Insurance Council of Australia

31 March 2022

General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Level 12, 1 Martin Place
SYDNEY NSW 2000

By email: insurance.policy@apra.gov.au, dataconsultations@apra.gov.au

Dear sir or madam,

Consultation on proposed changes to the capital and reporting and LAGIC frameworks

The Insurance Council of Australia **(Insurance Council**) welcomes the opportunity to provide comment on the *Response Paper: Integrating AASB17 into the capital and reporting frameworks for insurances and updates to the LAGIC framework, December 2021* (**Response Paper**) which forms a part of APRA's consultation into the proposed changes. Members will respond directly to APRA in relation to the QIS component of the consultation.

The Insurance Council is the representative body of the general insurance industry (the **Industry**) in Australia and represents approximately 95% of private sector general insurers. As a foundational component of the Australian economy the general insurance industry employs approximately 60,000 people, generates gross written premium of $59.2 billion per annum and on average pays out $148.7 million in claims each working day ($38.8 billion per year).

We provide feedback on the changes discussed in Response Paper for each of the three frameworks in separate appendices.

The key feedback is:

- the Industry does not support the proposed changes relating to procedural requirements for reinsurance contracts. These will drive unnecessary regulatory cost into the provision of insurance to consumers for little to no benefit: see Appendix 3, item 11;
- the Industry is concerned that the asymmetric treatment of profits and losses under the proposed four quarters dividend test may lead to undistributable profits: see Appendix 1, item 2; and
- the proposed restrictions on allowing mutually owned life and general insurers to issue Mutual Equity Interests are inconsistent with the purpose the 2019 amendments to the *Corporations Act 2001* permitting mutual entities to raise capital by issuing this specialised capital instrument without risking demutualisation. Accordingly, the Industry is of the view that these proposed limitations should be removed: see Appendix 1, item 7.

We trust that our initial observations are of assistance. If you have any questions or comments in relation to our submission please contact Aparna Reddy, General Manager, Policy – Regulatory Affairs, on telephone: 0421 183 783 or email: areddy@insurancecouncil.com.au.

Yours sincerely

Andrew Hall
Executive Director and CEO

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Appendix 1

Capital Proposals

1. Regulatory Adjustments

ARPA's position is to maintain the current framework for the calculation of the capital base as the net assets of the insurer less all regulatory adjustments (positive and negative). APRA's intent is to minimise impacts on industry and seek capital neutrality where possible and appropriate. To maintain capital neutrality APRA proposes a range of additional adjustments. These new adjustments, broadly, relate to accruals which are currently recognised as separate assets and liabilities on the balance sheet. That treatment will change under AASB17.

The Industry is supportive of APRA's intent and regards the existing framework as robust and fit for purpose going forwards. However, the Industry considers that greater clarity is needed in relation to:

- capital base adjustments and the flow on effect to the capital risk charge. It appears that items are being taken out of the capital base calculation and put into the asset risk charge, which change compromises capital neutrality;
- the definitions for the adjustment line items, which are not considered to be clearly defined;
- the definition of, in particular, GPS 112 - "accruals for the cost of reinsurance not recognised in the accounts required to cover premiums liabilities". Is this referring to deferred reinsurance expense or something else?;
- the fair value exemption relating to non-financial assets;
- the treatment of DAC under the PAA method (written-off or deferred?) as this may have an impact on calculation of the capital base; and
- it is suggested that APRA review the need for the "2 balance day" approach moving forward.

2. The four quarters dividend test

APRA's view is that the proposed adjustment remains appropriate, and therefore its position is unchanged from the discussion paper.

Some members remain concerned that if the adjustment is one-sided (i.e. losses are included in the test but not gains) then over time there will be a component of "profits" which are not able to be distributed as unrealised losses in one period and which will reduce dividend capacity. But, if these losses were to reverse in a future period, the offsetting unrealised gains might be trapped and be unable to be paid out as a dividend.

If APRA's view is that changes in the fair value of financial assets that are taken through Other Comprehensive Income (OCI) should be part of "profits" for considering the dividends test, then the OCI relating to both unrealised gains and losses should be included in the dividend test, and not just unrealised losses. APRA states that it is looking to ensure the optionality (in terms of electing to book these unrealised gains and losses through OCI) does not result in a less sound prudential outcome. If that is the case, APRA should ensure both unrealised gains and losses on financial assets through OCI are included in the dividend test to ensure that the dividend test is unaffected by an individual insurer's choice as to whether to book these through profit or OCI.

3. The expense basis

APRA's approach is to maintain the existing methodology for the calculation of expenses. After receiving feedback APRA has provided clarifications to the existing definitions, rather than mandate the inclusion of all expenses, as a mean to promote better consistency in approach across the industry and ensure that an appropriate level of capital is held.

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The Industry is comfortable with this approach, as long as there is no requirement to maintain twos sets of accounting transactions. The improved definitions provided by APRA are welcomed.

4. Risk margin adjustments

APRA's position is unchanged from the discussion paper. APRA holds the view that the risk adjustment required for AASB 17 and the APRA risk margin are two different concepts. Furthermore, APRA's view is that prescribing factors to be applied to the net central estimate would reduce the effectiveness of the risk margin (reflecting the inherent level of uncertainty within the insurance liabilities). APRA does not propose changing the underlying methodology for the calculation of the risk margin.

The Industry understands APRA's position from a solvency perspective and has no specific concerns.

5. Discount rate

APRA's view, which is unchanged, is that the requirement on discount rates and the illiquidity premium remain appropriate as it minimises subjectivity and achieves a more prudentially sound outcome for the insurer.

The Industry considers as a matter of principle that APRA should allow the inclusion of the illiquidity premium. However, as a matter of pragmatism the Industry accepts APRA's position given this requirement is not overly burdensome.

6. Capital risk charges

APRA has subsequently identified a targeted number of areas within the capital requirements (covering the capital risk charges) where updates are required due to linkages with the accounting framework. Accordingly, it has made consequential amendments to the measurement of capital – Clarification on the regulatory adjustments to CET1 capital for deferred tax etc.

As a matter of pragmatism these changes align with the methodology adopted by some members when preparing the Quantitative Impact Study (QIS). It is also noted that this approach may result in regulatory capital outcomes that differ from those calculated under the current Accounting Standards (i.e. incremental DTA balances to be deducted). Further information would be welcome. However, overall the Industry appears comfortable with this approach.

7. Mutual equity interests

APRA introduced provisions to allow mutually owned life and general insurers to issue Mutual Equity Interests (**MEIs**) following the *Corporations Act 2001* amendment in April 2019 to allow mutual entities to raise capital by issuing this specialised capital instrument without risking demutualisation. It is proposed that the proportion of MEIs is limited to 25% of an insurer's CET1 capital, with any MEIs in excess of this limit eligible for inclusion in Tier 1 capital and the capital base. The new provisions also propose that distributions for MEIs cannot exceed 50% of the issuers net profit after tax in the financial year. Lastly it requires that prior to any issuance, an insurer must obtain APRA's approval.

The purpose of the MEIs was to reduce the barriers faced by mutual entities compared to other listed entities and allow for greater flexibility around capital management. As defined within the *Corporations Act 2001,* all MEIs are classified as "a share in a mutual entity that meets requirements relating to voting rights and other matters". Therefore, all MEIs that meet the requirements listed within sections 167AE and 167AF of the *Corporations Act 2001* will identify as a share and as a result should be treated the same as ordinary shares.

The Industry does not support the proposals as they are restricted to only MEIs and there are concerns that these proposals will unfavourably hinder and restrict the ability of mutual entities to utilise MEIs for capital management in comparison to other insurers issuing ordinary shares.

The Industry seeks:

- an increase to the 25% cap on Mutual Equity Interest contribution to CET1 capital;
- removal of the distributions limit of 50% of net profit after tax to align with the distribution clauses ordinary shares adhere to; and
- further alignment of the MEI clauses with the ordinary share clauses and, given the MEI issuance requirements drafted by APRA reflect the requirements within the *Corporations Act 2001*, the removal of the requirement for APRA approval prior to issuing MEIs.

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Appendix 2

Reporting proposals

1. New Product Groupings

APRA's position in relation to general insurers is to introduce new product groups for Directors and Officers (D&O) insurance and cyber insurance.

The Industry has no comments in relation to APRA's position. The proposed definitions of the new product groupings are clear and reasonable.

2. Allocation principles

APRA will introduce allocation principles so that insurers can systematically allocate AASB 17 accounting financials to APRA product groups to ensure reliable product group financial data are presented for analysis. Following feedback APRA has revised the allocation principles by removing the reference to the word "profitability" and introducing allocation drivers to reduce the burden of allocating AASB 17 financials to APRA product groups.

The Industry supports the amendments proposed by APRA, in particular the removal of "profitability" and the addition that the allocation approaches are to reflect allocation drivers determined on accounting and/or actuarial judgments.

3. Supplementary data

APRA intends to collect enhanced data for the purpose of capital assessment and product profitability monitoring. In relation to general insurers, the granularity of some supplementary data items has been simplified. APRA is also considering collecting from general insurers data for performance monitoring purposes, such as, Loss Ratios and Combined Operating Ratios.

There is some scepticism from the Industry. While the approach seems reasonable, there is a concern that the additional reporting requirements will become onerous and add to the already extensive reporting structures. The issue of poorly co-ordinated and increasingly burdensome data requests from regulators in recent years, however, is a broader issue.

More specifically, it is noted that Loss Ratios and Combined Operating Ratios are based on current AASB1023 concepts. Therefore, these will not be able to be calculated without maintaining two sets of books which we understand is not intended. Alternatively, if APRA intends to redefine what these two terms mean in an AASB17 context, then they will lose their value for performance comparability with pre-AASB17 periods.

Members seek clarification as to:

- the purpose of changing from 1 July 2023 reporting in APRA's revised quarterly reporting forms for all general insurers from a cumulative year to date basis to a discrete reporting basis. The purpose is from an industry perspective neither clear nor meaningful, given results are analysed on a year-to-date basis and not on discrete quarter periods

  It is also noted that making this change mid-year for December balancers is likely to produce some very odd answers for the period to 30 September and 31 December 2023 since the profit for the year to date in those two quarters will be a mix of two bases. The P&L for the period from 1 July to 30 September 2023 will either have to reflect all the adjustments required to get to AASB17 reporting in that quarter's P&L, or effectively start from an opening 30 June AASB 17 balance sheet that has not been reported to APRA as the 30 September 2023 balance sheet will otherwise not reconcile; and

- the supplementary form which appears to require the continued reporting of AASB1023 items.

4. Liability data collection

APRA has for general insurers incorporated the liability data collection into the existing reporting collections suite and removed elements that industry considered burdensome. The changes are enumerated in the Response Paper.

The Industry is generally supportive of the removal of data collection requirements due to the onerous nature of providing this information. However, they observe that APRA doesn't seem to have answered the industry's query regarding how the additional data will improve its understanding of profitability trends.

5. Reporting direction for supplementary data collection

APRA has considered the feedback received from general insurers and reduced the granularity of some items collected and removed other items no longer relevant to reduce burden on industry. Details are enumerated in the Response Paper.

The Industry is supportive of the revised position. It also supports data collection requirements being aligned with AABS17 wherever possible.

6. Audit requirements

APRA's intends to broadly follow the existing approach to the audit and assurance requirements for data returns to APRA (see *draft Prudential Standard LPS 310 Audit and Related Matters* (LPS 310) and the relevant draft general insurance reporting standards). etc.

The Industry is supportive of this position.

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Appendix 3

LAGIC proposals

1. Real interest rate stress test

APRA intends to alter the calculation of the stress adjustment required for the real interest rate stress by applying a three per cent floor to the nominal risk-free rate before multiplying by the prescribed factors. APRA recognises that this may impact an insurer's ARC and therefore their investment strategy, APRA considers this to be the most effective proposal to ensure the standard operates as intended in a low or negative interest rate environment.

The industry notes that this approach will result in a considerable increase in capital required in a low interest rate environment. It is also noted that the economic outlook is for a higher interest rate environment.

2. Expected inflation stress test

APRA intends to alter calculation of the stress by reducing the downward expected inflation stress to 50 basis points when nominal risk-free rates are negative. When nominal risk-free rates are between zero and one per cent, the downward expected inflation stress would be determined as the sum of 50 basis points and half of the nominal risk-free rate. APRA considers these amendments to be necessary to ensure the risk charge operates appropriately in a low or negative interest rate environment.

The Industry notes that the economic outlook is of a higher interest rate environment. Not all members, as yet, fully understand the impact on their capital position in such a nominal risk-free rate situation.

3. Removing the floor of zero for nominal interest rates

APRA intends to remove the floor on nominal risk-free rates of zero that applied to the downward inflation stress and real interest rate stress to allow the calculation to produce appropriate results in a negative interest rate environment.

The Industry notes that the likelihood of a negative interest rate environment in the near term is remote. Not all members, as yet, fully understand the impact on their capital situation if a negative interest rate environment was to arise.

4. Dollar value exposure limits (all)

APRA intends to adjust dollar value exposure limits based on the existing dollar value limit indexed by historic inflation and rounded to the nearest $100,000. APRA does not intend to introduce an indexation mechanism at this stage.

The Industry considers this approach to be reasonable.

5. Maintaining alignment in APRA's approach to the measurement of capital instruments

APRA intends to adopt previous revisions to APS 111 that improve the simplicity and transparency of capital instruments, as well as those which clarify expectations and existing requirements. Allowances for mutual equity interests have also been introduced.

The Industry agrees with the approach and is still considering if there are implications for existing clauses or any other practical issues. Some members do not expect to be impacted.

6. Removal of Internal Capital Models (ICMs)

APRA continues to intend to remove GPS 113 and require general insurers to adopt APRA's standard method for calculating regulatory capital. APRA strongly encourages insurers to instead to develop and use, or to continue to develop and use, economic capital models to drive robust risk and capital management decisions.

The Industry has no additional comment to make on APRA's intention to remove the option for insurers to develop ICMs beyond those made in the ICA's submission of 31 March 2021.

7. Default stress

APRA is proposing to maintain the proposal to permit general insurers to apply a charge for default stress to the net rather than gross quota share position for unpaid premium and unclosed business, for business ceded under a whole of account quota share arrangement. APRA recognises some general insurers may not have access to appropriate data to determine a net of quota share position. However, APRA believes it is appropriate for this option to be available for general insurers who are able to determine the net of quota share position as this is a better reflection of the transfer of risk.

The Industry is supportive of APRA's changed position. As with item 9 below clarification is requested as to why the benefit is only for whole of account quota share, rather than a facultative or portfolio quota share? A definition of "whole of account" may help clarify this as the intention may actually be to cover all appropriate arrangements consistently.

8. Fair value requirement for the measurement of assets

APRA is proposing to require all assets to be measured at fair value for capital base determination, other than non-financial assets, short-term receivables and intercompany receivables and payables which may be measured in accordance with the requirements in the Australian Accounting Standards (AASB) financial reporting standards.

The Industry is generally supportive of APRA's revised approach to allow general insurers to measure non-financial assets, short-term receivables and intercompany receivables and payables in accordance with AASBs, which may not necessarily be at fair value. However, clarification is required as to whether the exemptions include assets such as interests in equity accounted investees and investments in subsidiaries

It is noted that the relevant wording in GPS 114 and GPS 112 is not fully reflective of APRA's intention. For example, we suggest that para 19 of GPS 114 be amended to incorporate the words in **blue** below:

> "The stress tests must be applied to the **fair value** of each of the regulated institution's assets. A regulated institution may measure its non-financial assets ad short term receivables and payables using the requirements in Australian Accounting standards **as an estimate of or as a proxy** for fair value."

9. Operational risk charge for whole of account quota share arrangements

APRA has decided following feedback to maintain the existing methodology for the calculation of the operational risk charge for whole of account quota share arrangements.

The industry has mixed views of APRA's decision to retain the existing methodology.

On the one hand, some insurers are supportive of the proposal to retain the existing methodology. But, they would also like clarification from APRA as to why only "whole of account quota share" will get this benefit, rather than a facultative or portfolio quota share? They also seek a definition from APRA of "whole of account".

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The alternate view is that where there is a long-term whole of account quota share treaty in place between an Australian regulated insurer and reinsurer, the operation of risk charges required under Prudential Standard *GPS 118 Capital Adequacy: Operational Risk Charge* leads to a double-counting of these risk charges at the industry level. This leads to an undesirable outcome for the industry as a whole and for individual insurers and reinsurers. These contracts are typically written on a 'follow-the-fortunes' basis which means that the reinsurer shares in the underlying experience of the portfolio, and so many of the risks covered by the APRA risk charges have been transferred to the reinsurer in part or in full.

10. Duration of policies in the calculation of the Insurance Risk Charge

APRA maintains that the current method for calculating the IRC results in excessive capital being held for multi-year quota share arrangements. APRA proposes an alternate method for calculating the capital charge for a multi-year quota share reinsurance arrangement with a remaining term of up to 5 years. The proposed method requires a reinsurer to calculate material net written premium using the full premium revenue, subject to the material net written premium not exceeding the amount expected to be written in 18 months.

The Industry is generally supportive of this approach.

11. Procedural requirements for reinsurance contracts

APRA is proposing to adjust the revisions to reinsurance management requirements to an 'inception date and two-month rule', rather than requiring contracts to be fully finalised by inception. This proposal would require the terms and coverage of reinsurance contracts to be finalised by inception, but provide an additional two month period for wordings to be finalised, stamped and signed. APRA views this proposal as a transitionary measure and will consider making further revisions to require reinsurance contracts to be fully placed, executed and finalised by the inception date of the contract

APRA's further developed proposal does not enjoy the Industry's support.

The proposed requirement to have all contracts fully executed by inception, imposes unnecessary administrative burden on the industry, and may have a detrimental effect on the rates paid by insurers for their reinsurance programmes. These increased, regulator created, costs will ultimately be borne by consumers.

It is common practice with reinsurance programs of Australian insurers for the formal binding of reinsurers to take place, in certain circumstances, immediately prior to inception.

In practical terms, the requirement to have fully executed contracts at inception may not be viable in all cases, particularly when dealing with international reinsurers, and may have adverse effects. Whilst all bound, lines are confirmed in writing at or before the time of inception, there is still the potential for some intricacies around bespoke terms, clauses and variations and further negotiations around parts of the contracts which do not materially affect the cover provided.

Requiring reinsurers to provide their terms early enough to ensure a fully signed contract wording prior to inception is likely to disadvantage insurers in their negotiations which in turn may lead to significantly higher reinsurance costs than may be available under the current regulation. This will also mean that the achievement of contract certainty will be highly reliant on the efficiency of reinsurers' administrative abilities and therefore may be to some extent out of insurers' control.

Of particular significance in the current environment, it would be helpful to understand how the purchase of back up reinsurance covers would operate under the future state proposal, if contract certainty is required "by inception".

In particular, the Industry does not support APRA's proposal to require general insurers failing to meet the inception date rule to provide detail on the actions taken to ensure the appropriate documentation is in place in their reinsurance declaration (even where the two month rule is met). This adds additional administrative burden for no added value, given contract certainty would already be achieved by the time the declaration is issued.

The Industry also seeks further detail from APRA with respect to the Reinsurance Arrangements Statement and CEO signed Reinsurance Declaration requirements which are linked to contract certainty. Does APRA will also require these to be completed at inception?

12. Adjustments to other standards

In relation to Category C insurers, GPS 120 Para 27 outlines the treatment of premium receivable outstanding for more than six months from the date they became due and payable. The concept of premium receivable is not part of AASB 17.

The Industry seeks guidance from APRA as to how such items will be treated under the revised requirements.

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