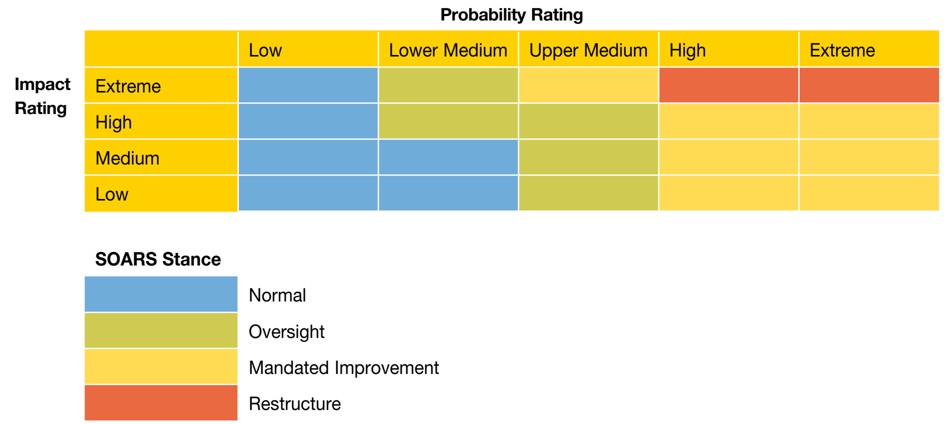
The PAIRS Supervisory Attention Index rises as the probability of failure and the potential impact of failure increase, ranging from "Low" to "Extreme". These ratings are not publicly available, and are used only to identify potential issues and seek remediation before serious problems develop.

Supervisory Oversight and Response System

The Supervisory Oversight and Response System (SOARS) is used by APRA 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 below.

Figure 1.1 – PAIRS and SOARS



Supervision and compliance

APRA achieves its prudential supervision objectives through administering the regulatory framework and monitoring the conduct of licensees through supervisory visits and the receipt from licensees of mandated financial and compliance reporting.

The regulatory framework comprises three tiers:

- **Tier 1** – The Insurance Act contains the high-level principles necessary for prudential regulation;
- **Tier 2** – Prudential standards providing principles based requirements for companies authorised under the Insurance Act; and
- **Tier 3** – Prudential practice guides providing non-binding guidance on prudential good practice and on how best to meet the requirements of the prudential standards.

Licensing

No private sector general insurance company may conduct insurance business in Australia unless authorised under the Insurance Act. Under Section 12 of the Insurance Act, APRA can authorise a body corporate which has applied in writing to carry on an insurance business. 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 appointed 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;
- An actuary's report in accordance with GPS 310;
- 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.

Under Section 29 of the Insurance Act, insurers must publish name changes in the daily press.

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.

A liability is in Australia 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.

As discussed in Section 1.2, a new level of supervision (level 3) has been proposed and is now currently under industry discussion.

The main features of the prudential standards which set out the mandatory elements of the regulatory framework are outlined in Table 1.1.

The standards are supported by the following Prudential Practice Guides, which aim to assist insurers in complying with requirements outlined in the prudential standards as well as outlining prudent industry practices:

- GPG 200 Risk Management;
- GPG 220 Credit Risk;
- GPG 230 Operational Risk;
- PPG 231 Outsourcing;
- GPG 232 Custody Arrangements;
- PPG 233 Pandemic Planning and Risk Management;
- PPG 234 Management of Security Risk in Information and Information Technology
- GPG 240 Insurance Risk;
- GPG 245 Reinsurance Management Strateqy
- GPG 250 Balance Sheet and Market Risk
- GPG 510 Governance;
- PPG 511 Remuneration; and
- GPG 520 Fit and Proper.

Table 1.1 – Summary of current GI prudential standards

Standard	Amended / Effective	Details
Level 1 Prudential Standards		
GPS 001 Definitions	Dec-09	
GPS 110 Capital Adequacy	Jul-08	See Section 1.4
GPS 112 Capital Adequacy: Measurement of Capital	Jul-08	See Section 1.4
GPS 113 Capital Adequacy: Internal Model-based Method	Mar-09	See Section 1.4
GPS 114 Capital Adequacy: Investment Risk Capital Charge	Jul-08	See Section 1.4
GPS 115 Capital Adequacy: Insurance Risk Capital Charge	Jul-08	See Section 1.4
GPS 116 Capital Adequacy: Concentration Risk Capital Charge	May-10	See Section 1.4
GPS 120 Assets in Australia	Jul-08	See Section 1.4
GPS 220 Risk Management	Jul-08	See Section 1.5
GPS 222 Business Continuity Management GGN 222.1 Risk Assessment and Business Continuity Management	Apr-05	See Section 1.5
GPS 230 Reinsurance management	Jul-08	See Section 1.5
GPS 231 Outsourcing	Jul-08	See Section 1.5
GPS 310 Audit and Actuarial Reporting and Valuation	Jul-08	See Section 1.6
GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers	Jul-02	See Section 1.5
GPS 510 Governance	Apr-10	See Section 1.6
GPS 520 Fit and Proper	Jul-08	See Section 1.6
Level 2 Prudential Standards		
GPS 111 Capital Adequacy: Level 2 Insurance Groups	Mar-09	See Section 1.4
GPS 221 Risk Management: Level 2 Insurance Groups	Mar-09	See Section 1.5
GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups	Mar-09	See Section 1.6

Licensing of compulsory insurance classes

While licenses to write most classes of insurance business are provided by APRA, state and territory governments issue licenses to write certain compulsory classes of business, such as:

- Workers compensation; and
- Compulsory third party (CTP).

The status of these lines of business is shown below by state or territory.

Table 1.2 – State and territory regulation of workers compensation and CTP insurance

State/Territory	Workers' compensation	CTP
ACT	Privatised	Monopoly private sector insurer (IAL)
NSW	Privatised administrator; risk borne by State	Privatised
NT	Privatised	Terriroty monopoly
QLD	State monopoly	Privatised
SA	State monopoly with claims managed by licensed private setor insurers	State monopoly with claims managed by licensed private sector insurers
TAS	Privatised	State monopoly
VIC	Privatised administrator; risk borne by State	State monopoly
WA	Privatised	State monopoly

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 Australian Financial Services Licence (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 AFSL.

To obtain a licence, the applicant must meet the obligations under Section 912A and demonstrate that they will provide financial services efficiently, honestly and fairly. Specific provisions under the Corporations Regulations require that financial services licensees have in place the following:

- Documented procedures to monitor, supervise and train representatives;
- “Responsible officers” (senior management responsible for day-to-day business decisions) with minimum standards of knowledge and skills in financial services;
- Adequate resources (financial, technological and human) to provide services covered by the licence. These requirements do not apply to APRA-regulated entities (such as registered insurers), but do apply to any non-APRA-regulated subsidiaries;
- Adequate risk management systems. These requirements do not apply to APRA-regulated entities, but do apply to any non-APRA-regulated subsidiaries;
- Adequate compliance framework (AS3806, the Australian Standard on Compliance Programs, acts as a guide to minimum requirements);
- Internal and external dispute resolution procedures (where dealing with retail clients);
- Adequate compensation requirements (where dealing with retail clients as described in Section 912B). This typically is achieved through membership of a guarantee fund or obtaining professional indemnity insurance cover; and
- Register of representatives, i.e. directors and employees of the insurer and its related bodies corporate, as well as authorised representatives and insurance brokers.

Once ASIC has granted an AFSL pursuant to Section 913B of the Corporations Act, any variations to authorisations and conditions of the licence can be made electronically via the ASIC website.

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

Ongoing notification obligations

Licence holders are required to meet ongoing notification obligations, which include requirements to notify ASIC about:

- Breaches and events;
- Changes in particulars (form F205 for change of name of corporate entities, form FS20 for all others);
- Authorised representatives (forms FS30, FS31, FS32);
- Financial statements and audit (forms FS70 and FS71); and
- Appointment/removal of auditor (forms FS06, FS07, FS08 and FS09).

Section 989B of the Corporations Act also outlines ongoing financial reporting and audit obligations. A licensee is required to prepare and lodge an audited income statement and a balance sheet within four months of the end of its financial year (disclosing entities are required to lodge within three months).

ASIC has released Class Order 06/68 which grants relief to local branches of foreign licensees from preparing and lodging accounts in accordance with Section 989B of the Corporations Act. This relief is only available where the foreign licensee lodges accounts, prepared and audited in accordance with the requirements of its local financial reporting jurisdiction with ASIC once every calendar year.

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.

1.4

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.

GPS 110 Capital Adequacy aims 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. In 2008 a number of changes were made to GPS 110 and GPS 120 with the aim of maintaining consistency between the definition of capital base for the general insurers and ADIs after the introduction of Basel II regime. These changes also aimed at increasing the security of reinsurance recoverables, especially those due from non-APRA authorised reinsurers.

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

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.

GPS 110 Capital Adequacy aims to ensure that 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 (MCR) taking into account the various risks that may threaten its ability to meet policyholder obligations;
- make certain 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 (where Category A to E insurers are defined in GPS 001) 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. 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 GPS120 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

Category/Type of Isurer	Capital buffer	Where MCR is
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

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 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.

Figure 1.2 summarises the calculation of the capital base.

Figure 1.2 – Capital base calculation based on GPS 112 Capital Adequacy: Measurement of Capital

TIER 1 CAPITAL

Fundamental Tier 1 Capital
(must be at least 75% of net Tier 1 Capital)

- Paid up ordinary shares;
- Reserves (excluding asset revaluation reserves);
- Retained earnings;
- Current year after tax earnings less expected dividends;
- Technical provisions in excess of those required by GPS 310;

Plus

Residual Tier 1 Capital

- Non-innovative Residual Tier 1 capital – comprising perpetual non-cumulative preference shares that satisfy the relevant criteria; and
- Innovative Tier 1 capital – comprising all other Residual Tier 1 capital instruments that satisfy the relevant criteria.

Less

Deductions from Tier 1 Capital

+

TIER 2 CAPITAL

Eligible to a maximum of 100% of net Tier 1 Capital

Upper Tier 2 Capital

- perpetual cumulative preference shares;
- perpetual cumulative mandatory convertible notes;
- perpetual cumulative subordinated debt;
- any capital amounts otherwise meeting APRA's requirements for Tier 1 capital instruments that are ineligible for inclusion as Tier 1 capital as a result of the limits in GPS 112;
- any other hybrid capital instruments of a permanent nature approved, in writing, by APRA;
- 45 per cent of pre-tax revaluation reserves of each of the following (subject to certain conditions)
  (i) property not held at fair value; and
  (ii) investments in subsidiaries not held at fair value, other than subsidiaries that APRA deems part of an Extended Licensed Entity (ELE). The amount recognised must be net of any fair value gains and losses and any gains or losses on hedges offsetting revaluations included in reserves; and
- 45 per cent of the post-acquisition reserves of associates as defined in the Australian Accounting Standards.

Plus

Lower Tier 2 Capital

(Must be less than 50% of net Tier 1 Capital)

- Term subordinated debt;
- Limited life redeemable preference shares; and
- Any other similar limited life capital instruments.

=

CAPITAL BASE

Internal model-based method

GPS 113 Capital Adequacy: Internal Model-based method, effective 31 March 2009, 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.

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 relevant investment capital factors for various assets and counterparty grades are listed in Table 1.4 and Table 1.5 respectively and the criteria for different counterparty ratings are set out in Table 1.6.

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

Table 1.4 – Investment capital factors

	Asset	Investment Capital Factor
1	Cash (notes and coins) Debt obligations of: the Commonwealth Government; an Australian State or Territory government; or the national government of a foreign country where: – the security has a Grade 1 counterparty rating; or, if not rated, – the long-term, foreign currency counterparty rating of that country is Grade 1 Assets in respect of anticipated recoveries from the Commonwealth Government or from an Australian State or Territory government GST receivables (input tax credits)	0.5%
2	Any debt obligation that matures or is redeemable in less than one year with a counterparty rating of Grade 1 or 2 (excluding subordinated debt and debt obligations of government dealt with specifically in this Table) Cash management trusts with a counterparty rating of Grade 1 or 2	1%
3	Any other debt obligation (that matures or is redeemable in one year or more) with a counterparty rating of Grade 1 or 2 (excluding subordinated debt and debt obligations of government dealt with specifically in this Table) Reinsurance assets due from APRA-authorised reinsurers with a counterparty rating of Grade 1 or 2 (subject to any determination by APRA under paragraph 13 of GPS 114)	2%
4	Reinsurance assets due from non-APRA-authorised reinsurers with a counterparty rating of Grade 1 or 2 except for reinsurance recoverables specified under paragraph 5 of Attachment A of GPS 114	3%
5	Unpaid premiums due less than 6 months previously (subject to any determination by APRA under paragraph 13 of GPS 114) Unclosed business Any other debt obligation with a counterparty rating of Grade 3 (excluding subordinated debt) Reinsurance assets due from APRA-authorised reinsurers with a counterparty rating of Grade 3 (subject to any determination by APRA under paragraph 13 of GPS 114) Cash management trusts with a counterparty rating of Grade 3	4%
6	Any other debt obligation with a counterparty rating of Grade 4 (excluding subordinated debt) Reinsurance assets due from APRA-authorised reinsurers with a counterparty rating of Grade 4 (subject to any determination by APRA under paragraph 13 of GPS 114) Reinsurance assets due from non-APRA-authorised reinsurers with a counterparty rating of Grade 3 except for reinsurance recoverables specified under paragraph 5 of Attachment A of GPS 114 Cash management trusts with a counterparty rating of Grade 4	6%
7	Any other debt obligation with a counterparty rating of Grade 5 (excluding unlisted subordinated debt) Reinsurance assets due from APRA-authorised reinsurers with a counterparty rating of Grade 5 Unpaid premiums due more than 6 months previously Cash management trusts with a counterparty rating of Grade 5 Listed subordinated debt	8%

	Asset	Investment Capital Factor
8	Reinsurance assets due from non-APRA-authorised reinsurers with a counterparty rating of Grade 4 except for reinsurance recoverables specified under paragraph 5 of Attachment A of GPS 114	9%
9	Unlisted subordinated debt	10%
10	Reinsurance assets due from non-APRA-authorised reinsurers with a counterparty rating of Grade 5 except for reinsurance recoverables specified under paragraph 5 of Attachment A of GPS 114	12%
11	Listed equity instruments Listed trusts except where otherwise provided for in Attachment A of GPS 114	16%
12	Direct holdings of real estate Unlisted equity instruments Unlisted trusts except where otherwise provided for in Attachment A of GPS 114 Other assets not assigned an Investment Capital Factor elsewhere in this Table (other than hybrid instruments with both equity and debt features (see paragraph 3 of Attachment A of GPS 114)	20%
13	Loans to directors of the insurer or directors of related bodies corporate (or a director's spouse) Unsecured loans to employees exceeding $1,000 Assets under a fixed or floating charge (refer to paragraphs 27 to 28 of GPS 114)	100%
14	Amounts required to be deducted from an insurer's capital base under Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital Amounts recorded on the balance sheet in relation to instruments subject to paragraphs 39 to 54 of GPS 114	0%

Source: APRA, Attachment A of GPS 114

Table 1.5 – Investment capital factors for reinsurance recoverables due from non-APRA authorised reinsurers

Counterparty Grade	Investment Capital Factor
1	20%
2	40%
3	60%
4	100%
5	100%

Source: APRA, Attachment A of GPS 114

Table 1.6 – Counterparty grades

Grade	Standard & Poor's	Moody's	AM Best	Fitch
1	AAA	Aaa	A++	AAA
2	AA+ AA AA-	Aa1 Aa2 Aa3	A+	AA+ AA AA-
3	A+ A A-	A1 A2 A3	A A-	A+ A A-
4	BBB+ BBB BBB-	Baa1 Baa2 Baa3	B++ B+	BBB+ BBB BBB-
5	BB+ or below	Ba1 or below	B or below	BB+ or below

Source: APRA, Attachment B of GPS 114

Note: Unrated assets or exposures must be classified as Grade 4.
Refer to GPS 114 for more details on the counterparty ratings.

Insurance risk capital charge

GPS 115 sets out the calculation of the Insurance Risk Capital Charge under the Prescribed Method for 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 a different outstanding claims liability is more appropriate for statutory reporting purposes.

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

The relevant factors for direct insurance and reinsurance are listed in Tables 1.7 and 1.8 respectively.

Table 1.7 – Insurance risk capital factors – Direct insurance

Class of business	Outstanding Claims Risk Capital Factor	Premium Liability Risk Capital Factor
Householders Commercial Motor Domestic Motor Travel	9%	13.5%
Fire and ISR Marine and Aviation Consumer Credit Mortgage Other Accient Other	11%	16.5%
CTP Public and Product Liability Professional Indemnity Employers' Liability	15%	22.5%

Source: APRA, Attachment A of GPS 115

Table 1.8 – Insurance risk capital factors – Inwards reinsurance

Class of business	Outstanding Claims Risk Capital Factor	Premium Liability Risk Capital Factor
Property		
• Facultative Proportional	9.0%	13.50%
• Treaty Propotional	10.0%	15.0%
• Facultative Excess of Loss	11.0%	16.50%
• Treaty Excess of Loss	12.0%	18.0%
Marine & Aviation		
• Facultative Proportional	11.0%	16.50%
• Treaty Propotional	12.0%	18.00%
• Facultative Excess of Loss	13.0%	19.50%
• Treaty Excess of Loss	14.0%	21.00%
Casualty		
• Facultative Proportional	15.0%	22.50%
• Treaty Propotional	16.0%	24.00%
• Facultative Excess of Loss	17.0%	25.50%
• Treaty Excess of Loss	18.0%	27.00%

Source: APRA, Attachment A of GPS 115

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 for calculating MCR. The concentration risk capital charge is equivalent to the maximum event retention (MER) after taking into account acceptable reinsurance arrangements less the cost of one reinstatement premium for those reinsurance arrangements.

Lenders mortgage insurance (LMI)

There are specific requirements for the concentration risk capital charge calculation for lenders mortgage insurers (LMI). Attachment A of GPS 116 sets out the method of calculating MER for LMIs.

The basic model for calculating the MER charge for LMI involves the following:

- The model is based on the hypothesis of a three-year downturn in the housing market;
- The probabilities of default to be applied allow for a three-year horizon. These vary by loan-to-value ratio (LVR) and have been calibrated to create a stressed scenario of "catastrophic" loss that would happen once in every 250 years. The probability of claim in year two is calibrated to be twice that in year one and three (based on the "head- and- shoulders" scenario that is generally observed during periods of economic stress);
- The losses given default to be applied are allowed to vary with the LVR;
- The seasoning factors allow for the age of the loans;
- Additional capital penalties will be applied to non-standard loans, top cover or pool cover;
- Available reinsurance recoveries over the three years can be recognised. Various constraints have been imposed in determining the extent to which recoveries can be recognised; and
- An allowance for claims handling expenses has been made.

Note that ADIs are only able to claim capital concessions if mortgage insurance is provided by "acceptable" LMIs as defined by APRA. In general, "acceptable" LMIs are those authorised by APRA. For overseas subsidiaries of Australian ADIs, APRA will accept the host supervisors' requirements on what constitutes an acceptable LMI in those jurisdictions. These requirements are set out in Attachment C of APS 112 Capital Adequacy: Standardised Approach to Credit Risk.

APRA has amended Attachment A of GPS 116 and the corresponding reporting standard GRS 170.1 'Maximum Event Retention and Risk Charge for Lenders Mortgage Insurers'. The amended standards are effective from 1 May 2010. The amendments aim to reduce the prescriptive approach in GPS 116 Attachment A relating to the calculation of allowable reinsurance in the MER calculation for LMI. Instead a principles-based approach to the calculation of allowable reinsurance has been taken. The revisions are not intended to change the foundations on which the MER for an LMI is based or to materially alter the level of capital required by the LMI industry. Overall, the process will have minimal impact on the LMI industry.

The proposals taking effect from 1 May 2010 are:

- Reinsurance principles – APRA will implement its proposed principles-based approach to the calculation of allowable reinsurance.
- Capitalised premium – APRA has reiterated that capitalised premium should be included in the loan-to-valuation ratio (LVR) calculation for PML purposes, irrespective of whether or not the premium is insured.
- PML for pooled policies – APRA has clarified the calculation of PML for pooled policies as well as a number of other definitions in the prudential standard.
- Reinsurance cover for new business – APRA will not require an LMI to include new business in the calculation of PML. Instead, APRA requires that an LMI describe in detail in its Reinsurance Management Strategy (REMS) how it will manage its future reinsurance needs and the mitigants it has in place for risks in relation to future reinsurance arrangements.

Level 2 Insurance Groups

Under the prudential standard 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 capita.

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 were the surplus capital of the group can be held;
- 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, 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. These are detailed in Tables 1.5 and Table 1.6. 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.

1.5 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 has released the following non-binding prudential practice guides (GPG 200 – GPG 520).

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;
- 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 Declaration (RMD)

The board of a general insurer is required to submit a RMD to APRA stating that:

- it has systems in place for the purpose of ensuring compliance with the Insurance Act, the Financial Sector (Collection of Data) Act, and the regulations, prudential standards reporting standards, authorisation conditions, directions and any other requirements imposed by APRA, in writing;
- the board and senior management are satisfied with the efficacy of the processes and systems surrounding the production of financial information at the insurer;
- here is an RMS in place that sets out its approach to risk management, which was developed in accordance with the requirements of GPS 220;
- there is a Reinsurance Management Strategy (REMS) in place for selecting and monitoring reinsurance programs, which was developed in accordance with GPS 230;
- over the last financial year, the insurer has substantially complied with its RMS and REMS obligations and that these strategies are operating effectively in practice, having regard to the risks they are designed to control; and
- copies of the insurer's current RMS and REMS have been lodged with APRA.

This declaration is to be signed by two directors (or the senior officer if a branch) and is due within four months of the financial year-end. If this declaration contains any qualifications, the deviation from the risk management framework should be disclosed, as well as any mitigating factors or steps taken to rectify.

Financial Information Declaration (FID)

An insurer is required to submit an FID to APRA on or before the day that the annual statutory accounts are required to be submitted to APRA. The FID must be signed by the CEO and CFO, stating that:

- the financial information lodged with APRA by the insurer has been prepared in accordance with relevant legislation, prudential standards and any other mandatory professional standard and is accurate and complete;
- the information provided to the Appointed Auditor and Appointed Actuary is accurate and complete.

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 GPS221 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 responsiblities 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 rather than focusing just on data recovery. The standard expects that this “whole of business” approach and the BCM itself should be commensurate with the nature and scale of the entity.

Key requirements of the prudential standard 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 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. These systems, together with the structures, processes, policies and roles supporting them, are referred to as a general insurer's risk management framework. There must be a clear link between this framework and the insurer's Reinsurance Management Strategy (REMS).

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" and submits the declaration to APRA.

The concepts above; reinsurance management framework, REMS, RAS, RD and the "two-month" and "six-month" rules are explained below.

Reinsurance Management Framework and REMS

The reinsurance management framework should include both reinsurance and retrocession arrangements and have a clear link to the risk management strategy. It should include clearly defined management responsibilities and controls, policies and procedures to manage the selection, implementation, monitoring, review, amendment and documentation of reinsurance arrangements of the general insurer, and a written, board approved REMS.

The REMS should document the objectives and strategy for reinsurance management including the risk appetite of the general insurer, the policies for setting and monitoring aggregate retentions and upper limits on policies, the methods for choosing appropriate reinsurance participants and the process used for setting and monitoring the MER. Members of global groups are expected to provide details of global reinsurance arrangements. The GPG 245 Reinsurance Management Strategy specifies that Category D insurer and Category E insurer should target to cede no more than 90% of their premium and for the other insurers the limit is 60%.

The general insurer is also required to have this 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.

Reinsurance Arrangements Statement (RAS)

General insurers are required to submit a RAS. The RAS provides evidence of the implementation of the REMS and details:

- schematics of the insurer's reinsurance program that depict retention levels, aggregate deductibles, policy layers, stop-loss policies, reinstatements, loss participation clauses and event limit clauses;
- the parameters for each class of business that represent the highest potential loss exposure and how the program reduces the gross loss to the general insurer;
- details of the MER calculation including modelling of catastrophes, PML and realistic disaster scenarios; and
- details of Limited Risk Transfer Arrangements, including those that have not been approved by APRA.

If the reinsurance program has a common date of renewal then this statement is due annually within two months of the renewal date. If there are multiple inception dates then this statement must be submitted to APRA every six months.

Reinsurance Declaration (RD)

General insurers are also required to submit an annual RD to APRA on the same day that the yearly statutory accounts are due. This declaration must be signed by both the CEO and the chief reinsurance officer (CRO) and state that all reinsurance arrangements placed are "legally binding" under either APRA's "two-month" rule or "six-month" rule.

If there are any reinsurance arrangements in place that do not meet the requirements of the "two-month" rule or "six-month" rule then they should be disclosed on the declaration. Recoveries arising from these arrangements will not be eligible for inclusion as Tier 1 Capital (thus reducing the insurer's capital adequacy) subject to transition rules described in attachment H to GPS 110.

The “two-month” and “six-month” rules

The “two-month” rule states that within two months of the inception date, the general insurer either:

- has a placing slip pertaining to the reinsurance arrangements that has been signed and stamped by all participating reinsurers and contains a slip wording, with no outstanding terms or conditions to be agreed; or
- has a placing slip pertaining to the reinsurance arrangements that has been signed and stamped by all participating reinsurers, with no outstanding terms or conditions to be agreed; or
- does not have a placing slip, but has a cover note issued by the participating reinsurer (in the case of direct placements with reinsurers) or from its appointed reinsurance broker (in the case of intermediated reinsurance placements). The insurer also must have systems to verify that the content of the cover note is the same as the placing slip agreed between the insurer and the reinsurer.

The “six-month” rule requires that within six months of the inception date, the general insurer either:

- has a placing slip pertaining to the reinsurance arrangements that has been signed and stamped by all participating reinsurers and contains a slip wording, with no outstanding terms or conditions to be agreed; or
- has in its possession a full treaty contract wording (including any appending contract wordings and/or schedules) that has been signed and stamped by all contracting parties, namely the insurer and all participating reinsurers.

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;
  - 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.

Government schemes to limit gross exposure

Medical indemnity insurance

Two schemes cover doctors with medical indemnity insurance, the High Cost Claims Scheme (HCCS) and the Exceptional Claims Scheme (ECS).

HCCS aims to minimise the impact that large claims may have on the ability of medical indemnity insurers to provide cover. It covers half the cost of each medical indemnity claim over $300,000, up to a cost of $20 million per claim.

ECS assumes liability for 100 per cent of any damages payable against a doctor that exceed the doctor’s insurance contract limit. The doctor must have medical indemnity insurance cover to at least $20 million for claims notified from 1 July 2003. The ECS will cover the same events and incidents as the doctor’s insurance policy, but will not cover claims from the treatment of public patients in public hospitals or claims from the treatment of patients overseas.

Terrorism insurance

The Terrorism Insurance Act 2003 rendered terrorism exclusion clauses ineffective and established the Australian Reinsurance Pool Corporation (ARPC) to manage a scheme for terrorism insurance coverage for commercial property, business interruption and public liability businesses.

The scheme was introduced in response to the progressive withdrawal of cover by insurers and reinsurers in the aftermath of the 11 September 2001 terrorist attacks. The scheme began on 1 July 2003 and covers any declared terrorist incident, except damage from nuclear causes. Various types of coverage are also excluded.

There is a two-tier reinsurance premium structure under the scheme. Insurance companies pay an initial standard rate (based on the class of business covered and geographical location of the property). This has built up a $300 million pool of funds.

There is a maximum post-terrorism event rate (again based on the class of business covered and geographical location of the property) for replenishing the scheme in the event of a major incident. The $300 million pool will be supplemented by another $10 billion from the Australian Government. Insurance companies must retain $1 million of claims cost per annum when reinsuring with the ARPC.

1.6 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.

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.

In 2003, APRA began a process of "targeted reviews" of general insurers, similar to the process it had implemented with the authorised deposit-taking institutions.

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.

The last targeted review focused on Reinsurance documentation was carried out during 2006/07 and the report was issued by APRA in May 2008.

Governance

GPS 510 Governance sets out what APRA consider to be 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 arrangements in place will vary from entity to entity depending on the size, complexity and risk profile of each entity.

In November 2009, APRA released a paper on "Remuneration: Extensions to governance requirements for APRA – regulated institutions". The paper covers prudential standards on governance and an associated prudential practice guide (PPG), dealing with remuneration. The revised governance standards came into effect on 1 April 2010.

APRA's approach to governance remains unchanged in most respects but some requirements have been modified. The key modifications are:

- narrowing the group of 'responsible persons' for whom the Board Remuneration Committee must make individual recommendations to the Board;
- removing the requirement that the Board of a foreign branch approve the Remuneration Policy. Instead, the senior officer outside Australia with delegated authority from the Board may approve the Remuneration Policy;
- clarifying in the PPG that basing the remuneration of risk and financial control executives on the performance of the institution is acceptable where there are proper safeguards to ensure that the integrity of their functions is not compromised; and
- excluding contractual arrangements with third parties from the coverage of the Remuneration Policy where the risk from incentive payments is explicitly addressed in the institution's risk management framework and overseen by another Board Committee.

The key requirements, including the amendments, 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. 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.

1.7 Financial reporting

Accounting standards

Australian general insurers are required to prepare financial statements that comply with the Australian Accounting Standards (AASB). Specific AASBs 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 general reinsurance contracts) that a general insurer issues and to general 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 AASBs applicable to these transactions or balances.

Key accounting issues dealt with by AASB 1023 and summarised in this chapter include:

- Definition of insurance risk;
- Definition of an insurance contract;
- Definition of premium revenue and earning pattern;
- Measurement of outstanding claims;
- Explicit risk margins;
- Fair value accounting of investments backing general insurance liabilities;
- Deferral of acquisition costs and liability adequacy testing for unearned premiums;
- Accounting for inwards reinsurance;
- Portfolio transfers within a group;
- Non-insurance contracts; and
- Financial statement disclosure principles and requirements

Definition of an insurance contract

AASB 4 and AASB 1023 include a 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.

Insurance risk is risk other than financial risk. 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 treated under AASB 139, to the extent that it gives rise to a financial asset or financial liability.

Definition of premium and earning pattern

AASB 1023 clarifies the measurement of premium revenue. Premium revenue comprises premiums from direct business (including underwriting pools written by the entity) and premiums from reinsurance business (including underwriting pools written by other members of the pool). They cover 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 the Goods and Services Tax (GST) effectively represent 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 accumulate to enable payment of 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 (CTP) and workers compensation) where a high proportion of such claims are settled outside a 12-month period.

AASB 1023 requires that the discount rate or rates selected should 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”.

The standard requires that expected future payments should 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.

Regulatory valuation

GPS 310 sets out the requirements for the valuation of the insurance liabilities for regulatory reporting. Where an insurer's board decides not to accept the appointed actuary's valuation of insurance liabilities or to adopt a valuation (higher or lower) not in accordance with the principles of this standard, details should be included in the insurer's published annual financial report.

For the main differences in treatment between financial reporting and APRA regulatory reporting, see Table 4.5.

Explicit risk margins

As noted above, 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. For outstanding claims, since the risk margin is applied to the net liability, 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

Under AASB 139 Financial Instruments: Recognition and Measurement financial assets may only be designated as at fair value through profit or loss when doing so results in more relevant information because either:

- it eliminates or significantly reduces an accounting mismatch that would arise from measuring assets or liabilities (or recognising the gains and losses on them) on different bases; or
- the instrument forms part of a group of financial assets and/or financial liabilities 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.

For insurers the first reason for designation is the most often cited because of the requirement to manage their assets backing insurance liabilities on a fair value basis under AASB 1023.

Note that this does not affect the treatment of those financial assets that are classified as held for trading (i.e. acquired principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio for which there is evidence of recent short-term profit taking) as these are automatically designated as fair value through profit and loss.

Deferral of acquisition costs and liability adequacy test for unearned premium

AASB 1023 requires that 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 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 exceed the unearned premium liability less related intangible assets and related deferred acquisition costs, then the entire deficiency shall be recognised, first by writing down any intangible assets and then DAC. If additional liability is required it is recognised as an unexpired risk liability.

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.

Inwards reinsurance

AASB 1023 requires that inwards reinsurance business should be accounted for in line with the general principles established for direct business. Essentially, the standard requires companies underwriting inwards reinsurance to take responsible steps 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 described above are referred to as non-insurance contracts. Financial assets and liabilities arising from such contracts are to be treated according to AASB 139.

Similarly to assets backing insurance liabilities described above, the financial assets and liabilities arising from non-insurance contracts are required by AASB 1023 to take the fair value option under AASB 139, where this is permitted.

Portfolio transfers within a group

Where the responsibility in relation to claims on transferred insurance business remains with the transferring insurer, the transfer shall be treated as reinsurance. As such, the acquiring insurer agrees to meet the claims. However, the contractual responsibility of the original insurer remains.

Disclosure requirements

AASB 1023 incorporates extensive additional disclosures in respect of accounting policies, sensitivities to key assumptions, risk exposures and risk management. The key disclosure requirements are summarised below.

The income statement should include:

- The underwriting result (net premium less net claims and underwriting expenses).
- Net claims incurred (showing gross undiscounted, reinsurance recoveries undiscounted, the effect of discounting and a split of risks borne in the current period and reassessment of old risks).
- Any deficiency arising from LAT (showing write down of DAC, write down of intangibles and additional unexpired risk provision recognised).

Balance sheet disclosures should include:

- Outstanding claims liability (quantifying central estimate and risk margin).
- Risk margin (including the percentage applied, probability of adequacy it achieves and process used to determine it).
- Process used for determining assets backing insurance liabilities.
- Non-insurance contracts (nature of contracts and assets, liabilities, income, expense and cash flows arising from them).
- Segmental information (per AASB 114 Segmental Reporting, geographical split based on location of the insured risks).

Other disclosures include:

- Accounting policies.
- Assets, liabilities, income, expense and cash flows arising from insurance contracts.
- Gains and losses recognised on buying reinsurance.

Key assumptions (quantification and process used to determine them):

- Effect of changes in assumptions (including quantification of impact of each material assumption change).
- Reconciliations of changes in insurance liabilities and related items.
- Risk management objectives and policies for mitigating risk.
- Description of insurance risk pre and post mitigation via reinsurance.
- Sensitivity of profit and equity to changes in variables in respect of insurance risks.
- Concentrations of insurance risk.
- Claims development (showing development of claims estimates, goes back to date of loss of any material claim that still has uncertainty over the amount and timing of the cash flow, not greater than 10 years).
- Terms and conditions of material insurance contracts.
- Information in respect of interest rate risk and credit risk.
- Exposures to interest rate risk or market risk under embedded derivatives.

Interaction with regulatory reporting

Additionally, GPS 110 Capital Adequacy for General Insurers requires the following to be disclosed in respect of capital adequacy in the financial statements:

a. The amount of eligible Tier 1 Capital, with separate disclosure of each of the components of capital specified in GPS 112;
b. The aggregate amount of any deductions from Tier 1 Capital;
c. The amount of eligible Tier 2 Capital, with separate disclosure of each of the components of capital specified in GPS 112;
d. The aggregate amount of any deductions from Tier 2 Capital;
e. The total capital base of the insurer derived from the items (a) to (d) above;
f. The minimum capital requirements (MCR) of the insurer; and
g. The capital adequacy multiple of the insurer (item (e) divided by item (f)).

APRA yearly statutory accounts

The yearly statutory accounts, which must be audited, are required for periods ending 30 June 2010 and prior to be prepared on a different basis than the financial statements prepared in accordance with the Corporations Act and Australian accounting standards. The key differences are outlined in the following table:

Table 1.9 – Key differences in treatment between financial and prudential reporting

Item	AASB 1023 treatment	APRA treatment	Adjustment required
Premiums (including unclosed business)	Earned over the life of the policy based on the pattern of risk and LAT, providing for premium deficiency	Recognised as income at policy attachment date	Write back movement in unearned premiums
Acquisition costs (including fire brigade charges)	Costs are deferred and amortised over the period of benefit (i.e. premium earning)	Recognised on an as-incurred basis	Write back movement in DAC
Reinsurance expense	Recognised on a basis consistent with the pattern of reinsurance	Recognised as an expense at policy attachment date	Write back movement in deferred reinsurance
Claims	Includes estimating expected claims (IBNR) on earned premiums	Includes estimating expected claims on written premiums	Increase liability for outstanding claims by expected losses on unexpired period of policies (premium liabilities). Adjust for differences in assumptions on discount rate and level of risk margins
Recoveries (reinsurance and other)	Includes estimating expected recoveries on outstanding claims	Includes estimating expected recoveries on outstanding claims and premium liabilities	Increase asset for expected recoveries consistent with change in liability for outstanding claims and premium liabilities
Tax	Liability method	Liability method	The adjustments above must be tax effected

APRA released a discussion paper on 3 December 2009 titled "Proposed changes to the general insurance prudential reporting". The aim of the proposed changes to the general insurance reporting arrangements is to align reporting requirements with the Australian Accounting Standards from 1 July 2010 and to obtain information which is more effective for assessing the financial performance of general insurers. The main changes proposed were to the treatment of unearned premium, deferred acquisitions costs and reinsurance expenses to be in line with AASB accounting treatment. While this will ensure the APRA balance sheet and income statement are aligned with those under AASB 1023, there will be no capital charge impact of these changes on these balances as they are not used in the capital calculation. APRA also proposes that bound but not incepted (BBNI) policies will not be reported under the proposed changes.

APRA prudential standards stipulate that for prudential reporting purposes, an insurer must:

- discount insurance liabilities using Commonwealth Government bond rates; and
- include a prudential margin so as to achieve 75 per cent probable adequacy of insurance liabilities and not less than half the coefficient of variation.

For some insurers, this may result in differing treatments for prudential and financial reporting purposes. In this case, the standards indicate that disclosure of the differing treatments should be included in the published financial statements.

The two accounting frameworks are reconciled within the audited APRA yearly statutory accounts forms. The yearly statutory accounts forms and their instructions can be found on the APRA website **www.apra.gov.au**

Other financial reporting with the APRA yearly statutory accounts

In addition to the yearly statutory accounts, the general insurer must also provide APRA with:

- 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.

An overview of these additional reporting requirements is discussed in the following pages.

Financial information declaration

The FID must state that:

- The financial information lodged with APRA has been prepared in accordance with the Insurance Act, regulations, prudential standards, the Collection of Data Act 2001, accounting standards and other mandatory professional reporting requirements in Australia, to the extent that the accounting standards and professional reporting requirements do not contain any requirements contrary to the aforementioned legislative and prudential requirements;
- The information provided to the Appointed Auditor and appointed actuary for the purpose of enabling them to undertake their roles and responsibilities is accurate and complete, consistent with the accounting records of the insurer, and a true representation of the transactions for the year and the financial position of the insurer; and
- The financial information lodged with APRA is accurate and complete, consistent with the accounting records, and represents a true and fair view of the transactions for the year and the financial position.

This declaration is to be signed by the chief executive officer (CEO) and the chief financial officer (CFO), or local equivalents for a branch operation, and is due within four months of the financial year-end.

Any qualifications must include a description of the cause and circumstances of the qualification, and the steps taken, or proposed to be taken, to remedy the problem.

Appointed Auditor's opinion

The Appointed Auditor must prepare a certificate, addressed to the board of the general insurer, in respect of the insurer's yearly statutory accounts.

The certificate must specify whether, in the Appointed Auditor's opinion, the yearly statutory accounts of the general insurer present a true and fair view of the results of the operations for the year and financial position at year-end, in accordance with:

- The provisions of the Insurance Act and prudential standards, the Collection of Data Act and reporting standards; and
- To the extent that they do not contain any requirements that conflict with the aforementioned, Australian accounting standards and other mandatory professional reporting requirements in Australia.

In preparing the certificate, the Appointed Auditor must have regard to relevant professional standards and guidance notes issued by the Auditing and Assurance Standards Board (AUASB), to the extent that they are not inconsistent with the requirements of the prudential standard.

Appointed Actuary's insurance liability valuation report

GPS 310 Audit and Actuarial Reporting and Valuation specifies the contents and the requirements of the ILVR. These are summarised as follows:

- The report must be addressed to the board of the insurer and provide the appointed actuary's advice in respect of the value of the insurer's insurance liabilities, determined in accordance with GPS 310;
- The report must, in respect of each class of business underwritten by the insurer (or in abbreviated details for classes that are immaterial), provide:
  - The value of the insurance liabilities;
  - The assumptions used in the valuation process and the justifications of these assumptions;
  - The availability and appropriateness of the data;
  - Significant aspects of recent experience;
  - The methodologies used to model the central estimates of outstanding claims liabilities and premium liabilities;
  - An indication of the uncertainty in the central estimate, including statistics such as the standard deviation;
  - The results of the sensitivity analyses undertaken;
  - A description of the probability distributions and parameters, or approaches adopted to estimate uncertainty; and
  - Risk margins that relate to the inherent uncertainty in the central estimate values for outstanding claims liabilities and premium liabilities; and
- The report must provide sufficient information in relation to the assumptions and methods used for the valuation liabilities so that another actuary reading the report can obtain a sound understanding of the valuation process and results, limitations and key risks in the insurance portfolio; and
- The report must be prepared by the appointed actuary and be subject to an independent peer review.

When an insurer does not adopt the value of the insurance liabilities recommended by the appointed actuary, the insurer must notify APRA in writing, and should include within its published annual financial statements:

- The reasons for not accepting the appointed actuary's advice, or for not determining the insurance liabilities in a manner consistent with GPS 310; and
- Details of the alternative assumptions and methodologies used for determining the value of the insurance liabilities.

Appointed Actuary's financial condition report

Under GPS 310, the appointed actuary must prepare an annual FCR. This report must be filed with APRA at the same time or before lodgement of the yearly statutory accounts.

The FCR must be addressed to be the Board of the insurer and provide the appointed actuary's objective assessment of the overall financial condition of the insurer. APRA requires that in preparing an FCR, an appointed actuary must have regard to relevant professional standards issued by the IAA, to the extent that they are not inconsistent with the requirements of GPS 310. The relevant professional standard for this purpose is General Insurance Standard 305 Financial Condition Reports for General Insurance.

In accordance with GPS 310 and professional standard 305, the FCR must include or show consideration for the following:

- Statements by the appointed actuary, setting out who commissioned the actuarial reporting, the scope and purpose of the FCR, the specified terms of reference and any limitations or restrictions placed upon the actuary;
- Information requirements, including identification of the information upon which the appointed actuary placed material reliance in preparing the FCR, the limitations of the FCR as a result of material data discrepancies, and any other data reliances and limitations;
- Business overview;
- Assessment of the insurer's recent experience and profitability, including at least the experience during the year ending on the valuation date;
- Summary of the key results of the ILVR (prepared in accordance with GPS 310);
- Assessment of the adequacy of past estimates for insurance liabilities (may include references to the current or past ILVRs);
- Assessment of the asset and liability management, including the insurer's investment strategy;
- Assessment of pricing, including adequacy of premiums;
- Assessment of the suitability and adequacy of reinsurance arrangements;
- Assessment of the suitability and adequacy of the risk management framework;
- Assessment of capital management and capital adequacy.

The appointed actuary is required to consider the future implications and outlooks of the above matters. If the implications are adverse, the appointed actuary must propose recommendations to address the issues.

As a general rule, an FCR must be completed in respect of each insurer. An insurance group may submit to APRA an FCR in respect of the insurance group where the appointed actuary completing the FCR is the appointed actuary for each insurer included in the FCR or it is practical to produce a single over-arching FCR. If the single FCR does not adequately address each of the above issues for any single insurer, APRA may require one or more insurers in the group to prepare and submit to APRA a new FCR.

Foreign insurers must prepare an FCR in respect of their Australian branch operation.

Independent peer review

Under GPS 310, the general insurer must arrange for an independent 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 lodgement 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.

Items to be reviewed by the external peer reviewer include:

- Scope – Consideration of the appropriateness of the scope of the primary actuary's specified valuation and of the actuarial advice provided in relation to it;
- Data – Consideration of the sources of data, whether appropriate and sufficient data inputs have been used, and that the quality of these have been checked by the primary actuary or the personnel employed to support the primary actuary;
- Valuation methods – Consideration as to whether the methods chosen are suitable in the circumstances and within the range of reasonable current practice, and whether their application has been appropriate;
- Assumptions – Consideration as to whether assumptions are consistent with experience investigations, industry trends and reasonable judgement;
- Controls – Consideration as to whether appropriate quality assurance reviews and controls are in place;
- Analysis of specified valuation results – Consideration as to whether results have been developed following a reasonable sequence of steps; that there is consistency within the results; and that changes in the results from one year to the next have been adequately explained;

- Specified valuation results – Consideration as to whether results have been clearly stated, that they are supported by the experience and any reasonableness tests undertaken have been identified in the primary actuary's report. Consideration must also be given as to whether the reliances and limitations of the primary actuary have been clearly stated; and
- Standards – The reviewing actuary must consider whether the work complies with applicable legislation, including regulations and subordinate legislation, relevant professional standards and takes regard of guidance notes with appropriate disclosures.

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 reduce the volatility through the insurance cycle, as insurers will have access to more information to assess the risks more precisely.

Key dates

Financial Sector (Collection of Data) Act

Lodgement of returns

- Quarterly forms (GRF 110.0 – 310.3*)
  Within 20 business days of the end of each quarter.

  * These forms may be subject to review as part of the work performed by the Appointed Auditor under GS 004 Audit Implications of Prudential Reporting Requirements for General Insurers.

- Annual forms and report (GRF 110.0 – 450.0), [only GRF 110.0 – 320.0 are audited] including 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 appointed by 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.

1.8 Taxation

General developments

The Government has continued with ambitious plans for significant tax reform. The comprehensive review of Australia's tax system, otherwise known as the Henry Review has been completed and the final report released to the public on 2 May 2010 together with the Government's response. Despite the 138 recommendations in the Henry Report, the Government has only made a handful of announcements, although there may be further announcements in the May budget.

The Government proposes to reduce the company income tax rate from 30 per cent to 29 per cent for the 2013-2014 income year and to 28 per cent from the 2014-2015 income year and introduce certain changes to the superannuation system including a staged increase in the Superannuation Guarantee payment from 9 per cent to 12 per cent. These initiatives are to a large extent funded by the Resource Super Profits Tax of 40 per cent.

One of the insurance specific recommendations in the Henry Report is the abolition of specific taxes on insurance products, including stamp duties and fire service levies, which is consistent with the recommendations in the "Australia as a Financial Centre: Building on our Strengths" report released by the Australian Financial Centre Forum. The Government has not ruled out this recommendation, although any changes will need agreement from the State Governments.

Some other key tax developments during the year are listed below.

- A rewrite of the existing general insurance provisions within Schedule 2J of the Income Tax Assessment Act 1936 has been proposed, by repealing the existing provisions and reproducing its effect in new Division 321 of the Income Tax Assessment Act 1997. Treasury has confirmed that the policy intentions of the existing provisions will remain the same in the proposed legislation.
- The new Taxation of Financial Arrangements (TOFA) measures which provide a comprehensive regime for the tax treatment of gains and losses arising from financial arrangements have been legislated. The TOFA measures will apply to eligible taxpayers for the income year beginning on or after 1 July 2010 unless the taxpayer chooses to have the rules apply for income years beginning on or after 1 July 2009 (i.e. the "early adopt" election). Taxpayers have a choice as to how TOFA will apply to their financial arrangements.
- New tax consolidation measures were introduced into Parliament on 10 February 2010 to refine the existing rules. Some of the relevant changes proposed include modification of certain cost setting rules for general insurance companies joining or leaving a consolidated group and clarification of the income tax treatment of rights to future income
- The Federal Government has proposed a reform of Australia's foreign source income anti-tax deferral (attribution) rules. The proposal includes a rewrite of the Controlled Foreign Companies (CFC) rules and the repeal of the Foreign Investment Fund (FIF) rules. The FIF rules will be replaced with a specific, narrowly defined anti-avoidance rule that applies to offshore accumulation or roll-up funds.
- The new International Dealings Schedule - Financial Services 2010 (the IDS-FS 2010) was released by the Australian Taxation Office ("ATO"). The IDS-FS 2010 is the ATO's newly proposed tax return schedule for large (> $250m turnover) financial services taxpayers to replace the Schedule 25A and Thin Capitalisation Schedule and provide additional information in relation to financial arrangements. For the 2010 income year the IDS-FS is optional. However, the IDS-FS will be mandatory for affected taxpayers for the 2011 year.
- During 2009 (subsequent to the release of last year's "Insurance Facts and Figures Publication"), the Australian Government announced its support for 41 of 46 recommendations that were made by the Board of Taxation in relation to its review of the Administration of the GST System. Generally these changes are aimed at reducing the administrative burden of complying with the GST legislation and represent the most significant package of GST reform in 10 years.

While many supported recommendations were identified as applying from 1 July 2010, the legislative process has only started for some of the recommendations with either Exposure Drafts or Bills being introduced and debated in Parliament during 2010. We expect some but not all of the current proposed changes to be passed by parliament prior to 1 July 2010 with the effective date of the changes ranging from 1 July 2000 to 1 July 2010 (that is, some changes are likely to apply retrospectively). Many of the changes have general application to business taxpayers and it is important for each organisation to consider the impact of each of the proposed or finalised changes.

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 brigade charges, 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.

The Commercial Union Australia Mortgage Insurance Corporation (CUAMIC) case in 1996 considered the tax implications of a change in the methodology adopted in calculating the UPR. It was held that the full reduction in UPR in the year was assessable, even though part of the reduction related to a change in methodology. The legislation reinforces this decision by bringing to account the movement of the UPR from one year to the next, which will automatically account for changes in the earning pattern of the premiums.

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 shall 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 of “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 for future investment income) 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, 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 (OCR).

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). Insurance that is provided as part of certain transport services will lose its character as insurance and will take on the GST character of the other services supplied. For example, insurance provided as part of exporting goods will also be GST-free.

Insurers are not required to account for GST on premium income on GST-free policies, but they are still entitled to recover input tax credits on the expenses incurred in making supplies of GST-free insurance where the expenses do not relate to settling a claim. No entitlement to input tax credits will arise for expenses incurred in settling a claim under an insurance policy which is GST-free.

Where an insurance policy may be treated as either GST-free, taxable or input taxed, the GST-free treatment will prevail.

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. For example:

- Excesses – the GST implications differ depending on whether an excess is paid to the insurer directly, received by a service provider as agent for the insurer, or paid to the service provider directly (where no agency role exists).
- Insurers must differentiate between costs incurred in 'settling' a claim and costs incurred in 'managing' a claim as the special rules that give rise a DAM (mentioned above) only apply to costs incurred in settling a claim.
- Insurance recoveries – whether or not GST implication arise in relation to recoveries received by an insurer depends upon on a number of factors including whether the recovery is a subrogated recovery or not, the recovery relates to salvage proceeds and whether or not a DAM entitlement has arisen on the claim payments made.

Further, there are special GST rules dealing with the various state and territory-based compulsory third party (CTP) insurance schemes. New GST laws were introduced in 2003 to address the statutory and working differences between CTP and general insurance businesses. These laws are complicated and generally require careful consideration.

Investment activities

Investment activities are input taxed in many cases as they are classified as financial supplies for GST purposes.

The effect of this is that, while GST will not be payable on the supplies made, not all of the GST incurred as part of the price paid for expenses associated with investment activities will be recoverable unless one of the following exceptions applies:

- The expense relates directly to the purchase or sale of securities or other investments in an overseas market.
- The expenses incurred by the insurer for the purpose of making input taxed financial supplies do not exceed the "financial acquisitions threshold" (which is a "de minimus" test to ensure that entities that do not usually make financial supplies are not denied input tax credits on making financial supplies that are not a significant part of their principal commercial activities).
- The financial supply is a borrowing and the borrowing relates to supplies which are not input taxed.

Where the above exceptions apply, the insurer retains the entitlement to fully recover the GST incurred on related costs. However, where the exceptions do not apply, the insurer will have to use an appropriate apportionment methodology to determine the extent to which it is entitled to recover GST incurred on general costs.

It should be noted that where acquisitions made by an insurer for the purpose of its investment activities are "reduced credit acquisitions", the insurer is entitled to claim a reduced input tax credit equal to 75 percent of the GST included in the price of the expense.

Stamp duty

General Insurance Supervisory Levy Imposition Act 1998

Financial Institutions Supervisory Levies Collection Act 1998

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 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.

Generally, the liability for duty on general insurance policies falls on the general insurer.

Table 1.10 – Stamp duty rates – General insurance products

As at March 2010	Class	Rate
NSW	Type A Insurance other than Type B or Type C insurance	9%
	Type B Insurance for motor vehicles, aviation, disability, occupational health and hospital	5%
	Type C Insurance for livestock, crops	2.5%
VIC, WA, ACT, NT	All	10%
QLD	Class 1 Insurance other than Class 2 insurance or CTP insurance	7.5%
	Class 2 Insurance such as professional indemnity, motor vehicle (not CTP insurance), personal injury from air travel, first home mortgage, life insurance rider	5%
	CTP Insurance	$0.10
	Accident Insurance	5%
SA	All	11%
TAS	All	8 %

The lodgement of returns and payment of duty needs to occur:

- New South Wales, Victoria, Australian Capital Territory, Tasmania, Western Australia and the Northern Territory – within 21 days after the end of each month.
- South Australia – within 15 days after the end of each month. Annual licence to be applied for by 31 January of each year.
- Queensland – within 14 days after the end of each month or such other period as the Commissioner may determine.

Other levies and taxes

Fire Services Levy (FSL)

Fire service 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. The levies vary in each state with different rates applying to various classes of insurance. Policies which include coverage for risks prior to this date must include a proportional contribution to the levy.

The lodgement and payment requirements for FSLs are outlined in the following table:

Table 1.11 FSL lodgement and payment requirements

Lodgement of returns	Payment of charges	
NSW – Fire Brigades and Rural Fire Brigade	In September each year (audited)	Fire Brigade and Rural Fire Brigade quarterly advance payments due by 1 July, 1 October, 1 January and 1 April. Advance payments to be adjusted based on returns lodged in September in the following financial year.
VIC – Metropolitan and Country Fire Brigades	Before 15 August each year	Metropolitan & Country quarterly advance payments and country due by 1 July, 1 October, 1 January and 1 April. Advance payments to be adjusted based on returns lodged by 15 August in the following year.
TAS	Within 14 days after the end of each month	Payment made with monthly return.

Insurance Protection Tax (NSW)

The Insurance Protection Tax Act (NSW) 2001, which came into effect on 1 July 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 for the year commencing 1 July 2001 and for each subsequent year is $65 million. The tax for subsequent years may be reduced by determination of the New South Wales Governor on the recommendation of the New South Wales Treasurer. The tax is apportioned among general insurers according to their share of the total premium pool for the relevant year.

Where insurance is undertaken with a non-registered insurer and duty is payable by the insured person, an ad valorem duty of one per cent is imposed on dutiable premiums.

Lodgement and payment deadlines:

- Lodgement of returns by 15 August of each year.
- Notices of assessment issued by 1 September of each year.
- Quarterly payments due by 15 September, 15 December, 15 March and 15 June of each year.

General Insurance Levy

General Insurance Supervisory Levy Imposition Act 1998

Financial Institutions Supervisory Levies Collection Act 1998

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 (2009/2010: unrestricted levy of 0.006796 per cent of assets; restricted levy of 0.02185 per cent of assets; minimum restricted levy: $4,700; maximum restricted levy: $810,000).

This publication is designed to provide an overview of the accounting, tax and regulatory environment relating to insurance in Australia. Information contained in this booklet is based on the law and Government announcements as at 16 April 2010.

The information presented in this publication should be used as a guide only and does not represent advice. Before acting on any information provided in this publication, readers should consider their own circumstances and their need for advice on the subject. PricewaterhouseCoopers insurance experts will be pleased to assist – please contact your usual PwC contact or one of the experts listed at the end of this publication.

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