



APRA's Agenda

IFSA Life Discussion Group

16 June 2010

Agenda for today



- APRA's Policy agenda for 2010-12
- Life and General Insurance Capital review
- Life insurance Supervision issues
- Variable annuities

APRA's Policy Agenda for 2010-12



- **ADIs**
 - Basel II enhancements - capital; liquidity
 - Funds Management & Risk Management Standards
- **GIs**
 - Level 2 tidy up
 - Performance reporting
- **Life insurance:**
 - Prudential rules to standards
 - Consequential amendments from NOHCs
 - Product Rationalisation
- **Superannuation:**
 - PPGs
 - Cooper review
- **Other**
 - LI & GI Capital review
 - Conglomerate proposals



Objectives of review

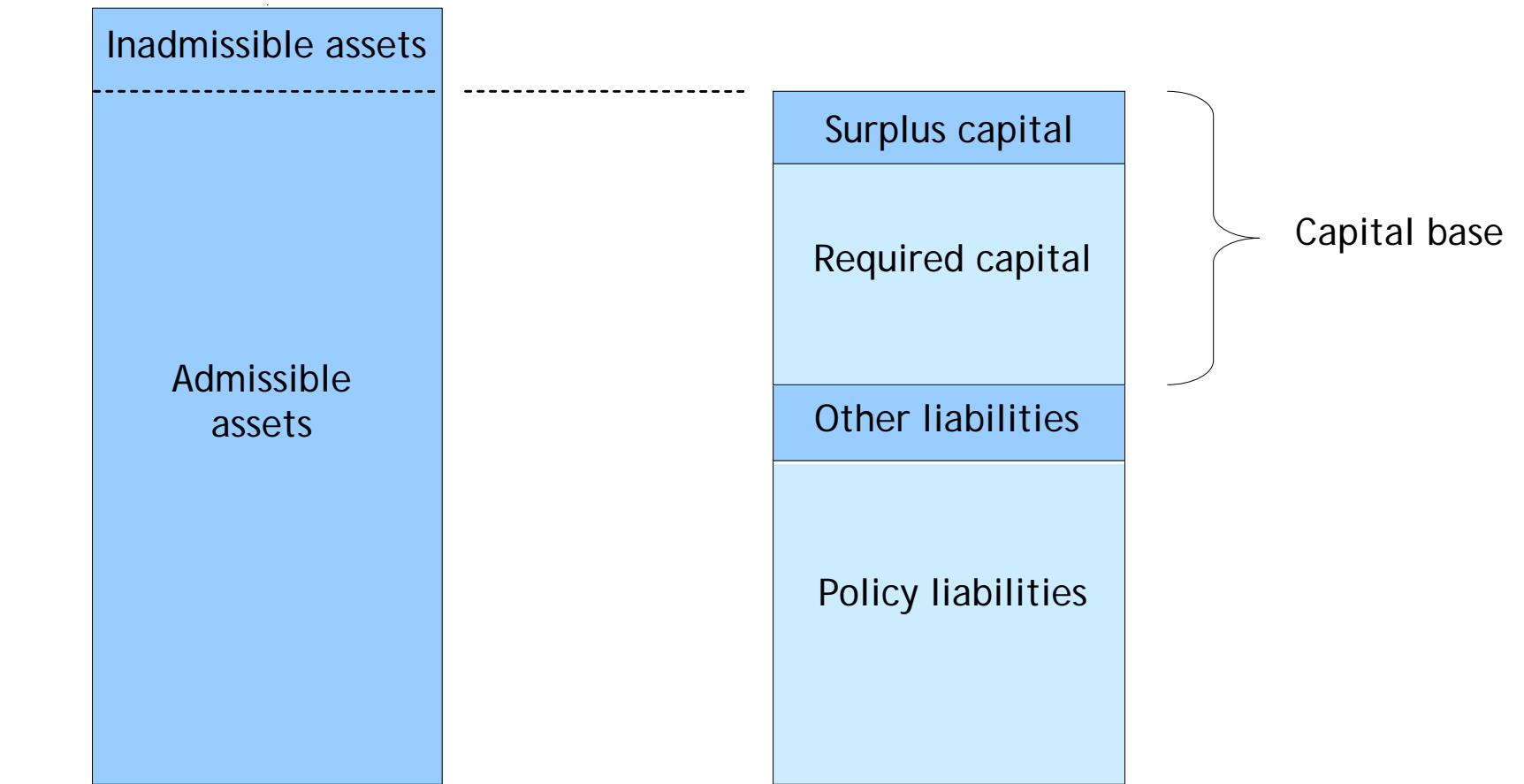
- Improve risk sensitivity, whilst avoiding excessive complexity
- Improve alignment of capital standards for general insurance and life insurance industries
- Improve alignment of insurers with ADIs, where appropriate
- Monitor international regulatory developments and maintain broad consistency of direction

Expected timetable



- May 2010 Discussion paper
- Jun 2010 Technical papers
- Jul 2010 Quantitative impact study issued
- Aug 2010 Submissions on discussion paper
- Oct 2010 Completion of QIS
- End 2010 Draft standards and response paper
- Mid 2011 Final standards
- Late 2011 Draft reporting forms
- Early 2012 Implementation

Proposed structure



Capital concepts



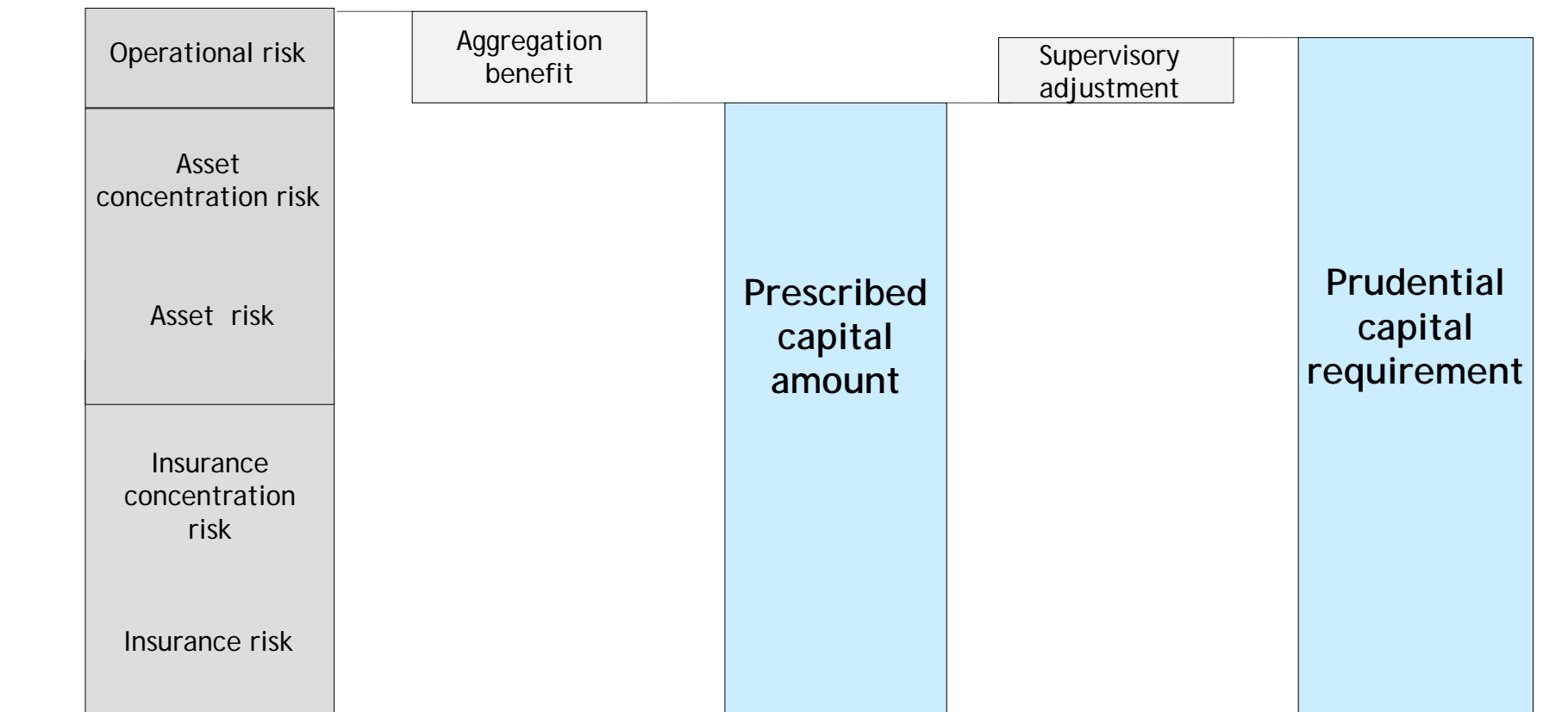
- Required capital - minimum capital that APRA requires a statutory fund to hold, determined with a probability of sufficiency of 99.5% over 1 year.
- Capital base - capital held by the statutory fund that APRA recognises as eligible for capital adequacy purposes.
- Surplus capital - excess of capital base over required capital
- Target surplus - targeted amount of surplus capital as determined by the board of the insurer

Structural changes



- Replace solvency & capital adequacy with one capital requirement (requires changes to the Life Insurance Act)
- Capital base and required capital (aligns with GIs and ADIs)
- Inadmissible assets reduce the capital base, instead of increasing the required capital

Components of required capital



Prudential capital requirement



Consists of:

- A prescribed capital amount determined in accordance with the quantitative rules set out in APRA standards; and
- A supervisory adjustment, if required by APRA.
- Prescribed capital amount must be publicly disclosed
- Supervisory adjustment must NOT be publicly disclosed

Capital base



Shareholders net assets (capital and retained earnings)

- Less inadmissible assets
- Plus approved subordinated debt
- Less adjustments to policy and other liabilities

Adjusted policy liabilities:

- *Greater of CTV and BEL*
 - *Include participating policy owner profits*
 - *Exclude shareholder profit margins*
- Capital base is aimed at being broadly consistent with ADIs and general insurance

Asset risk capital charge



- Replaces resilience reserve
- Eight stress tests applied to the balance sheet
- Inflation and real interest rates are stressed separately
- Volatility stress applied
- Includes all admissible assets of the fund (except asset concentrations)
- Uses unstressed liability assumptions with termination value minimum
- Capital aggregated using a correlation matrix
- Hypothecation of assets allowed

Asset concentration risk capital charge



- Recognise assets secured by third party or collateralised
- Reduce retrocession limits for specialist reinsurers from 100% to 50% of VASF
- Define specialist reinsurer as a statutory fund where all policy liabilities are inwards reinsurance

Insurance risk capital charge



- Margins applied to best estimate assumptions
- Short-term (12 month) margins for extreme claims experience - includes a pandemic stress
- Long-term margins for mis-estimation of the mean and adverse trends
- Restrictions on assumptions regarding future repricing of premium rates and fees
- Includes termination value minimum

Operational risk capital charge



- Applies to all products
- Based on premium income and/or liabilities
- Appropriate for a well-managed insurer
- Poor operational risk management may lead to a supervisory adjustment
- Details of factors and basis will be included in the QIS
- Remove existing investment-linked margins

Risk free discount rates



- Same definition for life and general insurance capital standards
- Must use yields on Commonwealth Government Securities for Australian liabilities
- Foreign government bond yields may need to be adjusted by the actuary for credit risk and liquidity
- Liquidity premium for lifetime annuities - if APRA can develop a robust method for quantification.
- Impact on LPS 1.04 policy liabilities yet to be decided

Life Insurance Supervision Issues



- Capital monitoring
- Industry consolidation
- Insurance capacity
- Unit pricing practices and governance
- Investment and longevity guarantees
- Design and pricing of risk products

Variable Annuities - background



- What are variable annuities
- Lessons learnt from overseas
- Are variable annuities life insurance?
- Bundling vs unbundling
- Statutory Fund

Management of Investment Risk



- Dynamic hedging
- Operational risk
- Outsourcing

Capital Treatment



- Complex risks
- Not specifically covered in current standards
- Most appropriately dealt with under resilience reserve
- Likely use of stochastic models
- Need to specifically address hedge effectiveness
- Limits on hedge effectiveness
- Risks beyond 12 months
- Allowance for any discretions available
- Need to discuss approach with APRA