



Regulation Impact Statement

Life and General Insurance Capital Review

(OBPR ID: 13560)

Introduction

This Regulation Impact Statement (RIS) follows the previous related preliminary assessment OBPR ID: 13560 on the Life and General Insurance Capital (LAGIC) review submitted on 8 January 2010. The preliminary assessment detailed APRA's proposed changes to prudential standards relating to capital requirements applicable to general insurers and life insurers (generally referred to as insurers in this RIS unless otherwise indicated).

The general insurance industry has 124 participants and total assets of \$115.6 billion, with direct insurers accounting for \$102.6 billion of total assets and reinsurers accounting for the remaining \$13.0 billion.¹ The life insurance industry consists of 29 life insurers and 13 friendly societies. The total assets for the life insurance industry are \$230.2 billion.²

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that in all reasonable circumstances they can meet their financial promises to depositors, policyholders and beneficiaries within a stable, efficient and competitive financial system. APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. Under the *Insurance Act 1973* (Insurance Act) and *Life Insurance Act 1995* (Life Act), APRA is empowered to issue binding prudential standards that set out specific requirements to which general insurers and life insurers must adhere. These standards are supported by prudential practice guides (PPGs) which clarify APRA's expectations with regard to the prudential requirements.

¹ Statistics are current as at 31 December 2011. See:
<http://apra.gov.au/GI/Publications/Documents/GI%20Quarterly%20Performance%2020111231.pdf>

² Statistics are current as at 31 December 2011. See:
<http://apra.gov.au/lifs/Publications/Documents/LI%20Quarterly%20Performance%2020111231.pdf>

APRA periodically reviews and amends its prudential requirements in consideration of factors such as:

- international regulatory developments;
- market developments and changes in industry practice, including risk management practices; and/or
- identified weaknesses in the current prudential framework particularly following the impact of local and international stresses on the insurance industries.

APRA has well-established prudential standards relating to the capital requirements for insurers. The prudential framework for general insurance was substantially overhauled in two stages, in 2002 and 2005. The experience in subsequent years warranted further assessment of the reforms. Amendments were made to the general insurance capital standards in 2008, with the expectation of further review at a future date as some types of risks were not adequately catered for within the existing capital standards (in particular, asset/liability mismatch risk and certain concentration risks).

For life insurance, the original versions of the current capital standards were introduced by the Life Insurance Actuarial Standards Board (LIASB) soon after the enactment of the Life Act in 1995. The capital standards were revised by the LIASB a number of times, most recently in 2006. The legislative power to make capital standards for life insurers was transferred from the LIASB to APRA at the beginning of 2008. At the time, the LIASB was in the process of reviewing some parts of the capital standards.

APRA began its review of the capital standards in late 2008 and announced the broad scope of the review in May 2009.

Consultation

APRA has engaged in multiple rounds of consultation with industry. The consultation is ongoing and will continue through 2012; industry now has been consulted at least once in relation to all of the key proposals. Through the consultation process and quantitative impact studies, APRA has collected information on the costs and benefits of the proposals. APRA has also modified the proposals as appropriate to take account of the feedback received through the consultation process.

Problem

APRA's regulation of insurers involves periodic review of the adequacy of the capital requirements for insurers. Through this regular review process, and in light of issues arising from recent natural disasters in Australia and the Global Financial Crisis (GFC), APRA has identified a range of areas in which the current capital framework lacks adequate risk sensitivity.

Recent experience with natural disasters in Australia has exposed gaps in the adequacy of the current general insurance capital standards to deal with extreme events or multiple large losses in any one year.

The experience during the GFC, particularly overseas, showed that certain types of capital instruments which were included in the capital base of banks and insurers did not behave as expected in times of stress. Results from APRA's quantitative studies on the impact on industry highlight the need for a more risk sensitive view of capital, showing that the current requirements may not be adequate in this regard.

Although there were no insurer failures in the Australian insurance industry during this period, the above points indicate that the current capital framework may not adequately protect insurers in very stressed market conditions and this may lead to a higher than targeted risk of insurer failure. APRA is seeking to improve the risk sensitivity of the capital requirements for insurers by better matching the risks to which insurers are exposed with the level of required capital corresponding to a 99.5 per cent probability of sufficiency over a one-year period.

Other areas in the current capital standards that have been identified as requiring change include the need to explicitly take into account operational risk and more explicitly allow for the level of diversification between some risks.

Additional benefits are expected to be realised through alignment of the capital requirements for general and life insurers with each other, and where appropriate with those for ADIs, due to improved comparability between regulated industries and simplified compliance by industry.

Industry is in a sound financial position and APRA expects that the necessary adjustments to meet the revised requirements can be accommodated through appropriate transition arrangements.

Market failures

APRA has statutory responsibility for prudentially regulating the general insurance and life insurance industries to protect the interests of the owners and prospective owners of insurance policies. APRA is required to exercise this responsibility in a manner consistent with the continued development of a viable, competitive and innovative insurance industry.

The primary rationale for the prudential regulation of insurers is to address the risk of insurer failures. A key tool to minimise instances of such failures is a risk-based capital adequacy regime, to ensure insurers maintain a minimum level of capital commensurate with the risk profile of their businesses. When these conditions are not met, insurers can take on risks that are not supported by adequate capital, thus increasing the likelihood of failure of the insurer beyond the levels acceptable to APRA and the general community.

The market alone cannot always be relied on to ensure adequate capital support for an insurer's risks. Examples of market failures include:

- **Asymmetric information between insurers and policyholders** - Financial promises can be complex and long term. It is difficult for individual

policyholders to assess the strength of a financial institution and its ability to meet its financial promises in the future. The prudential regulator has the ability to gather relevant information to facilitate assessments of financial strength. By licensing only entities that meet relevant capital standards, and supervising those institutions on an ongoing basis to ensure that the capital held reflects their risk profile, the likelihood that promises to policyholders and beneficiaries will be kept and that their entitlements will be paid out can be reasonably expected to increase. This may also lead to increased confidence in the insurance industry.

- **Principal/agent problems** - Insurers take premiums from policyholders and capital from financial markets and manage those resources to meet various financial promises. There are a range of risks that, if not appropriately managed, could lead to the insurer failing to meet its obligations. For example, remuneration structures for the management of an insurer can encourage management to take undue risks with policyholder funds. Gains can accrue to shareholders (and management through bonuses) whereas losses may ultimately be borne by policyholders and beneficiaries. Appropriate risk-based capital requirements increase the likelihood that promises to policyholders and beneficiaries can be met and provide some protection where management may take undue risks with policyholder funds. Where the capital requirements are both adequate and risk sensitive, sound risk management can also be encouraged, helping to reduce the potential for insurers to take on excessive exposure to risks that are inadequately capitalised.

APRA's capital requirements for insurers form a key part of its assessment of the financial strength of the insurer and provide incentives for appropriate management of risks. It follows that appropriate design and calibration of the capital requirements is essential to their effectiveness. The framework needs to be:

- calibrated to a low overall risk of failure such that the financial strength of the insurer is sufficient to withstand significant adverse conditions and will continue to meet its financial promises. APRA has taken the view that a 0.5 per cent chance of failure over a one year period is an appropriately low risk of failure for insurers. This calibration is also consistent with international practice; and
- risk sensitive such that the capital requirement adequately reflects the risks undertaken by the insurer. If the framework is not sufficiently risk sensitive then individual insurers may have a higher risk of failure than the overall calibrated level of 0.5 per cent chance of failure over a 1 year period. Inadequate risk sensitivity can also encourage inappropriate risk taking, where insurers disproportionately take on risks that attract inadequate capital charges. This results in a weakening of insurers that may not be apparent from examining their capital position.

Issues identified with the current capital standards

APRA has identified a range of areas in which the current capital framework lacks adequate risk sensitivity. Some issues relate to general insurers only and some

issues relate to life insurers only. Other issues apply to both general and life insurers.

General insurance issues

A few key issues with the current capital framework for general insurers have been identified. A range of other enhancements to the framework are also proposed.

The asset risk capital charge for general insurers is currently determined using a factor-based method and can be made more risk sensitive by subjecting the balance sheet to a series of stress tests. Such an approach addresses asset/liability mismatch risks which are not fully captured under the current framework. The proposed approach better responds to changes in the asset risks to which an insurer may be exposed and hence ensures adequate capital is held for these risks. This in turn better addresses the market failures identified above that the prudential framework is intended to address.

Recent experience with natural disasters in Australia has demonstrated that the financial strength of insurers may be adversely impacted by the occurrence of multiple large losses in any one year. The current capital requirements, however, only address the capital that needs to be held for one extremely large event. In order to ensure an appropriately low risk of failure, insurers need to consider their exposure to multiple events and hold an additional amount of capital and/or purchase additional reinsurance protection. APRA's proposals incorporate requirements to allow for such multiple events.

There are a number of other areas identified where refinements can be made to enhance the effectiveness of the current capital framework for general insurers, for example, by addressing the double counting of capital held in investments in subsidiaries, associates and joint ventures.

Life insurance issues

Life insurers currently have to meet two capital requirements - a solvency standard and a capital adequacy standard. The solvency standard considers the various risks undertaken in a statutory fund in the context of a fund closed to new business. The capital adequacy standard considers a statutory fund that is open to new business. The two standards compare total assets to a stressed value for the liabilities, together with other reserves, at the statutory fund level. The general fund of the life insurer is subject to a single management capital requirement.

The current capital requirements for life insurers are structured very differently to the minimum capital requirement for general insurers and ADIs.³ This makes comparisons between life insurers and other regulated institutions more difficult, and also complicates the management and supervision of conglomerate groups that operate across multiple regulated industries. Such groups form a substantial proportion of the APRA-regulated part of the financial sector.

The life insurance regulatory framework also currently does not make allowance for losses from extreme events (such as a pandemic) and assumptions about the future repricing of contracts in response to adverse insurance risk experience are

³ Under the current capital framework, a general insurer must maintain a capital base in excess of its minimum capital requirement at all times.

not always appropriately set. APRA has undertaken industry-wide stress testing that required insurers to calculate the impact of a specified pandemic scenario on their capital position. The results showed that certain types of life insurance business may be adversely impacted by pandemic events in a way that is not captured in the current capital requirements. This may result in the capital requirement calculated under the existing capital standards providing insufficient protection to withstand such adverse scenarios. To address this, the LAGIC proposals require insurers to hold enough capital to withstand the greater of an APRA-defined pandemic scenario or another event to which the insurer has a concentration of insurance risk exposure.

Both life insurance and general insurance issues

The current standards for both general insurers and life insurers do not include any explicit capital requirements to address operational risk. International and Australian experience has shown the potential for operational risk exposures to result in severe and unexpected losses. In the Australian life insurance industry, some insurers have experienced operational risk events in the form of unit pricing errors. These errors require substantial time and money to correct. There is also evidence that operational risk is continuing to increase in its size and complexity due to factors such as the increasing reliance on advanced technology, legacy and IT system issues, outsourcing, agency distribution channels and merger and acquisition activity.

Operational risk may pose a significant risk for insurers in the future, and it is felt appropriate that this risk is addressed through capital requirements that reflect an insurer's operational risk profile. An explicit capital charge for operational risk also has the potential to increase Board and management focus on operational risk and drive increased sophistication in its measurement and management. An explicit operational risk capital charge also enhances alignment of the capital requirements for insurers with those of the ADI industry and international practice.

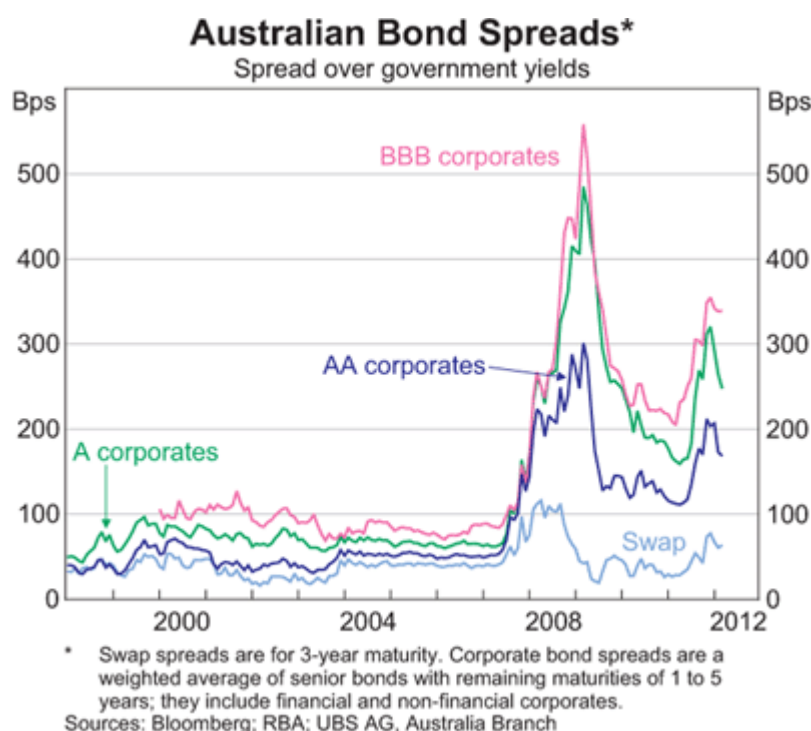
Under the current prudential standards for insurers, allowance for diversification between key risks is implicit. The components of required capital for asset and insurance risk are added together with no allowance for diversification between these risks or recognition of the level of independence between asset and liability risks. There is, however, some implicit recognition of diversification in the calibration of the components of the capital charges. This implicit approach to the recognition of diversification between risks leads to required capital that is either too high for insurers with significant exposures to both asset and insurance risks, or too low for insurers with a significant exposure to only one of these types of risks. Including an explicit allowance for diversification between key risks improves the risk sensitivity (and hence effectiveness) of the capital requirements.

Impact of the global financial crisis

The GFC resulted in substantial financial losses and instability in a number of countries. This global instability had an immediate spill over effect on the Australian economy, by freezing the wholesale funding markets due to liquidity issues and credit risk uncertainty and through substantial decreases in asset prices in a range of financial markets.

The financial crisis had a material impact on some segments of the insurance industry, particularly life insurers, primarily due to the impact of significant deterioration in the global and domestic financial markets on the investment portfolios of insurers.⁴ Although there were no insurer failures in the Australian insurance industry during this time, this experience revealed that the 1 in 200 level loss event is more severe than assumed in the current framework, meaning that there are risks which are not fully addressed by the current capital framework. For example, the existing risk charges for certain credit and market risks did not reflect the level of capital required (at the target sufficiency level) for the stressed conditions experienced. In particular, credit spreads were much more volatile than had been assumed in calibrating the current capital framework. The capital required for structured products under the current framework was also inadequate, as credit spread movements were substantially greater than for equivalently rated corporate and government bonds and this was not reflected in the calibration of the current capital framework.

APRA undertook analysis to determine appropriate stress assumptions for credit risk. The following graph shows the extreme volatility in credit spreads during the GFC event.



These weaknesses revealed in the current framework are such that the existing risk charges do not adequately address the market failure problems identified above and, if not altered, would mean that the future risk of insurer failure will be at higher than acceptable levels. The LAGIC proposals seek to address these issues by improving the risk sensitivity of the capital requirements as an enhanced risk management measure.

⁴ The global financial crisis saw a sharp decline in equity markets. In Australia, the All Ordinaries Index fell by 55% to a low of 3112 in March 2009. Credit spreads also showed substantial volatility (discussed further below).

The following table illustrates the inadequacy of the existing stress assumptions for life insurers, by comparing them to the assumptions calculated by APRA taking into account the impact of the GFC. The analysis shows that the credit spread shocks need to be substantially greater for all ratings grades to meet the targeted 99.5 per cent probability of sufficiency. The effect is greater still for securitised and re-securitised assets.

Counterparty grade	Current standards		LAGIC proposed			
	Default(%)	Spread (%)	Default(%)	Bond spread (%)	Structured/securitised spread (%)	Re-securitised spread (%)
1 (Government)	0.0	0.0	0.0	0.0	0.0	0.0
1 (Other)	0.0	0.3	0.2	0.6	1.0	1.8
2	0.0	0.4	0.6	0.8	1.4	2.4
3	0.25	0.6	1.2	1.2	2.0	3.2
4	1.75	0.9	3.0	1.6	2.5	4.0
5	4.0	1.0	6.0	2.0	3.0	5.0
6	11.0	1.1	10.0	2.5	3.5	6.0
7	17.0	1.1	16.0	3.0	4.5	7.5

The credit stresses for general insurers under the current framework are not directly comparable to the revised factors. They are substantially less risk sensitive and are not duration dependent.

For general insurers, the volatile investment conditions experienced during the GFC revealed that the asset risk framework was inadequate. For example, the current framework does not adequately allow for mismatch between the duration of assets and liabilities and the outstanding term of the assets are not considered. Moreover, the current investment capital factors are fixed and inflation and currency mismatch risks are not considered.

Quality of capital and Basel III

The GFC experience, particularly overseas, showed that certain types of capital instruments which were included in the capital base of ADIs and insurers did not behave as expected in times of stress. Capital is intended to absorb losses and allow an institution to remain viable. Capital requirements based on the Basel II framework⁵ for ADIs allowed institutions to meet substantial proportions of their capital requirements using lower quality capital instruments such as various forms of preference equity and subordinated debt. Under stress, some of these instruments did not absorb losses as expected and the level of protection afforded by a given level of capital was lower than it appeared before the crisis.

Basel III⁶ addresses these concerns in two key ways - by requiring substantially greater proportions of minimum capital requirements to be met using the highest quality of capital (common equity), and by requiring that lower quality instruments

⁵ APRA's capital standards for ADIs follow closely with those set by the Basel Committee for Banking Supervision (BCBS) and implement the following international capital accords: the 1988 Basel Capital Accord (Basel I) and the 2004 *International Convergence of Capital Measurement and Capital Standards* (Basel II). The 2010 *International regulatory framework for banks* (Basel III) are currently being implemented within APRA's regulatory framework for ADIs.

⁶ Bank for International Settlements 2010, *International regulatory framework for banks* (Basel III), Bank for International Settlements, Basel, viewed 10 April 2012, <<http://www.bis.org/bcbs/basel3.htm>>.

explicitly include the ability to convert into ordinary equity or be written off in a time of stress.

APRA's capital standards for authorised deposit-taking institutions (ADIs) follow closely those set by the Basel Committee for Banking Supervision (BCBS). The recent Basel III capital framework is being implemented within APRA's regulatory framework for ADIs. APRA's existing general insurance framework for quality of capital is aligned with the current ADI framework, as it is felt appropriate to maintain the broadly same quality of capital requirements for insurers as for ADIs. The current capital requirements for general insurers may therefore be subject to the weaknesses described above. Although these risks have not been realised in the Australian insurance industry, there is the potential that they could occur in the future, hence the proposal to continue to align the quality of capital requirements with those for ADIs. For similar reasons, APRA is taking the opportunity to align the quality of capital requirements for life insurers with those for general insurers.

Alignment of requirements across industries and internationally

There is an increasing trend for prudentially regulated financial institutions to operate as part of a wider corporate group across more than one industry. Such groups account for a substantial proportion of insurers within Australia. For example, the major Australian banks own life insurers that represent almost 50 per cent of the life insurance industry by assets. Alignment can reduce opportunities for regulatory arbitrage; this is an issue for cross industry groups who have the ability to adjust legal structures and have access to licences across multiple industries. Cross industry groups can make decisions regarding which legal entity owns an asset and also which legal entity underwrites certain types of risks in such a way as to minimise the capital requirement, if regulatory arbitrage is available. Regulatory arbitrage can therefore result in reductions in required capital due to changes in ownership or structure, without any corresponding reduction in the actual risk exposure of the institution. Such reductions have no economic substance as they do not reflect any change in economic risk. This can therefore result in a misleading presentation of the capital strength of a given insurer and cause a mismatch between the capital requirement of an insurer and that insurer's risk profile, reducing the risk sensitivity of the capital framework.

To address this, APRA proposes to improve the risk sensitivity of the capital requirement through aligning the capital requirements for general insurers and life insurers, and also alignment with ADIs where appropriate. This better matches capital with risk, rather than allowing required capital to be affected by changes in ownership or structure where there is no real change in economic value.

Where possible, it is important that equivalent risks are treated in a similar way between entities through the alignment of capital standards. For groups whose activities extend across two or more APRA-regulated industries, this can facilitate a simplified risk management process, easier comparisons between groups and as a result, more effective supervision. For example, the structure of the capital standards for life insurers, particularly the dual reporting requirements for solvency and capital adequacy, is out of line with both the banking and general insurance industries in Australia. Hence, there is a case for exploring both simplification and harmonisation of capital standards for general insurers and life

insurers and, where appropriate, to align capital standards for insurers with those for ADIs.

In undertaking the LAGIC review APRA has focused on alignment between requirements for general insurers and life insurers. Alignment with ADIs has been undertaken as appropriate. Given differences in industry risks and structure, alignment with the ADI industry has primarily focussed on the requirements relating to the capital base (and particularly the quality of capital instruments able to be included in the capital base) and on capital management requirements, rather than on the requirements for calculating the minimum required amount of capital. For example, APRA did not adopt the ADI requirements for a Capital Conservation Buffer as this was not seen as appropriate for the Australian insurance industry. The consideration of the build-up of adequate capital above the minimum that can be used to absorb losses during periods of financial and economic stress would be factors that APRA expects insurers to consider when establishing appropriate capital targets.

APRA is cognisant of developments in insurance regulation internationally. APRA has looked at a range of international capital frameworks in order to inform its considerations and ensure broad comparative outcomes, for example, by looking at alternative approaches and levels of calibration of capital requirements for insurers. One such relevant international development that has been considered is the Solvency II framework in Europe.⁷ While it is not appropriate to completely align with Solvency II, APRA had regard to it in developing the LAGIC proposals. Improved harmonisation and comparability with regulatory regimes in other jurisdictions outside Australia has benefits for companies that operate overseas, subsidiary companies or branches of foreign companies and for local insurers competing with foreign-owned insurers.

Objectives of the LAGIC review

APRA's stated supervisory approach is to be 'forward-looking, primarily risk-based, consultative, consistent and in line with international best practice'.⁸

In undertaking the LAGIC review, APRA's objectives are to:

- improve the risk sensitivity and appropriateness of the capital standards for insurers to address risks in the insurance industry (and in the process address the observed emerging risks such as those discussed above, which, although they have not been fully realised as yet, have the potential to increase the risk of insurer failure beyond acceptable levels); and
- where appropriate, improve the alignment of the capital standards across industries and internationally.

Overall, APRA's objective is to better address the potential market failures that the prudential capital regime for insurers is designed to address.

⁷ 'Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)' Brussels, 26.2.2008 (COD) 2007/0143

⁸ See: <http://www.apra.gov.au/AboutAPRA/Pages/default.aspx>

Summary of LAGIC proposals

An insurer needs to have sufficient capital to absorb unexpected shocks that may arise and continue to be able to meet its obligations to policyholders and beneficiaries. This facilitates the stability and ongoing viability of the insurance market, which will maintain consumer confidence in the ability of insurers to honour their claims.

The implementation of APRA's proposals will impact a range of prudential standards across insurance industries and involve a combination of new standards and amendments to existing standards.

Alignment

APRA proposes to introduce a common framework for required capital and eligible capital across general insurers and life insurers. For general insurers, the proposed required capital broadly corresponds to the existing minimum capital requirement (MCR). For life insurers, the two existing requirements for solvency and capital adequacy would be replaced with a single measure of required capital. This measure of required capital would be compared with the capital base, in contrast to the current solvency and capital adequacy requirements that are compared with total assets.

The LAGIC proposals provide a clearer view of the financial position of insurers through a direct comparison of the amount of eligible capital with required capital. The level of required capital for insurers under the proposals is intended to correspond to a 99.5 per cent probability of sufficiency over a one-year period, that is, a 0.5 per cent probability of insurer failure over a one-year period.

Capital base

APRA proposes to require that insurers hold a capital base which is freely available to absorb losses and ranks behind the claims of policyholders and other creditors in the event of winding up. APRA intends to use consistent definitions of capital for general insurers, life insurers and ADIs. The capital base would consist of the sum of the following components, net of regulatory adjustments:

- Tier 1 capital, comprising of:
 - Common Equity Tier 1 (CET1);
 - Additional Tier 1; and
- Tier 2 capital.

CET1 is recognised as the highest quality component of capital, subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date. Additional Tier 1 capital includes instruments that must be able to absorb losses on a going-concern basis. Tier 2 capital consist of the other components of capital such as subordinated debt that fall short of the quality of Tier 1 capital but nonetheless contribute to the overall strength of an entity as a going-concern.

Insurers at all times must satisfy minimum requirements for the composition of their capital bases and ensure that the capital base exceeds the Prudential Capital Requirement (PCR).

For life insurers, it is proposed that the minimum requirements for CET1, Tier 1 and capital base apply at the insurer level as well as at statutory fund level. The PCR of the life insurer will be the sum of the PCRs for the general fund and the statutory funds, subject to a minimum prescribed capital amount of \$10 million. Each statutory fund and the general fund must also have a capital base in excess of the PCR for the fund and meet requirements for the composition of that capital base.

Regulatory adjustments

The existing capital standards for general insurers allow a general insurer to include the regulatory capital of a subsidiary, associates and joint venture as admissible in the determination of its capital base, in contrast with those for life insurers which do not. This amount, however, would not necessarily be accessible by the parent insurer to meet its policyholder obligations. Therefore, APRA proposes that these amounts be treated as inadmissible and be deducted from the capital base of insurers.

In addition, a series of regulatory adjustments are proposed to remove certain CET1 assets which, although they appear on the balance sheet for accounting purposes, may not have any value in a stressed situation such as a wind-up. As the capital framework is focussed on protecting policyholders and beneficiaries in a time of stress, and these assets may not be available to protect policyholders and beneficiaries at that time, it is appropriate that they be removed from the capital base. For general insurers, APRA proposes to amend the regulatory adjustments under the current capital framework which are applied to Tier 1 capital. These amended regulatory adjustments will be applied to CET1 under LAGIC.

Prescribed capital amount

The minimum level of capital an insurer would be required to hold at all times would be the prescribed capital amount plus any supervisory adjustment determined by APRA. This total required capital amount is the PCR. Falling below the PCR is a trigger for intense supervisory intervention. Insurers are therefore expected to set appropriate target capital levels in excess of the PCR such that they are unlikely to fall below their PCR.

The prescribed capital amount can be calculated by APRA's standard method or the insurer's internal model (which must be approved by APRA). For insurers using the standard method, the prescribed capital amount is determined as:

- the insurance risk charge; plus
- the insurance concentration risk charge for general insurers; plus
- the asset risk charge; plus
- the asset concentration risk charge; plus
- the operational risk charge; less
- an aggregation benefit (to allow for diversification benefits, if any); plus

- any adjustment for tax benefits and management actions (called the combined stress scenario adjustment) for life insurers.

Insurance risk charge

This is the amount of capital to be held against insurance risk. Insurance risk is the risk that insurance liabilities as reported to APRA will prove to be understated. For general insurers, this relates to the uncertain future outcomes of claims that have already occurred (the outstanding claims risk) and the uncertain cost of claims yet to occur for which the general insurer is on risk (the premiums liability risk). For life insurers, this relates to the risk of adverse impacts due to movements in future mortality, morbidity, longevity, servicing expenses, lapses and other insurance risks such as option take-up rates.

Insurance concentration risk charge

This is the amount of capital to be held against the concentration of insurance risk for general insurers. Insurance concentration risk reflects the possibility of catastrophic losses as a result of exposure to natural perils or exposure to an accumulation of losses arising from another common dependent source.

In determining the insurance concentration risk capital charge, APRA proposes an approach based on the greater of the vertical requirement for exposures to natural perils (NP VR), the horizontal requirement for exposures to natural perils (NP HR) and the vertical requirements for exposures to non-natural peril accumulations ('other accumulations'). The NP VR is very similar to the existing minimum event retention (MER)⁹ requirement, and is the net cost to the insurer of a 1 in 200 year single event loss. Under LAGIC, the NP VR will be calculated at a whole of portfolio level, allowing for reinsurance cover and the cost of reinstating that cover. However, the NP VR does not consider the risk that an insurer's capital position can be adversely affected over a year by the occurrence of a succession of smaller sized loss events, including the cost of purchasing additional reinstatements of reinsurance cover. The NP HR is intended to address this weakness.

The NP HR considers the expected net loss from the occurrence of several smaller-size events in a given year on a whole of portfolio basis. Each scenario considered in the horizontal requirement represents a combination of events of given frequency and size which are intended to represent a 1 in 200 loss scenario over one year. The costs of reinstatements of the appropriate layers of any catastrophe program are also included. In addition, APRA proposes to maintain the requirement for a general insurer to allow for the cost of one full reinstatement of its catastrophe program in the NP VR.

APRA also proposes to use a whole-of-portfolio principle in relation to other accumulations whilst recognising the structure of those exposures.

For life insurers, the current standards do not adequately allow for extreme events (e.g. the impact of pandemics, natural catastrophes and terrorist attacks). APRA does not propose to include a separate insurance concentration risk capital charge

⁹ The minimum event retention (MER) is the largest loss to which an insurer will be exposed due to a concentration of risk exposures (such that the probability of a loss exceeding that amount is within a specified probability) after netting out any potential reinsurance assets.

for life insurers. Instead, allowance for losses arising from extreme events is included in the insurance risk charge.

Asset risk charge

This is the amount of capital to be held against asset risk. Asset risk is the risk of adverse movements in the value of on-balance sheet and off-balance sheet asset exposures. It arises from the impact of market and credit risks, investments and other assets, including reinsurance assets. The asset risk charge is designed to encourage insurers to adopt an investment policy that has regard to the term and nature of their liabilities and the creditworthiness of investment and reinsurance counterparties.

For general insurers, instead of using the previous factor-based method, the asset risk charge will be calculated in a more risk-sensitive manner by subjecting the balance sheet to a series of stress tests according to parameters specified by APRA. These include tests for mismatches between assets and liabilities by duration for both interest rates and inflation.

For life insurers, the method used for recognising diversification between different types of asset risks will be improved and stress tests for inflation and volatility will be added to the asset risk charge. All assets would be included in the calculation of the asset risk charge, not just those required to meet the liabilities of the statutory fund.

The stress tests in the asset risk charge relate to:

- real interest rates;
- expected inflation rates;
- currency risks;
- equity risks, including equity volatility;
- property risks;
- credit spreads; and
- default risks.

Asset concentration risk charge

This is the amount of capital to be held against the concentration of assets. Asset concentration risk results from investment concentrations in individual assets or large exposures to individual counterparties or groups of related counterparties. The risk charge requires a capital amount to be held where exposures exceed prescribed limits. This is expected to drive appropriate risk management practices as insurers structure their investment approaches to avoid the risk charge.

Additionally, for life insurers, the asset concentration limits that apply to the retrocessions of specialist reinsurers to their overseas parents would be reduced and specialist reinsurers would be redefined to be the statutory funds of registered

life insurers whose policy liabilities consist exclusively of inwards reinsurance from third parties.

Operational risk charge

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events. Operational risk is a key risk for insurers and APRA is of the view that it is appropriate to explicitly address this risk in its capital standards through introducing an explicit capital requirement for operational risk.

The proposed operational risk charge would have two components; a 'base component' related to the scale of the insurer's operations, and thus exposure to operational risk, and a component based on risk attributes specific to the insurer.

To the extent that an insurer has a higher operational risk profile or an inadequate approach to operational risk management, APRA would increase the insurer's PCR by making a supervisory adjustment. This is intended to provide incentives for insurers to improve their operational risk management.

Aggregation benefit

Under the proposed capital standards, APRA will make the recognition of diversification within and between risk types more explicit.

APRA proposes to make an explicit allowance for diversification between asset and insurance risks, so that required capital better reflects the level of independence between asset risks and insurance risks.

For life insurers, the calculation of the aggregation benefit would be undertaken separately for each statutory fund. There is also explicit allowance for insurance risk diversification in the determination of the insurance risk charge and for diversification between asset risks in the asset risk charge.

Risk-free discount rate

APRA is proposing to apply the same definition for risk-free discount rates for general and life insurers. APRA is of the view that the risk-free discount rates appropriate for valuing liabilities should reflect the rates that can be earned on assets that:

- have no credit risk;
- are readily realisable or liquid, even in times of stress; and
- match the term and currency of the future liability cash flows.

For Australian-denominated liabilities, APRA regards the zero coupon spot yield curve of the Commonwealth Government Securities (CGS) as the best proxy for risk-free rates. For foreign denominated liabilities, risk-free rates should be determined with reference to yields from national government bonds in the same currency as the liabilities and rated AAA. The risk-free rates may be determined with reference to other instruments, adjusted for credit risk and liquidity, if it can

be demonstrated that there is insufficient supply of highly rated foreign national government bonds in the relevant currency.

For life insurers, this approach to selecting the risk-free discount rate is more restrictive than the current capital adequacy requirement which allows life insurers to use a higher risk-free discount rate, up to a limit of the mid swap rate. APRA proposes to allow an illiquidity premium to be added to the risk-free discount rate when calculating certain types of illiquid life insurance liabilities. These include liabilities for certain annuities, fixed term/rate products and funeral bonds. This recognises that, where a life insurer has assumed an illiquid liability, it can back that liability with risk-free but not completely liquid assets and earn the illiquidity premium.

Prudential Capital Requirement (PCR)

The PCR is the prescribed capital amount plus any additional capital required to be held according to a supervisory adjustment required by APRA. It is the minimum required amount of capital held by insurers.

APRA is proposing the introduction of a three pillar supervisory approach for general insurers and life insurers similar to that in place for ADIs and consistent with the three pillar approach proposed for Basel III and Solvency II. These pillars would comprise of:

- Pillar 1: quantitative requirements in relation to required capital and the capital base as described above;
- Pillar 2: the supervisory review process, which includes APRA's assessment of the risk management and capital management practices of an insurer and may include a supervisory adjustment to capital; and
- Pillar 3: disclosure requirements designed to encourage market discipline.

Supervisory adjustment

APRA will have the power to adjust any aspect of the prescribed capital amount calculation where, in its view, application of the method outlined in the prudential standard does not produce an appropriate outcome in the particular circumstances of an insurer. Such an adjustment could result in an increase or decrease in the prescribed capital amount.

In addition, APRA will have the ability to specify an additional amount of capital to be held over the calculated prescribed capital amount. This adjustment could be used, for example, to address strategic risks, reputational risks, unusual operational risks, or it may be used to reflect qualitative assessments related to poor corporate governance or risk management systems.

A decision to impose a supervisory adjustment will be based on information available to APRA from the full range of APRA's supervision activities and will only be applied after discussion with the insurer. The adjustment would not be publicly disclosed.

Internal Capital Adequacy Assessment Process (ICAAP)

APRA proposes to strengthen the capital management practices of insurers as part of the Pillar 2 supervisory process. The proposals require an insurer to develop and maintain a rigorous and well-documented Internal Capital Adequacy Assessment Process (ICAAP), which should be appropriate to the nature, scope and complexity of the insurer's activities and be consistent with prudential requirements.

APRA does not propose to mandate any particular format for insurer ICAAPs. However, in line with sound business practice, APRA's proposals would require an insurer:

- to maintain at all times a level and quality of capital commensurate with the level and extent of risks to which the insurer is exposed from its activities;
- to have adequate systems and procedures for identifying, measuring, monitoring and managing the risks arising from its activities on a continuous bases, and for assessing the capital needed in relation to those risks;
- to document how it determines its target capital level for supporting the degree of risks associated with its current activities and its overall business plans;
- to document its strategy for maintaining appropriate capital resources over time, including how the required level of capital is to be met, the means available for sourcing additional capital where needed and the procedures for monitoring compliance with APRA's minimum capital requirements; and
- to ensure that its ICAAP is subject to effective and comprehensive review. The frequency and scope of the review would need to be appropriate to the insurer having regard to the size, business mix and complexity of the insurer's operations and the nature and extent of any change to its business profile and risk appetite.

APRA proposes that each insurer submit to APRA on an annual basis an ICAAP report that addresses the points outlined above and includes capital projections for at least a three-year period.

Disclosure requirements

Pillar 3 of APRA's supervisory approach aims to ensure disclosure by insurers that would assist market observers to assess the capital adequacy of insurers. APRA proposes that insurers give market observers ready access to some basic information on their capital adequacy on a regular basis.

The proposed disclosure requirements for Pillar 1 will be essentially the same as the current disclosure requirements for general insurers. In summary, insurers will be required to disclose annually:

- the individual components of the insurer's Pillar 1 prescribed capital amount;

- the insurer's total Pillar 1 or prescribed capital amount; and
- the individual components of the insurer's capital base.

Regulatory reporting requirements

APRA's current capital framework is supported by a set of statistical returns completed by insurers on a quarterly and annual basis. These returns allow APRA supervisors to assess the financial position of insurers and their compliance with regulatory capital requirements. The data is also used by APRA to conduct industry-wide analysis and by other government agencies for various purposes. APRA publishes a range of data in its regular publications.

In order to support the revised capital framework under LAGIC, APRA intends to update the reporting framework to align with the LAGIC requirements.

Transition arrangements

APRA recognises that the implementation of more risk-sensitive capital standards will have a material impact on the capital position of some insurers. If insurers are unable to implement changes to their current operations or arrangements before 1 January 2013, APRA has indicated to insurers that it will consider appropriate transitional arrangements. In some cases, such as in relation to certain existing capital instruments and the horizontal requirement for insurers, APRA has provided industry-wide transition arrangements. Insurers will be required to submit requests for transitional arrangements to APRA by 30 September 2012. This is to enable transition arrangements to be considered and determined by APRA ahead of the 1 January 2013 effective date of the revised capital framework.

Regulatory Options

Option 1: Implement the LAGIC proposals

Under this option, APRA would adopt the LAGIC proposals.

Option 2: Maintain existing framework

Under this option, APRA would not make any changes to the existing standards.

Impact Analysis (Costs and Benefits)

Option 1: Implement the LAGIC proposals

Benefits

The LAGIC review seeks to enhance the risk sensitivity of the capital framework for insurers, to align capital standards for general insurers and life insurers, and where appropriate, to align capital standards for insurers with those of ADIs. APRA anticipates that the benefits of this review are likely to include:

- enhanced risk sensitivity by better alignment between capital requirements and risk exposures for insurers;
- easier comparison and understanding of regulated entities operating in different industries;
- simplified risk management for groups whose activities extend across two or more APRA-regulated industries; and
- more effective supervision by APRA of conglomerate groups whose activities extend across more than one APRA-regulated industry.

The LAGIC review closely follows the three pillar approach adopted under Basel II and Solvency II, as well as the changes being adopted under Basel III. Aligning Australian practice with international developments, where appropriate, promotes a regulatory regime that is consistent with international best practice.

By adjusting regulatory capital to be more closely aligned with risk profiles, the LAGIC proposals are likely to encourage more effective risk management by insurers as it makes the underlying economic cost of underwriting the risk more apparent to the insurer. As a result, APRA anticipates that better risk and capital management practices will be promoted within the insurance industry. Institutions with a relatively higher risk profile are likely to seek to reduce the capital they need to hold by changing their financial structure, business practices, reinsurance and internal capital targets to decrease their level of risk and, consequently, their risk charges. Institutions with a relatively lower risk profile are likely to benefit by being required to hold a lower level of capital after the implementation of the LAGIC proposals.

The increased risk sensitivity of capital standards and associated improvement in business practices will benefit insurers, policyholders and beneficiaries. The changes will mean a lower risk of failure by insurers, even in the face of extreme adverse events. Overall, APRA anticipates that the LAGIC proposals will produce a stronger and more resilient insurance industry, ensuring better protection for policyholders with clear consequent benefits to insurance beneficiaries. This is consistent with APRA's mandate.

Increases in the quality of capital instruments allowed to support the prudential capital requirements will increase the protection afforded to policyholders and beneficiaries and achieve better alignment across regulated industries.

Costs

The potential costs of the LAGIC review will manifest in two stages; costs incurred during the implementation stage and ongoing costs.

Implementation costs

Insurers will need to meet initial compliance costs of implementing the LAGIC standards, to modify their systems and processes to measure, monitor and report their capital adequacy position. Initially, substantial management attention will be needed to adopt the changes and time will be needed to develop internal policies as well as enhance insurers' internal capital management processes.

Some of the proposals (e.g. the requirement for an ICAAP) largely formalise existing processes and so should not lead to substantial new costs given insurers should already be undertaking these processes.

Insurers may also incur initial costs for changing capital structures and investment strategies to meet any additional required capital they will need to hold. For general insurance in particular, reinsurance structures may need to change.

Insurers will incur costs in modifying systems and processes for regulatory reporting to comply with the revised reporting framework. APRA will be consulting on these reporting requirements in June to September 2012 and will seek information on these costs from insurers as part of this consultation process.

APRA has established internal processes to assess and approve requests for transition arrangements by insurers, where it can be demonstrated that transition is appropriate. Transition arrangements can take the form of increased time to comply with particular requirements. Appropriate transition arrangements can be expected to defer capital charges and may defer some implementation costs.

In certain instances, such as with regard to existing capital instruments and the horizontal requirement for general insurers, APRA has allowed industry-wide transition arrangements to defer the cost impacts of LAGIC implementation. In other cases, the impacts are entity-specific and will be considered by APRA on a case-by-case basis.

Costs to insurers under this option can be broadly grouped into non-capital and capital related costs. Capital related costs have been assessed in detail through APRA's QIS process (discussed below). In relation to non-capital costs, APRA requests data as part of the consultation process, including requesting that insurers use the Business Cost Calculator to estimate costs. No insurers used the Business Cost Calculator to provide an estimate of non-capital costs in response to APRA's request. Accordingly, it is difficult to assess the non-capital costs associated with implementing LAGIC. For example, APRA does not have reliable data from the industry on the compliance costs involved in changing processes and reporting arrangements.

For insurers, APRA has assessed that the ongoing cost of any potential increased capital requirement is significantly greater than any non-capital costs. This assessment is supported by the lack of industry feedback regarding non-capital costs compared to substantial feedback regarding capital costs and is also consistent with APRA's understanding of the industry. APRA considers that reliable

data is available through the QIS process to assess the capital-related costs. As these capital costs are the most significant potential costs to industry, APRA is confident that it has sufficient data to assess the overall impact of the LAGIC proposals on industry (and has made this assessment in the section below).

APRA will incur costs in reviewing and changing prudential standards and practice guides. These costs are primarily one-off costs associated with the development and implementation of the revised requirements. Ongoing costs to APRA are expected to be similar under each option.

Ongoing costs

Ongoing costs associated with the LAGIC proposals include, for insurers with a comparatively high risk profile, the costs associated with a requirement to hold a higher amount of capital than under the current capital standards.

Ongoing costs incurred by insurers, including the cost of any additional capital needed (or savings from reduced capital), would be expected to lead to a trade-off between potential increases in premiums which could be passed onto policyholders, or reduced returns on capital for shareholders. APRA anticipates that there will be a combination of both these effects. It is not possible to produce an estimate of changes in premiums that may occur under LAGIC. There are a range of other factors simultaneously impacting premiums which cannot be disentangled from the impact of changes in capital requirements. Having said this, APRA anticipates that a material increase in premiums is not warranted as a result of the LAGIC changes.

In relation to policyholders of insurers with a higher risk profile, the costs associated with holding higher levels of capital may have a flow on effect where premiums are increased, holding all else constant. The opposite would be expected to be the case for policyholders of insurers with a lower risk profile or with stronger risk management/mitigants, as the insurer will be required to hold less capital and the associated lower costs would have a flow on effect where premiums are decreased, holding all else constant. Any increase in premiums for policyholders with higher risk insurers must be balanced against the benefits to policyholders and beneficiaries of the insurer's reduced likelihood of failure through the improved risk sensitivity of its capital requirements.

Quantitative impact studies

APRA undertook two quantitative impact studies to assess the impact of its proposals on required capital and capital base for insurers. APRA used the results of this process to adjust the requirements to ensure appropriate calibration of the risk charges.

The second quantitative impact study (QIS2) enabled APRA to assess the impact of its proposals based on an assessment of the risk charges under the proposals at a past reporting date. The risk charges reported in QIS2 therefore relate to the position of insurers at that date, based on their business and capital management strategies developed under the existing capital standards. APRA expects that insurers are likely to review their business and capital management strategies in light of the proposed changes to the capital standards and to address any material increase in capital requirements where practical and appropriate to do so. Accordingly, APRA took into account reasonable behavioural changes likely to be

made by the insurers in undertaking detailed analysis of the QIS2 results and their impact on the industry and individual insurers. Note that the changes to the proposals following QIS2 are expected to have a further impact on the overall results. In most cases, these changes are expected to reduce the capital required relative to QIS2.

General insurers

For general insurers, QIS2 showed a wide variation in impact on individual insurers, reflecting the enhanced risk sensitivity of APRA's proposed capital requirements. At an industry-wide level, QIS2 indicated that APRA's proposals to revise the capital standards will reduce the overall level of solvency coverage of the general insurance industry. QIS2 showed that the general insurance industry would see an overall increase in capital requirements of less than 15 per cent. However, APRA estimates that the overall increase in capital required will likely be less than 5 per cent, and the solvency coverage would decline by 8 per cent (from 1.8 times to 1.65 times the PCR), after taking into account readily achievable behavioural changes by general insurers to mitigate the impact of the changes. General insurers may opt to address risks using reinsurance rather than additional capital. Such insurers may face higher reinsurance costs, however, use of reinsurance can be less costly than servicing the additional capital that would be otherwise required. In particular, the introduction of the horizontal requirement¹⁰ in the insurance concentration risk charge, calculated at the reporting date on or prior to the date of change in the reinsurance program, may lead firms to adopt a strategy to increase reinsurance protection. APRA anticipates that each insurer would make a decision regarding use of capital or reinsurance on a commercial basis. Conditions in the reinsurance market will also play a major role.

The increase in the PCR indicated in the QIS2 results for general insurers primarily reflects an increase in the asset concentration risk charge and the introduction of an operational risk charge. There were also small increases in the asset risk charge and insurance concentration risk charge relative to the current requirements. The increases in the risk charges were partially offset by the aggregation benefit. The capital base reported by some insurers reduced, primarily due to the proposed deductions relating to the regulatory capital of investments in subsidiaries, joint ventures and associates.

APRA has estimated the impact of the refinements proposed following QIS2 on the capital position of individual general insurers and the overall industry. APRA's expectation is that the current proposals will marginally improve the solvency coverage of insurers relative to the position indicated in QIS2. APRA estimates that a small number of general insurers will have capital instruments that no longer qualify in the relevant category of capital. These general insurers will have access to transition arrangements that will assist in reducing the impact on their solvency coverage.

¹⁰ The horizontal requirement considers the expected net loss from the occurrence of several smaller-size events in a given year on a whole-of-portfolio basis.

Life insurers

For life insurance investment-linked statutory funds, the total required capital for the funds that participated in QIS2 was not materially different from the capital required under the existing capital standards.

For non-investment linked business, the results for QIS2 varied widely between funds, reflecting the enhanced risk sensitivity of the capital requirements under LAGIC. There was a significant increase in average required capital. 14 of the 40 non-investment-linked statutory funds reported lower required capital than under the existing capital standards.

One of the reasons for the increase is that under LAGIC, consistent with the current approach for general insurers, the asset risk stresses will be applied to a life insurer's total assets, including surplus assets above the level needed to meet the PCR. Surplus assets over and above the PCR are important to overall policyholder security. Where surplus assets are invested in risky assets, APRA therefore considers it appropriate that the additional risk is captured in the PCR. Further, because the minimum quality of capital is based on the PCR, the additional risk will be supported by capital of appropriate quality. APRA expects that insurers will take into account the asset risk charge on surplus assets when setting their target capital level.

The QIS2 results indicated that further refinements to APRA's proposals were needed and these refinements have been included in the current proposals. APRA assesses that most of the proposed refinements will reduce the capital requirements of funds relative to their position in QIS2.

Direct comparisons between the existing and proposed capital requirements are difficult. Nonetheless, the estimated increase in total required capital for the non-investment-linked statutory funds that participated in QIS2 is about 15 per cent and the coverage ratio reduced from 169 per cent to 148 per cent. The impact was much lower for the majority of insurers, and transitional arrangements and capital management actions by insurers are likely to mitigate the overall impact.

The required capital for the general funds of life insurers that participated in QIS2 was higher than the required capital under the existing capital standards for many of the funds. The main reason for this was the application of the asset risk charge to all assets (including surplus assets) of the fund. Some general funds were also affected by the asset concentration risk charge. This charge is not applied to general funds under the existing capital standards. APRA's revised approach following QIS2 mitigates some of this impact. Once again, insurers may mitigate this impact through appropriate management actions.

Reporting requirements

Insurers also face an ongoing reporting burden. However, this cost would be expected to be similar under both options once past the implementation stage. Insurers have existing systems for producing data to report to APRA. Once these systems have been appropriately adapted, they will be used to produce the revised statistical returns.

Option 2: Maintaining the status quo

Benefits

The benefits in maintaining APRA's existing framework is that the costs incurred in implementing the LAGIC review are avoided.

Costs

Making no change to the existing regulatory framework leaves insurers open to risks which were revealed in the GFC and other risks identified by APRA that will not be adequately addressed. These risks have been discussed above. As such, the current regulatory regime offers policyholders and beneficiaries a lower level of protection than perceived.

The costs in maintaining this option are considered long term and latent as they are not immediately evident. Leaving these risks unaddressed increases the likelihood of poor practices occurring in the industry and in extreme cases, could lead to institutional failure. The potentially very high costs of failure of a financial institution have been seen overseas through the GFC. Costs to society through the burden imposed on taxpayers, lost GDP and increased unemployment are potentially significant. The current framework does not address the identified market failures as robustly as the proposed LAGIC approach.

Internationally active insurers would also suffer from a perception that the regulatory regime is less robust when measured against global expectations and standards. This could affect the reputation of Australian insurers and could affect the competitiveness of Australian insurers operating branches overseas.

Consultation

A summary table of APRA's consultation actions, both to date and intended, is listed below.

Date	Consultation
13 May 2010	APRA issued a discussion paper outlining its proposals to review its capital standards for general and life insurers.
12 July 2010	APRA released technical papers providing further details on: • the asset risk charge; and • the capital base and insurance risk charge for life insurers.
13 September 2010	APRA released a technical paper providing further details on the issue of the insurance concentration risk charge

	for general insurers.
Late 2010	APRA invited insurers to participate in the first quantitative impact study (QIS1).
31 March 2011	APRA issued a response paper outlining the main issues raised in submissions and arising from assessment of the QIS results. It detailed refinements to the proposals in a number of areas to address some of the issues raised in submissions and clarified other aspects of APRA's proposals.
April 2011	APRA invited insurers to participate in a second quantitative impact study (QIS2).
9 December 2011	APRA released a response paper summarising the issues raised in submissions on the March 2011 response paper and arising from assessment of the QIS2 results. Draft prudential standards reflecting the policy position were also released.
March 2012	APRA released detailed proposals relating to the illiquidity premium for life insurers.
May 2012	APRA intends to release prudential standards that implement the proposals on the composition of the capital base and changes to other prudential standards which are consequential to the LAGIC changes.
June 2012	APRA intends to release initial proposals for implementing APRA's proposed changes in the capital framework into the reporting framework.
September 2012	APRA intends to release draft prudential practice guides giving additional guidance on the LAGIC requirements.

APRA has also met with a number of insurers and other stakeholders to discuss its proposals and the feedback provided in submissions. In addition, APRA has also held workshops with various stakeholders to discuss implementation issues.

Submissions received

During the two years of consultation on the LAGIC proposals, APRA has received approximately 120 submissions and more than 100 insurers participated in both QIS1 and QIS2.

Submissions have consistently indicated a broad level of support for APRA's aims in undertaking the review of improving the risk sensitivity of the capital standards and achieving better alignment across APRA-regulated industries. It should be noted that APRA has already addressed a number of areas of concern through ongoing consultation and enhanced amendments to its proposals. This RIS does not comment on those areas of feedback which have been addressed through changes to the proposals, focusing instead on areas in which industry continues to have concerns with the LAGIC proposals. A number of key areas of feedback are discussed below.

Issues affecting both general and life insurers

International comparisons

Some submissions argued that, with the implementation of LAGIC, Australia will be amongst the first countries to apply the Basel III approach to composition of capital to insurers. This 'front-of-pack' approach to regulatory reforms in the insurance industry may create a competitive disadvantage for Australian domiciled insurers, who may face higher costs of reinsurance and higher costs of raising capital. APRA maintains that its supervisory approach operates under the mandate to be consistent and in line with international best practice.¹¹ In light of the risks raised during the GFC, APRA contends that the benefits of increasing the risk sensitivity of the capital standards and improving alignment between industries outweigh the potential costs of the LAGIC reforms.

Calculation and quality of capital

Submissions commented that the limits on composition of capital backing the PCR are unduly penal, and out of line with those proposed to apply to ADIs under Basel III. APRA has responded to these submissions by increasing the limits for Additional Tier 1 capital to support the PCR. Whilst these limits are not directly aligned to the Basel III equivalents (due to the difference of approach on inclusion of a capital conservation buffer), APRA is satisfied that the limits provide an appropriate comparison whilst increasing the quality of capital held by insurers.

Operational risk

The formula used to determine the operational risk charge was seen to be insufficiently sensitive to the quality of management and internal risk controls, so

¹¹ See: <http://www.apra.gov.au/AboutAPRA/Pages/default.aspx>

that improvements in operational risk management would not be reflected in a lower operational risk charge. Submissions argued that the operational risk charge should be replaced with a more risk sensitive measure.

APRA accepts that the operational risk charge as proposed is not as risk-sensitive as would be desired, but no better alternative has been proposed by industry. APRA expects that an improved approach will evolve over time when industry has more experience with the measurement of operational risk capital. APRA does not support a subjective approach for the calculation of the operational risk charge at this stage or the use of partial internal models to determine specific risk charges. If inappropriate results are produced through the formula, APRA has powers within the capital standards to vary the result in exceptional circumstances. APRA will review and revise the formula in future if necessary.

Calibration of the asset risk charges

Some submissions argue that the shocks assumed for the purposes of the asset risk charge are too high to represent the 99.5 per cent confidence level intended under LAGIC. APRA does not agree with these arguments. Detailed analysis undertaken by APRA, taking into account the impact of the GFC, shows that the assumptions used are not out of alignment with the target 99.5 per cent confidence level.

Transitional arrangements

Industry has raised some concern that decisions on transitional arrangements will be made too close to the end of the year, creating undue uncertainty for insurers regarding the requirements that will apply from the effective date of 1 January 2013. APRA has emphasised in public speaking engagements and response papers that APRA is open to considering appropriate transition arrangements where required, and that insurers can and should approach APRA as soon as possible to discuss transition arrangements. APRA has indicated that the latest insurers can apply is 30 September but that discussions can and should commence well ahead of that time.

While some submissions argued that it would be appropriate to defer the overall effective date of the LAGIC regime, APRA does not consider that there is a case to defer the overall effective date given the availability of transitional arrangements. The broad LAGIC proposals, including the implementation timeline, have been well known to industry for a substantial period of time.

Supervisory adjustments

Submissions continued to seek additional guidance on the circumstances in which a Pillar 2 supervisory adjustment may be applied by APRA. APRA has provided significant clarification in response papers and insurers will receive further guidance through final prudential standards and prudential practice guides. APRA notes that the power to apply a supervisory adjustment is one tool in a broader supervisory toolkit for addressing prudential concerns.

General insurance specific issues

Timing requirements

Submissions requested an industry wide transition period for the horizontal requirement of the insurance concentration risk charge for general insurers. It was argued that insurers needed additional time to determine and implement an appropriate strategy. In response, APRA has deferred the effective date of the horizontal requirement until 1 January 2014. This will allow general insurers to develop their understanding of the operation of the horizontal requirement and finalise and implement any strategies for managing the horizontal requirement.

Submissions were opposed to APRA's proposal to bring forward the due date of the Financial Condition Report (FCR) and the Insurance Liability Valuation Report (ILVR), arguing that this may place a strain on key actuarial resources, could reduce the quality and usefulness of the documents and make it difficult to present the results to the Board prior to the deadline. APRA has considered the submissions by industry and held discussions with other stakeholders to ascertain the extent to which the three month deadline is not feasible due to actuarial and Board availability. APRA is of the view that insurers will be able to adjust their processes to meet the three month timeframe. Providing both of these reports to the Board and to APRA within a three month deadline will increase their usefulness because they will be considered closer to the financial year end. In order to give insurers time to adapt their processes, APRA has provided an industry-wide transition. APRA has also allowed flexibility on the timing of the ICAAP reporting requirements which will also help alleviate concerns about workload. The three month deadline will need to be met for the first ILVR and FCR for balance dates from 30 June 2014 onwards.

Clarifications

Further clarification was requested on the rationale for the approach and calibration of the horizontal requirement for the insurance concentration risk charge. In light of industry feedback on the calibration levels, APRA undertook further analysis internally, with results suggesting that the calibrations were reasonable overall. Therefore, APRA has retained the proposed calibration of the horizontal requirement scenarios and has more clearly defined the loss threshold to be used for the calculation of the expected claims offset.

Life insurance specific issues

\$10 million minimum

There are ongoing concerns from the friendly society industry about the application of the \$10 million minimum to the prescribed capital amount for friendly societies. It is not APRA's intention that existing friendly societies would need to raise capital or reduce distributions to members to meet the \$10 million minimum. APRA will use its discretion under the prudential standards to apply appropriate transition arrangements (or grandfathering in some cases) to ensure that the requirement operates as intended. Exemptions and modifications will be assessed on a case-by-case basis as part of determining specific transition arrangements.

Deferred acquisition costs

Submissions argued that deferred acquisition costs (DAC) and future profit margins have value to a life insurer, even in severely stressed circumstances, and should be given more value than the intangible assets of a life insurer. APRA acknowledges that the DAC of a life insurer may have some value under certain severe stress situations, such as if a stressed life insurer is recapitalised or the policies are transferred to another insurer. As a result, APRA proposed in its December 2011 Response Paper to allow some of the value of the DAC to be included, by allowing one year of DAC and profit margins to be explicitly allowed as an offset in the insurance risk charge, subject to the insurance risk charge not being negative. In addition, the methodology under LAGIC allows for some additional implicit value to be attributed to DAC and profit margins in the calculation of the capital base and the insurance risk charge, and where a new life insurer may be reliant on the recovery of existing DAC to fund the DAC in new business, in the absence of significant surplus assets.

As a result, APRA does not consider it appropriate to make any additional changes to the treatment of DAC and future profit margins for a life insurer.

Conclusion and recommended option

APRA has identified certain weaknesses in, and risks that are not adequately addressed by, the current capital standards for insurers, both through APRA's regular review of capital standards and in light of issues arising from recent natural disasters in Australia as well as the GFC. To address these, the LAGIC proposals refine the capital framework by improving the risk sensitivity of the current capital requirements, matching capital to the risks undertaken by insurers as an enhanced risk management measure. The framework will require insurers to hold enough capital to meet the target level of sufficiency of 99.5 per cent over a one year period. In determining an insurer's capital base, the definitions of capital will be broadly aligned with the ADI framework. This will strengthen the current capital requirements for insurers, requiring that capital must be freely available to absorb losses and rank behind the claims of policyholders, beneficiaries and other creditors in the event of winding up. APRA recommends that Option 1, the implementation of LAGIC, strikes the best balance between the interests of all stakeholders concerned. APRA's view is that the revised capital requirements are appropriately calibrated. Some insurers will have increased capital requirements, however any increases in required capital will be better linked to the risks undertaken by each insurer. APRA has analysed extensive data on the capital costs to insurers through the QIS process and industry submissions. It is not possible to quantify in dollar terms the non-capital costs due to very limited data provided by insurers on these costs. APRA has assessed through consultation and its knowledge of the industry that the capital costs are significantly greater than the non-capital costs.

While the net benefit cannot be quantified in dollar terms, in part due to the lack of data on non-capital costs, in APRA's assessment, the benefits of reduced risk of insurer failure will, in all likelihood, compensate for the increased costs for some insurers.

APRA supports Option 1.

Implementation

APRA intends to release the final prudential standards in advance of their effective date to assist industry in meeting the new requirements. The majority of the substantive LAGIC prudential standards will be released in May 2012. The remaining final prudential standards (including prudential standards containing requirements for the composition of the capital base and other prudential standards with changes consequential to the LAGIC changes) are intended to be released by October 2012. The revised standards will be effective from 1 January 2013. The following table gives an outline of release dates.

Date	Releases and consultations due
May 2012	Release of final versions of some prudential standards, draft standards on measurement of capital and draft versions of other prudential standards with changes that are consequential to the LAGIC changes.
September - October 2012	Release of remaining final prudential standards (covering composition of the capital base, the illiquidity premium and LAGIC-consequential changes to other prudential standards).
October 2012	Release of final reporting standards
1 January 2013	New standards effective
1 st quarter 2013	Release of final prudential practice guides
1 January 2014	Effective date for the horizontal requirement for general insurers and Level 2 insurance groups

If insurers are unable to implement changes to their current operations or arrangements to mitigate these impacts before 1 January 2013, APRA will consider transitional arrangements on a case-by-case basis. In addition, APRA has the ability to modify particular provisions if they result in inappropriate outcomes for a particular insurer.

The prudential standards will be reviewed as necessary to ensure they continue to reflect good practice and remain relevant and effective, for both APRA's prudential supervision purposes and for regulated institutions.