

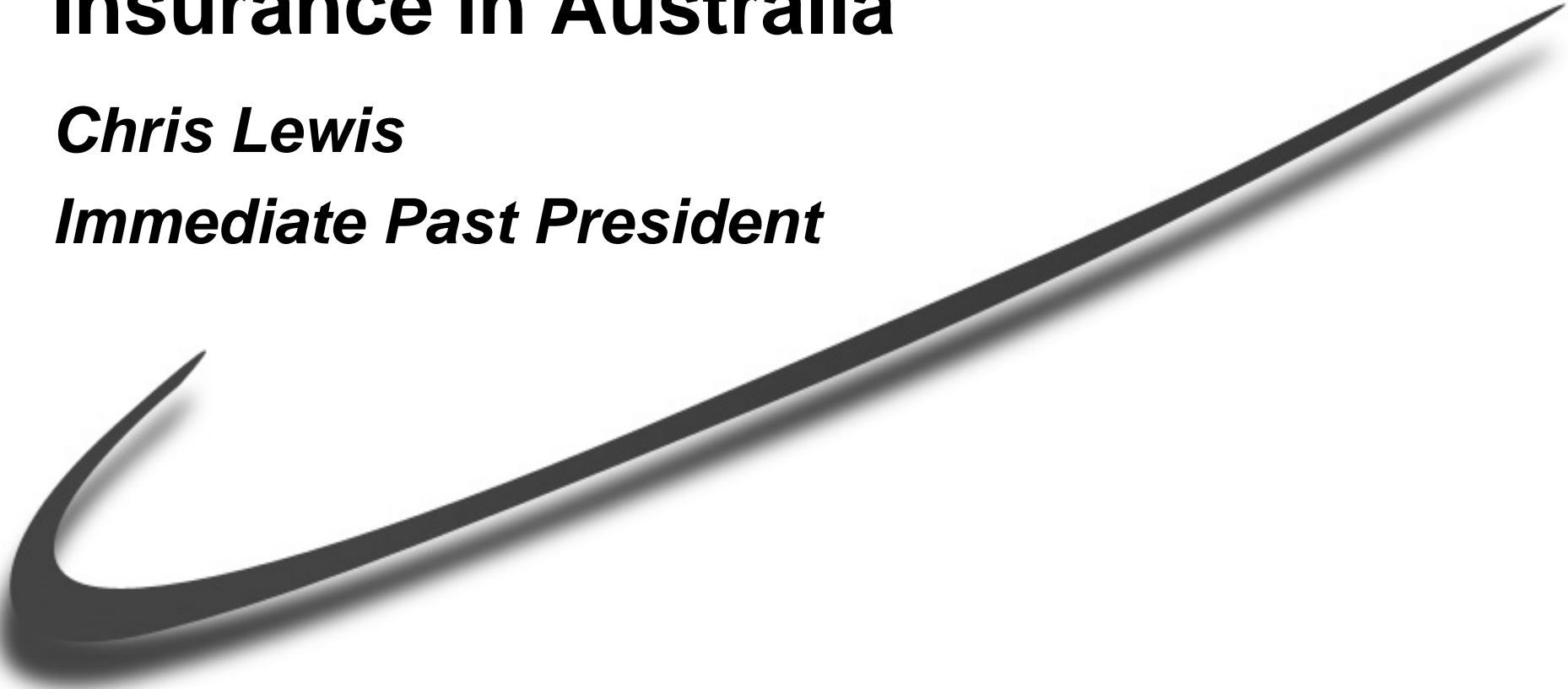


Institute of Actuaries of Australia

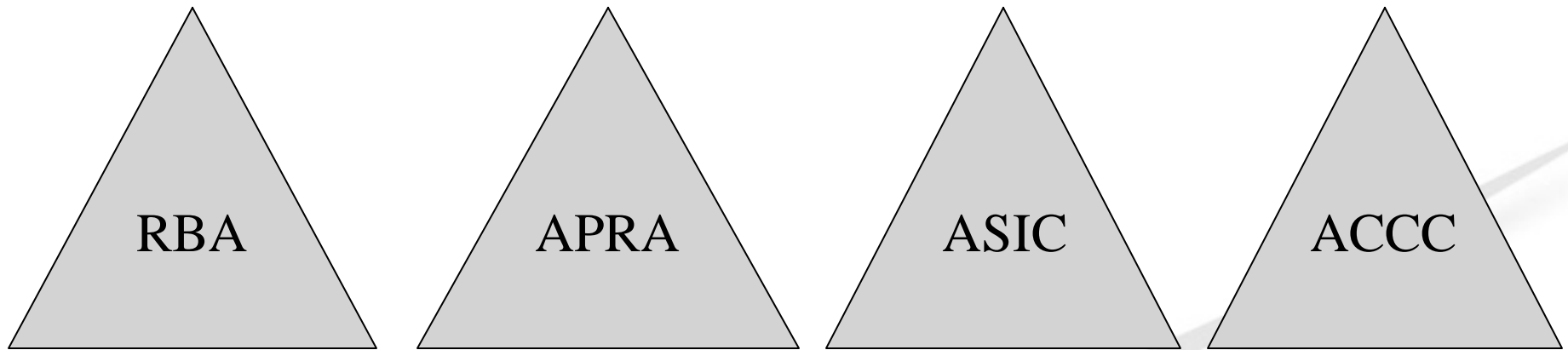
Prudential Supervision of Insurance in Australia

Chris Lewis

Immediate Past President



REGULATORY FRAMEWORK



Monetary Policy
System Stability
Payments System

Prudential
supervision
- banks
- building societies
- credit unions
- life and general
insurers
- superannuation
funds

Market Integrity
Corporations Law

Consumer Protection
(excl Finance)
Competition Policy



APRA

- Prudential regulator for banking, insurance (life and general), superannuation (pension funds)
- Nearly 500 staff, mostly in Sydney
- Nearly 4000 institutions
- Commenced operations 1 July 1998
- I am indebted to APRA for much of the material in this presentation



APRA's Conceptual Model

Probability And Impact Rating System(PAIRS)

- Covers all regulated entities

Assessment looks at:

- Inherent risk
- *Minus* Management and Control
- *Minus* Capital Support
- *Equals* Overall risk of failure



PAIRS – Inherent Risks

- **Asset Quality & Counterparty Risk**
- **Balance Sheet & Market Risk**
- **Contagion & Related Party Risk**
- **Insurance Risk**
- **Operational Risk**
- **Liquidity Risk**
- **Legal and Regulatory Risk**
- **Strategic Risk**



PAIRS – Management, Controls & Capital

- **Board of Directors or Trustees.**
- **Senior & Operational Management**
- **MIS/Financial Control, Other Controls**
- **Risk Management & Compliance**

- **Current Coverage/Surplus**
- **Earnings/Access to New Capital**



Banks and other ADIs

- **APRA supervises local banks, foreign bank branches, credit unions, building societies**
- **Little actuarial involvement**



Life Insurance



Life Insurance

- **Life Insurance Act (1995) – modern act**
- **Solvency and Capital Adequacy standards integral components of Act- a two tier approach**
- **Clear roles for Appointed Actuary and Auditor**
- **Ultimate responsibility with Board**



Solvency Standard

- **Purpose is to prescribe the minimum capital requirement of a statutory fund of a life company to ensure that under a range of adverse circumstances the company would be expected to be in a position to meet (guaranteed) obligations to policy owners and other creditors**



Solvency Standard

- **Solvency position disclosed in financial statements**
- **Test applies continuously**
- **If fail test at any time , APRA may give any instructions it deems necessary to ensure company can meet its liabilities**



Capital Adequacy Standard

- **Purpose is to prescribe the capital requirement to ensure that the obligations to, and reasonable expectations of, policy owners and creditors are able to be met under a range of adverse circumstances, in the context of a viable ongoing operation**



Capital Adequacy Standard

- **Not required to be disclosed in financial statements**
- **Test applies continuously**
- **If fail test, APRA can give instructions it deems necessary to ensure company can continue to operate as ongoing vehicle**
- **Can't pay a dividend except with APRA approval**



Life Insurance Actuarial Standards Board(LIASB)

- **Solvency and Capital Adequacy requirements set down in standards issued by LIASB**
- **LIASB is statutory body set up under Life Act**
- **Independent of APRA and Australian Institute, but works closely with them**



Appointed Actuary

- **Concept around for many years**
- **Required to comply with IASB standards**
- **Must produce Financial Condition Report – copy to APRA**
- **Significant whistle blowing responsibilities**
- **Must be FIAA with 5 years experience, or any other candidate approved by APRA**



General Insurance



Background

- **Collapse of HIH occurred March 2001 under old regime**
- **New regime in pipeline but not introduced until July 2002**
- **Approved Actuary role established**
- **Experience being monitored**
- **Revisions/improvements planned in 2004/5**



Topics

- **Liability Valuation**
- **Risk Based Capital Framework**
- **GI Reforms Mark II**



Liability Valuation



Prudential Standard

- **Aims to provide a framework for consistent valuation of a general insurer's policy liabilities at a level appropriate to the risks undertaken**
- **Responsibility for placing a value on the liabilities belongs to the Board**



Outstanding Claims Liabilities

- **Amount to take account of claims that have already occurred but are still outstanding at the balance date**
 - **known claims still not yet paid out**
 - **claims incurred but not reported (IBNR)**
- **Discounted values**
- **More significant in long tail classes**



Premiums Liability

- **Amount to take account of claims that will occur after the balance date under policies which still have a period of risk to run**
- **Valued prospectively**
- **Discounted value**
- **More prominent in short tail classes**



Central Estimate

- **Probability of sufficiency of 50%**
- **Reflects the mean of the range of likely outcomes of the distribution for the class of business**
- **Neither optimistic or pessimistic**



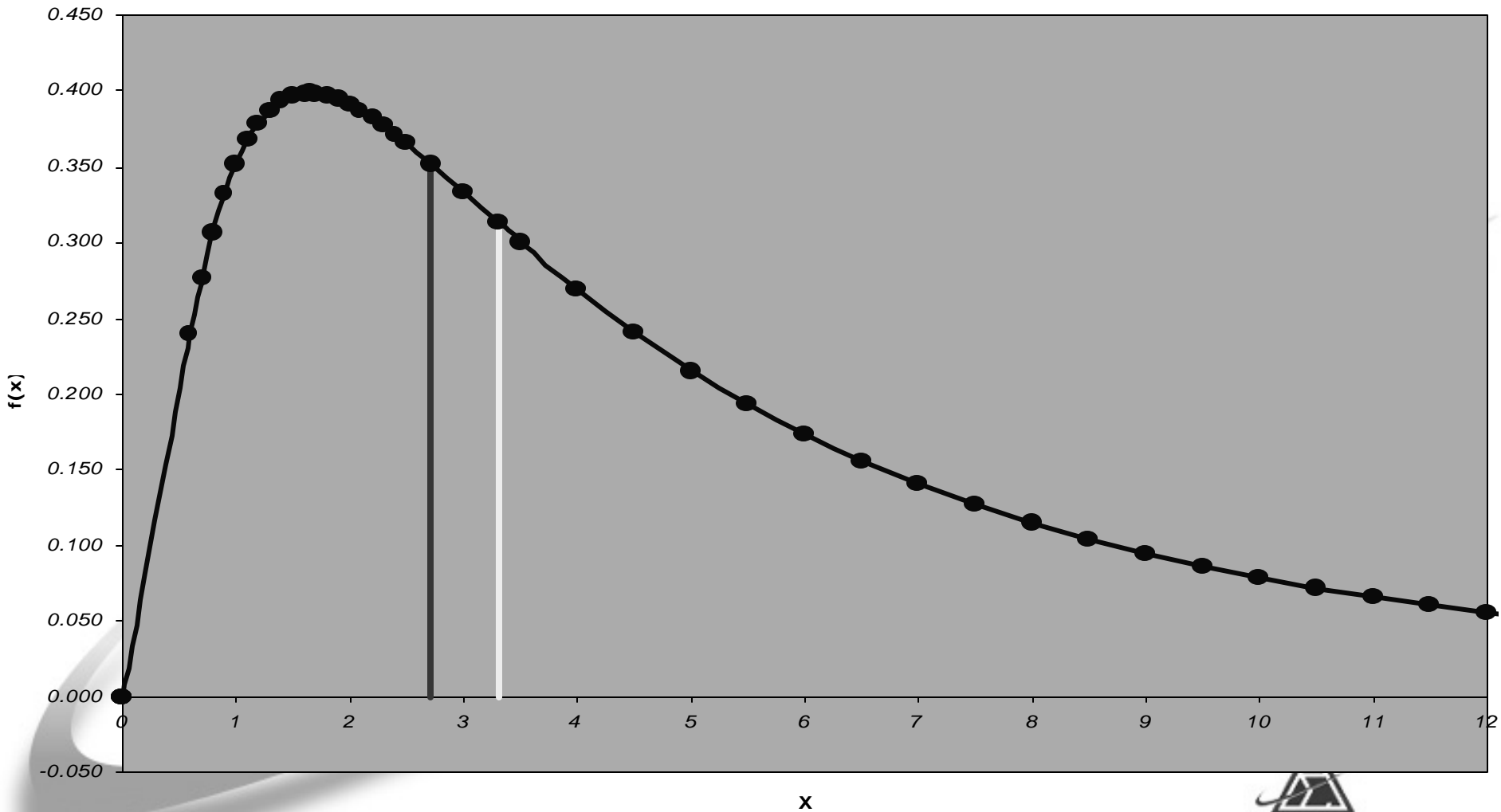
Risk Margin

- **Additional amount added to the central estimate**
- **“Safety margin” to increase probability of sufficiency above 50%**
- **GPS 210 requires a risk margin which increases probability of sufficiency to 75%**



75 % sufficiency

● Log Normal Dist — Mean — 75% Sufficiency



Risk Margins

- **Different margins apply to Outstanding Claims and Premium Liabilities**
- **Many factors influence risk margins selected**
- **Approved Actuary allowed to assume benefits of diversification**
- **Experience of risk margins and diversification allowances adopted being monitored and developed further**



- **Insurer must seek advice from Approved Actuary on central estimate plus risk margins for insurance liabilities**
- **Insurer can use different liability value/risk margin than recommended by Approved Actuary but must disclose**



Pricing Controls

- **No direct controls – APRA’s liability and capital requirements influence premiums and costs**
- **Australian Consumer and Competition Commission (ACCC) monitors pricing in the insurance market**
- **Productivity Commission recently reviewed claims practices in public liability insurance**



Approved Actuary

- **External or internal actuary approved by APRA. Some exemptions from need to appoint actuary**
- **Generally must have 5 years experience in general insurance field and qualifications from suitable professional body. Generally expected to be resident of Australia.**
- **APRA can approve candidates outside these conditions**
- **Whistle blowing responsibilities**



Risk Based Capital Framework



- **Insurer determines Minimum Capital Requirement (MCR) based on risk factors**
- **Insurer must have eligible Tier 1 & Tier 2 capital in excess of MCR at all times**
- **APRA generally seeks minimum capital of at least 1.2xMCR**
- **Absolute minimum capital requirement of AUD\$5 Million**



Risk capital requirements for:

- **Insurance risk** - the risk that the value of net insurance liabilities could be greater than the 75% sufficiency value;
- **Investment risk** - the risk of an adverse movement in the value of an insurer's assets and/or off-balance sheet exposures; and
- **Concentration risk** - the risk associated with an accumulation of exposure(s)
- **Designed so insurers have 99.5% probability of being solvent in 12 months time**



Insurance Risk Capital factors:

Class of Business	Outstanding Claims	Premium Liability
Householders & domestic	9%	13.5%
Fire, Marine, Mortgage	11%	16.5%
CTP, Public Liability, PI	15%	22.5%



Investment Risk Capital factors:

Class of Asset	Capital Factor
Cash, Federal/ Govt securities	0.5%
Debt < 1yrs, CMTs (Gr. 1,2)	1%
Debt > 1yrs, reinsurance recoveries (Gr. 1, 2)	2%
Debt, reinsurance (Gr. 3 or 4)	4% or 6%
Listed equity, trusts; Debt (Gr. 5)	8%
Direct property; unlisted equity	10%
Loans to directors; assets under charge	100%



Concentration Risk

- **Capital charge is in response to the risk associated with an accumulation of exposures to a single catastrophic event.**
- **Catastrophe set at 1 in 250 year event**
- **Based on Company's Maximum Event Retention(MER)**
- **MER is largest loss insurer exposed to (allowing for probability of loss) due to concentration of policies, net of reinsurance if catastrophe occurred**



GI Reforms Mark II



Three key parts

- **Revisions to Prudential Standards**
- **Supervision framework for conglomerate groups**
- **Disclosure**



Revisions to Prudential Standards

- **Capital management and related issues**
- **Governance issues eg**
Board composition
Auditor/Actuary independence
Fit & Proper Criteria
- **Role of Approved Actuary**
(Introduction of Financial Condition Report)



Superannuation



Background

- **Predominantly lump sum benefits provided at retirement**
- **Private provision of lifetime income streams (pensions) not common**
- **Defined contribution benefits also predominant – defined benefits in decline**
- **Five main types of funds – corporate, industry, public sector, retail, self managed**



Overview of investments

Split of investments (approximately)

- **35% directly invested**
- **35% placed with Investment Manager**
- **30% invested with Life Office**



Government Policy

- **Retirement Income Policy**
 - Provide adequate and secure retirement incomes
 - Reduce tax burden of ageing population on future generations
 - Retirement savings help meet national saving goals
- **“3” pillars to achieve objectives**
 - Means-tested age pension
 - Compulsory superannuation (9%)
 - Voluntary superannuation
- **Involve private industry / professions as far as possible**
- **Tax incentives: reasonable benefit limits / encourage income streams vs lump sums**



Legislation Overview

Main Legislative framework

- **Superannuation Industry (Supervision) Act 1993 and related regulations**

Administered by 3 Regulators

- **APRA – Prudential safety**
- **ASIC – Conduct and disclosure**
- **ATO- small funds**



Legislation - principles

- **Trustee**
 - Sole responsible entity
 - Trustee covenants – best interests of members; investment strategy
 - ‘Disqualified’ persons – negative tests
 - Retail – licensing and flat capital requirements
 - Non-retail – equal representation
- **Fund investments**
 - Sole purpose test
 - Restrictions – borrowing, lending, in-house assets, arm’s length transactions



Legislation - principles

- **Financial position monitored**
 - DC – external auditors
 - DB – external auditors and actuaries
 - Whistle blowing obligations
- **Fund rules cannot be changed to reduce accrued benefits**
- **Full disclosure of information to members (on specified occasions)**
- **Powers and sanctions against trustees who are negligent or misbehave intentionally**



Regulation by APRA

- **Licensing of some trustees, registering funds**
- **Risk rating to determine intensity of supervision**
- **Regular cycle for on-site review**
- **Analysing annual and quarterly APRA returns (currently being enhanced)**
- **Using rehabilitation and/or enforcement powers where required**



Capital Requirements

- **No specific capital requirements on superannuation plan itself**
- **Capital requirements on institutions providing services eg life offices, investment managers, approved trustees.**



Super and Insurance Policies

- **Super invested through insurance policies**
- **No difference in supervision model**
- **Essentially outsourcing investment asset allocation**
- **Extra regulatory level – Life Insurance Act 1995 (policyholder interests precede shareholders’)**
- **Impacts on risk assessment**
- **Related parties may bring additional layer of risk**



Further changes proposed

- **Licensing of all trustees – tiers of license**
- **Registration of funds before accept contributions**
- **Risk management strategies/plans required**
- **Expanded reporting requirements for auditors & actuaries**
- **Additional operating standards and guidelines e.g. fit & proper requirements, outsourcing, etc**



Thank You

