Mr Neil Grummit
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29 March 2012

Dear Mr Grummit

LAGIC: SUBMISSION ON DRAFT GPS 116

The Insurance Council of Australia[1] (Insurance Council) appreciates the open and constructive dialogue that characterised the workshop on 13 March 2012 (the Workshop) on draft GPS 116: Insurance Concentration Risk Charge (ICRC).

As a general point, APRA's attempts to add consistency to the use of reinsurance by direct insurers are commendable. However, reinsurance contracts by their very nature are generally complex, large and structured to the unique requirements of individual insurers and in different jurisdictions globally. This generates many practical difficulties in attempting to set out exact approaches. Under clearly articulated principles, the majority of these reinsurance contracts could be broken down into similar components and tested against such principles.

Therefore, the Insurance Council suggests a better approach might be for GPS 116 to avoid "hard coding" methods and instead state general principles. APRA could then issue guidance notes that would need to be followed by individual companies in complying with these principles. We would expect that where individual company guidance was provided, such guidance would be "sanitised" by removing the most competitively sensitive components and then shared as industry wide guidance. For the sake of transparency, reference would be made in the Appointed Actuary's commentary on the calculation of the ICRC in the FCR/ILVR to any guidance that was not followed.

The Insurance Council welcomes the opportunity provided by APRA to make a further submission on the specific issues discussed at the workshop and these additional comments are detailed in **Attachment A**.

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. December 2011 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $36.0 billion per annum and has total assets of $115.6 billion. The industry employs approx 60,000 people and on average pays out about $110 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).

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We note that Ms Bible undertook, at the workshop, to reconsider a number of matters before finalising GPS 116. These are listed in **Attachment B**. The Insurance Council looks forward to discussing with APRA its response to the further information provided in this submission and the outcomes of its reassessment of the matters listed in Attachment B.

At the Workshop, APRA also discussed the possibility of using the Insurance Council's APRA Working Group as a sounding board for any proposed changes to the draft GPS116, prior to the issue of a final standard. The Insurance Council endorses this approach given the productive discussion that has already taken place between APRA and the Working Group on numerous questions of interpretation.

If you require further information in relation to this submission, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at email: janning@insurancecouncil.com.au or tel: 02 9253 5121.

Yours sincerely

Robert Whelan
Executive Director & CEO

INSURANCE COUNCIL OF AUSTRALIA

ATTACHMENT A

INSURANCE COUNCIL COMMENT ON SPECIFIC ISSUES IN GPS 116

Paragraph 5 (d) Definition of "Whole of portfolio"
The Insurance Council endorses the suggestion made at the Workshop that a Prudential Practice Guide (PPG) developed with industry input would be useful on the calculation of whole of portfolio – particularly in relation to the horizontal requirement.

It is noted that APRA's Response Paper refers to modelling at lower return periods:

> "APRA is confident that, given the availability of data, market models and individual insurer's approaches to pricing and reinsurance, insurers will be able to model at lower return periods the gross and net cost of the smaller-sized events proposed to be captured in the determination of the horizontal requirement. These events should include both single policy exposures as well as multiple claims from policyholders due to the occurrence of a natural peril event."

A PPG would promote clarity around these calculations. For instance, it is typical practice to adopt a blend of exposure and experience model outcomes when considering risk at the low severity, high frequency arena – rather than rely solely on an exposure based approach which is more appropriate for low frequency, high severity outcomes.

Paragraph 12 NP Vertical Requirement
This (and several other) paragraphs refers to a requirement for reinsurance to be in place for the next reporting period. In the Workshop, APRA indicated that the intention of these references was to capture changes to the reinsurance program that occurred on the day after the calculation/reporting date. APRA indicated that it would reconsider the wording of these paragraphs to ensure that it meets APRA's intentions. The Insurance Council supports this reconsideration, as the current wording could be interpreted to require reinsurance to be in place for the entirety of the next reporting period.

Members raised the need to think through the implications of having to advise the market of the PCA under Pillar Three Disclosure when this figure may change daily.

Paragraph 13 NP PML
For (b), we recommend changing the language to "all natural perils", as all perils are, by definition, modelled if they are included in the calculation.

We recommend a comprehensive definition such as:

> "Natural Peril Event" shall mean a loss occurrence caused by earthquake, seaquake, earthquake shock, seismic and/or volcanic disturbance/eruption, hurricane, rainstorm, storm, tempest, tornado, cyclone, typhoon, tidal wave, tsunami, flood, hail, winter weather/freeze, ice storm, weight of snow, avalanche, meteor/asteroid impact, landslip, landslide, bush fire, forest fire or lightening, as well as fire or surge following any of the above perils.

For (c), we recommend moving this to guidance, as discussed at the Workshop.

Paragraph 15 NP Reinstatement Premiums
The Workshop discussed the need for this paragraph to better reflect the practical realities of reinsurance contracts. As an example, we would consider these types of standard clauses as a contractual netting arrangement:

Reinstatement

A. In the event that all or any portion of the reinsurance under this Contract is exhausted by loss, the amount so exhausted will be reinstated from the time of occurrence of such loss. The Reinsurers' liability will not exceed $XXXXXX with respect to any one loss occurrence nor $XXXXXXXX in all during the term of this Contract.

B. For each amount so reinstated, the Company will pay an additional premium based upon the pro rata amount of the reinstatement only. The provisional reinstatement premium, based on the deposit premium, will be paid by the Company at the same time the Reinsurers pay the loss and will be finally adjusted as set forth in the Rate and Premium Article

Reinstatement premium offset is the market practice and as such these clauses should be adequate to meet the objective of this paragraph.

Paragraph 16 NP Reinstatement Cost
The Insurance Council understands the intent of this section is to capture the cost of a reinstatement of cover for the vertical requirement where one cover has been eroded during the year, leaving a subsequent reporting period without a contractually agreed reinstatement at an agreed price. However, where a company has purchased an upfront cover and a backup at one cost, the identification of the rate applicable for the third cover is problematic.

The cost for the reinstatement will not be the cost of the upfront, as this included a further reinstatement. We recommend that insurers use their judgement to estimate this cost based on experience, with brokers possibly supplying some verification of the reasonableness of these assumptions.

The cost of these prospective covers should also be allowed to be subject to a pro-rata adjustment for time (if that represents the practice for the particular cover being considered), meaning that if a cover is exhausted in May, the replacement cost need only cover the remaining portion of the year (assuming a 1 January inception and no seasonality).

Paragraph 23 H3 requirement
Similar to the comments above in relation to paragraph 13, for (b) we recommend changing the language to “all natural perils”, as all perils are, by definition, modelled if they are included in the calculation. For (c), we recommend moving this to guidance, as discussed in the meeting.

Paragraph 24 H3 requirement
As discussed at the Workshop, the second sentence of this clause can be deleted.

Paragraph 25 H3 requirement
See comments regarding paragraph 15 above.

Paragraphs 26 H3 requirement and 31H4 requirement
Paragraphs 26 and 31 set out a requirement to allow for various reinstatements when calculating the horizontal component. The Insurance Council requests further consideration

be given to clarify these requirements, particularly the requirement that the "… amount must not be less than the full original cost of the cover". For example:

- General market practice is that the first event cover and reinstatement(s) are purchased in a single transaction (with a single cost). Similar issues to those presented above for paragraph 16 also apply in this instance;

- Insurers will generally not wait until all reinsurance coverage is exhausted prior to purchasing any further reinsurance. Clarity is requested regarding the assumed cost of reinstatements as to whether the cost assumed must relate to a first event cover, or whether approaches reflecting market practice (for example maintaining at least one cover at all times) is appropriate.

The cost of these covers should also be subject to pro-rata for time, meaning that if a cover is exhausted in May, the replacement cost need only cover the remaining portion of the year (assuming a 1 January inception and no seasonality).

Paragraph 28 H4 requirement
Similar to the comments above in relation to paragraph 13, for (b) we recommend changing the language to "all natural perils", as all perils are, by definition, modelled if they are included in the calculation. For (c), we recommend moving this to guidance, as discussed in the meeting.

Paragraph 29 H4 requirement
As discussed at the Workshop, the second sentence of this clause can be deleted.

Paragraph 33 PL offset
We request a transition provision for incorporating this into the ILVR.

Paragraph 39-47 Other Accumulations
It is critical to get the definition of "Other Accumulations" right. The Insurance Council submits that it should be consistent with paragraph 7 which relates to "events":

> The Insurance Concentration Risk Charge for a regulated institution represents the net financial impact on the regulated institution from either a single large event, or a series of smaller events, within a one year period. The determination of the net financial impact is based on the formulae and requirements set out in this Prudential Standard.

The current Other Accumulations definition of "common dependent source or non-natural perils", using a whole-of-portfolio approach, seems like property-type terminology, which is inconsistent with the concept of these other types of risks. Presumably the definition is not intended to include "common dependent sources" such as inflation and interest spikes that are already allowed for within the insurance risk charge.

As discussed at the Workshop, the category of "other accumulations" should not include systemic type risks. For example, all losses arising from "asbestos" should not be seen as a single event. Rather, it would be the common causal factor in a number of separate events.

Whilst noting APRA's desire to avoid the use of Realistic Disaster Scenarios (RDS) in the calculation of natural peril vertical and/or horizontal requirements, the Insurance Council suggests that APRA reconsider whether a scenario-based approach would be more appropriate for these types of losses. For example, marine collision events or terrorism events are not consistent with the whole-of-portfolio approach.

It should be noted that practical and theoretical considerations around paragraph 61 with reference to "exposure to multiple events in a year" cannot be resolved without more certainty regarding paragraph 39.

Paragraph 54 Reinstatement
This paragraph requires a regulated institution to have a contractually agreed reinstatement for its catastrophe reinsurance arrangements at the program inception date. APRA recognised at the Workshop that there were difficulties with the paragraph as currently worded and suggested that the approach outlined in the Response Paper better represented its intentions.

The Insurance Council has a number of concerns with the proposed wording:

- As noted above, the drafting does not refer to catastrophe cover used to reduce an insurer's vertical requirement, which is described in the Response paper;
- Even if the position in the Response Paper is reflected in the standards, this will actively discourage insurers from usage of certain types of reinsurance to reduce risk. For example, the use of a first event "drop down" below the main retention (without a reinstatement) materially reduces risk, but will not be able to be counted for vertical requirement purposes, in many cases negating any capital benefit from purchasing such covers;
- It is not clear how partial placements of reinstatements should be treated;
- The treatment of a purchase of further reinsurance during a year is not apparent; and
- The paragraph currently appears to partially contradict paragraph 16.

The Insurance Council suggests that APRA should take account of the possibility that (at inception of a reinsurance programme):

- a reinstatement may not be available from the reinsurance market;
- a reinstatement may not be available at commercially acceptable terms from the market;
- reinsurance may be offered by selected markets (many of which are collateralised markets) on a single-shot basis;
- particularly from a horizontal perspective, the ability to fill sideways gaps with a mix of single-shot and reinstateable covers provides more flexibility to Insurers.

The practical implication of only fully reinstatable cover being valid for the vertical requirement clearly limits the options open to insurers. The effect of this paragraph will be to disincentivise the opportunistic purchase of reinsurance cover where a reinstatement is unavailable. Moving to a principles-based approach whereby it would be open to the insurer to demonstrate that the effect of its program is to achieve the goal of dual event protection (complete or partial) should provide insurers with the required level of commercial flexibility.

<u>Transition</u>
Given that there will be no industry wide transition for the vertical component of the ICRC, paragraph 54 (even if amended) will presumably apply to insurers from 1 January 2013.

The Insurance Council seeks confirmation that this clause will not be retroactive. That is, for insurers where 1 January 2013 is mid-reinsurance program, then if there was not a full reinstatement in place at the renewal prior to 1 January 2013, for example 1 July 2012, then there will not be regulatory penalties, in terms of either compliance with GPS116 and/or the ability to utilise this reinsurance to reduce the vertical component of the ICRC.

Given that insurers with 1 July 2012 reinsurance renewal dates are already engaged in their renewal process, ***the Insurance Council requests clarity of this point as soon as possible***. If the clarification is not available until the final GPS116 is issued in May, this is likely to cause difficulties for those insurers, as they will be required to complete the bulk of their reinsurance renewal process without a clear understanding of the prudential implications of that program.

Paragraph 56 Securitisation
The Insurance Council suggests that this paragraph be expanded to include other forms of capital or risk mitigation which are not traditional reinsurance (rather than just securitisation). This would then allow an insurer to approach APRA to seek approval to allow the possible use of alternative forms of capital (e.g. catastrophe bonds) to reduce the ICRC.

Paragraphs 57-58 Catastrophe Models
We note the difficulties with complying with these paragraphs as a GPS requirement and recommend reformulating them as guidance. This type of requirement would be the equivalent of expecting a company to fully understand an external actuarial valuation, which would defeat the purpose of the outsourcing to experts.

The Insurance Council recognises that an insurer should be able to understand the models that they use and considers that this could be documented in conjunction with paragraph 59 below.

Paragraph 59 Review and reporting
The Insurance Council recommends moving this documentation elsewhere, as inclusion in the ReMS confuses its purpose.

Paragraph 61 Review and reporting
Members were concerned the second sentence effectively amounted to a de facto horizontal requirement for OA.

ATTACHMENT B

ISSUES THAT APRA AGREED TO RECONSIDER

Paragraph 5 (c) Definition of natural perils
APRA will reconsider the wording around “man-made disasters”. The issue is whether risks such as terrorism and nuclear would also be caught rather than come under “Other Accumulations” as intended. It was suggested that “conflagrations” which was commonly used in reinsurance arrangements be used instead of “bushfires”. Please also note discussion under paragraph 13 above.

APRA will also reconsider whether “all possible perils” included natural perils.

Paragraph 7
APRA will provide guidance on whether the horizontal requirement needed to be recalculated for an acquisition or divestment.

Paragraph 12
How APRA would regard unplaced components of proposed cat towers at the reporting date.

Paragraph 16
Whether a deduction should be allowed for the expiry of time.

Paragraph 17
How this paragraph could be worded more clearly

Paragraph 33 PL offset
As noted at the meeting paragraph 33(c) needs to be re-worded to be consistent with the Response Paper. Also, it should probably be clarified that the PL offset cannot be bigger than the greater of H3 and H4.

Paragraph 40
Whether any unintended differences had developed between the PL offsets for NP and OA.

Paragraph 56
The purpose of this paragraph.

Paragraphs 57 and 58
Whether these paragraphs would not be better as guidance.

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