INSURANCE COUNCIL OF AUSTRALIA

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12 October 2011

Dear Ms Rowell

LAGIC: PROPOSED INSURANCE CONCENTRATION RISK CHARGE (ICRC)

The Insurance Council of Australia[1] (Insurance Council) appreciates the meetings and discussions that you and your colleagues have had with the Insurance Council and its members on the detail of the proposed ICRC. We welcome the opportunity to provide a written submission following up on the issues explored in relation to calculation of the ICRC, particularly of its horizontal component.

It is essential that the various components of the ICRC formula work together so that general insurers will be encouraged to take appropriate capital and reinsurance measures to manage the actual level of insurance concentration risk they face. Unnecessarily opaque requirements in this area may lead to inefficiencies in the market and consequent higher costs to policyholders without commensurate increases in their protection. For example, in order to reduce the impact of the four "one in six" events under the horizontal requirement, it would be beneficial to purchase aggregate cover. However, the significant cost and limited availability of aggregate cover at such low levels makes this impractical.

Need for clarification

We take as our starting point APRA's goal that the ICRC's horizontal requirement ensures general insurers hold sufficient capital to meet a 1 in 200 year aggregate loss. It is unclear how APRA determined that H_3 and H_4 approximated this level of risk. It would facilitate industry's understanding of what APRA is trying to achieve if the rationale behind H_3 and H_4 were made explicit.

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. March 2011 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $34.3 billion per annum and has total assets of $110.8 billion. The industry employs approx 60,000 people and on average pays out about $91 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

Calculation of "C"

We have raised in previous submissions the difficulties that may be caused by the significant scope for differing interpretations across general insurers of how "C"[2] is to be derived. In order to establish a clear, unambiguous method for calculating C, the Insurance Council would like to express its support for the exploration of an option that we understand has been put to APRA by at least one member. This would involve C being the sum of a proportion of premium liabilities for each of the APRA classes sold by the insurer. The proportion would vary in accordance with the percentage of the premium liabilities for that APRA class which APRA deemed (after consultation with industry) as being related to coverage of catastrophes.

In order to provide flexibility, this calculation of C could be set as the default method. It would be open to the Appointed Actuary of a general insurer to propose and justify an alternative to APRA.

In exploring this factor based approach to deriving C, the Insurance Council notes that further analysis is necessary for how it would apply at Level 2 and in relation to particular reinsurance classes.

Consideration of profitability

The Insurance Council welcomes indications that APRA is prepared to consider a role for profitability in determining the ICRC's horizontal component. Although precise quantification of the aggregate loss probabilities related to the series of catastrophes experienced in the first half of 2011 is difficult, estimates produced by members indicate that the floods, Cyclone Yasi and the New Zealand earthquakes would approximate to at least the 1 in 200 year aggregate loss figure targeted by APRA.

Australian general insurers have come through the extraordinary series of perils experienced in 2011 still profitable and without their solvency being impaired, and the Insurance Council therefore submits that it is clearly reasonable that profitability should be considered as an element of the ICRC calculation.

Realistic Disaster Scenarios (RDSs)

The Insurance Council and members have discussed with APRA the difficulties of estimating low level and unmodelled perils and the potential advantages of using a RDS style approach. The Insurance Council acknowledges that APRA has already considered and discounted the value of such an approach to modelling perils because it wants general insurers to consider the actual risks that they face.

However, the Insurance Council considers that there would be advantages in terms of consistent outcomes if APRA worked with industry to develop RDSs for key Australian perils. APRA's concerns about the need to take account of insurer specific risks could be managed by a RDS style approach coupled with the ICAAP. The work in developing RDSs would be considerable and time consuming. At this stage of LAGIC, the Insurance Council therefore suggests that the issue be put to one side, to be reconsidered as the new capital regime matures.

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[2] The annualised portion of premiums liabilities relating to events that lead to a substantial number of claims – APRA Response to Submission, 31 March 2011, Page 58.

Need to reconsider effective date of new standards
In its Response to Submissions, APRA confirmed its intention to release draft prudential standards for consultation by 30 October 2011, with implementation of the new capital regime to be effective from 1 January 2013. With work still underway on key aspects of the ICRC proposals, the Insurance Council understands that the release of draft prudential standards has been pushed back to November.

The Insurance Council welcomes the detailed discussions still being conducted because it is important that design of the new capital regime is thoroughly considered and judged satisfactory before implementation. However, the practical reality of all major components of the new regime not being settled is that general insurers are already having to make pricing decisions without knowing what their capital requirements will be. For example, members have had to file prices for Compulsory Third Party insurance in Queensland which will still be in force in 2013 and those for New South Wales will be filed before November. APRA will appreciate that this situation is far from ideal.

The Insurance Council and its members are willing to work with APRA to resolve as rapidly as possible the remaining methodological issues. However, if this proves impossible over the next month and release of the draft prudential standards is further delayed, the Insurance Council urges APRA to postpone commencement of the new capital standards by a further six months to 1 July 2013.

If you require further information in relation to this submission, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at janning@insurancecouncil.com.au.

Yours sincerely

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