Senate Select Committee on Superannuation and Financial Services

Main Inquiry
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Institute of Actuaries of Australia

23 May 2000

Senator John Watson
Chairman
Senate Select Committee on
Superannuation and Financial Services
The Senate,
Parliament House,
Canberra ACT 2600
AUSTRALIA

Dear Senator Watson,

Prudential supervision, global financial services and superannuation guarantee charge

I am writing on behalf of the Institute of Actuaries of Australia to introduce myself and to draw your attention to two previous submissions which may be of assistance in your current inquiry.

My name is Jane Ferguson and I am the recently appointed Director: Public Affairs for the Institute of Actuaries. As you know, the Institute and its members have an active interest in many issues of relevance to Government and are keen to assist Government by making submissions whenever this would be helpful. I look forward to assisting the Parliament in my liaison role on behalf of the Institute.

The two previous submissions that may be of relevance to your current inquiry are:

1. The Institute of Actuaries Prudential Regulation Taskforce Submission to APRA dated 5 March 1999; and

2. The Institute of Actuaries of Australia Response to the APRA General Insurance Discussion Papers dated 17 December 1999.

I have attached for your information the cover page, contents and executive summaries of these two documents. The complete documents may be downloaded from our website at http://www.actuaries.asn.au. From the home page go to "Publications" and then from there to "IAA Submissions to Government".

If you have any queries of wish to discuss the Institute's views, please do not hesitate to contact me.

Yours sincerely,

Jane Ferguson

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Director: Public Affairs

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INSTITUTE OF ACTUARIES OF AUSTRALIA

PRUDENTIAL REGULATION TASKFORCE

SUBMISSION TO THE

AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

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1. EXECUTIVE SUMMARY

This paper considers the desirable attributes of a regulatory framework; surveys the methodology and intensity of prudential supervision of financial institutions in Australia; and recommends, in view of the recent creation of APRA, some steps that can be taken to improve the quality and consistency of prudential regulation in Australia.

The key recommendations are that APRA should consider:

(a) adopting a more uniform approach to the supervision of financial services entities, by adopting a holistic risk-based approach to regulation, and aiming to control the intensity and cost of supervision appropriately and consistently across the various institutions;

(b) continuing and extending the current successful use of qualified professional people appointed by regulated entities for internal risk management, monitoring and reporting, rather than relying principally on reactive systems operated from within the regulatory body; and

(c) making maximum use of its powers to influence the development of international regulatory regimes, and co-ordinate the development of domestic approaches with international frameworks as far as possible.

It is the view of this taskforce that these recommendations will combine to produce a more effective, efficient, timely and responsive regulatory system.

They will do this:

- by targeting regulatory resources to the cases most in need of it;
- by placing the onus of problem identification on an identified individual(s) with intimate, real-time knowledge of the risks to which each particular entity is subject;
- by recognising that quality systems for the control of risk may reduce the need for risk financing; and
- by supplementing mechanical risk measurement processes with professional judgement.

IAA RESPONSE

APRA GENERAL INSURANCE DISCUSSION PAPERS

17 DECEMBER 1999

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A New Statutory Standard for General Insurers

A Statutory Liability Valuation Standard for General Insurers

Executive Summary

The Australian Prudential Regulation Authority (APRA) has recently issued three Policy Discussion Papers relating to regulation of General Insurers. These are:

Study of the Prudential Supervisory Requirements for General Insurers in Australia

A New Statutory Solvency Standard for General Insurers

A Statutory Valuation Standard for General Insurers

In the preamble to their papers, APRA invites comments from the general insurance industry and the Institute of Actuaries of Australia (IAA) by 17 December 1999. The IAA welcomes the opportunity to comment on the papers, and has prepared this document as its response.

A summary of our main comments on the policy papers is contained under the following headings, and the main part of the document goes through in detail our comments on each section of the policy papers, in the same order as presented.

i. Study of the Prudential Supervisory Requirements for General Insurers

The IAA supports the principles of APRA's supervisory approach as outlined in the paper, and agrees that it is appropriate for APRA to review the prudential supervision of general insurers in light of these principles.

The first chapter of the paper outlines the objectives of the study and highlights the areas of prudential supervision that APRA intends to address. These include risk responsiveness, transparency, reduction of barriers to competition, consistency with international best practice and consistency between the regulation of like risks across all financial institutions.

The IAA particularly concurs[1] with APRA's statement that the "supervisory framework should not be so prescriptive and restrictive as to entirely remove the risks associated with general insurance business", and that "ultimate responsibility for the prudent operation of general insurers should rest with the board and management of the

[1] Section 1.3

insurer". Striking the right balance between costs of regulatory compliance, and additional security this offers policyholders, is a difficult task.

The IAA strongly supports the move to a more risk responsive regulatory regime. It is important, however, to clearly define risk. The term risk has been used in many different contexts throughout the paper, and the IAA believes it is important to distinguish clearly between risk that is part of the insurance process (for example, individual policies are risks that are pooled in the insurance process), and risks that the insurance company faces, which have been categorised in the paper as liability, asset, ALM and operational risks. While certain parts of the paper group specific risks under these broad categories, other parts of the paper refer to risk more generally. APRA states[2] that *"prudential supervision should seek to respond to risky behaviour by imposing greater capital, reporting and other supervisory requirements on relatively higher risk insurers"*. APRA provides examples of requiring higher capital for insurers engaging in higher risk business, and requiring greater reporting for insurers at high risk of failure. While these examples are justifiable, **the IAA does not believe it would be appropriate to impose more stringent reporting requirements on insurers engaging in higher risk business**, unless they are close to insolvency, in which case they should be treated consistently with other insurers close to insolvency. There is an important distinction to make between the relative riskiness of the business underwritten, and the way this risk is managed by the insurer, including its management of capital and its operational risk framework. In seeking to make the regulatory regime more risk responsive, **it will be important not to create barriers to competition or other anomalies within particular segments of the insurance market.**

The IAA also supports increased transparency of the general insurance market through greater disclosure, where this information is not commercially sensitive. It is important that disclosed information such as prudential or risk margins is consistently presented and therefore comparable, and that disclosure is accompanied by appropriate explanations to avoid misinterpretation of the information by uneducated users.

Consistency with international best practice, where practical, and adherence to competition principles are supported by the IAA. In principle, consistency of regulation between like risks across financial institutions is also supported, especially where there is a possibility of regulatory arbitrage. However, it is important to note in this regard that in many respects **general insurance risks are different from life insurance and banking risks, due to their greater uncertainty, in particular the**

volatility of the liability risk. Moreover, the industries operate in different ways and have different practices, including the differing role of actuaries within the industries. It is therefore important to consider carefully the differences as well as the similarities between these industries, and ensure that the regulatory regime imposed on general insurers takes these into account.

The IAA broadly supports the principles put forward by APRA in relation to entry standards, such as the capacity to vary the minimum capital entry standard for different types of general insurers. The IAA agrees that it will be critical to monitor a start up company's adherence to its business plan if minimum capital is allowed to vary, and suggests that this be monitored more frequently than annually during its early years of operation.

The IAA broadly agrees with APRA's proposal in relation to **asset risks**. It will be important to spell out clearly the process and criteria for evaluating riskiness of related body assets, as the possible range of such assets is quite diverse. Consideration of "look through" provisions to underlying investments may be appropriate. There are also practical issues to address in using ratings agency ratings for risk-weighting reinsurance assets.

The framework and proposals put forward in the Section on **liability risks** are supported by the IAA in principle. We strongly support the inclusion of unexpired risks in the valuation of liabilities. We note that considerable consultation will be required to achieve an improvement in consistency of provisions.In particular, while the IAA has well established guidance for determining central estimates, **it will require time to develop appropriate guidance for the actuarial profession in carrying out any mandatory role with respect torisk margins or in advising on unexpired risk**.

The IAA believes that in identifying which companies or lines of business will be subject to mandatory actuarial advice, the guiding principle should be whether the majority of portfolios in the category (by size or class) currently seek actuarial advice. While the IAA encourages APRA to formalise the actuary's role in cases where actuarial advice is already standard practice, it is concerned that requirements not be too onerous. The actuarial profession has expanded its role in general insurance substantially over the last twenty years, as the industry has come to recognise the value of actuarial skills, and the demand for actuaries in general insurance continues to rise. It is the IAA's view that formalisation of the actuary's role in particular areas through regulation should not precede general acceptance of the actuary's value in that role by the industry.

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[1] Section 1.4

The IAA agrees that the new solvency standard should take into account the extent to which the assets and liabilities of general insurers are matched. There needs to be a clear definition of matching, including consideration of inflation matching as well as matching by currency and term. Care also needs to be taken in determining appropriate resilience requirements because of the inherently volatile nature of general insurance liabilities.

The IAA strongly supports APRA's increased focus on operational risks. While capital and reporting requirements can be used to increase security for policyholders, a comprehensive and sound risk management framework is likely to be most effective in providing early warning signs and preventing insolvencies. Liability risks and asset risks are often a manifestation of operational risks, and hence represent a symptom caused by an underlying lack of control of operational risk. For example, the risk of inadequate pricing is increased if the operational framework does not include close monitoring of business written and of emerging claims experience for that business, so that prices can be "corrected" quickly if necessary.

The most relevant proposal in this section of APRA's paper for the IAA is the proposed requirement for **an approved valuation actuary**. While the IAA broadly supports this formalisation of the actuary's role, it believes that discussion with the profession and consultation with the industry will be required to define the parameters of this role and ensure that these are practical relative to current practice. In particular, a statutory role should follow rather than precede actuarial involvement in a particular area of practice or segment of the market. Subject to this proviso, the IAA believes that the technical skills and experience of actuaries in risk analysis, and the requirement for actuaries to adhere to professional code of conduct and standards, mean that actuaries are well placed to assist in the development and eventual application of the General Insurance Solvency and Valuation Standards.

The IAA believes that ultimate responsibility for the provisions should rest with the board, which is in line with APRA's principle as stated in Section 1.3. The IAA does not consider that the approved valuation actuary should have "responsibility for ensuring compliance with the prudential standards for liability valuation". This contradicts the statement that the board should be ultimately responsible for such matters. The IAA suggests changing the wording to "The reserving recommendations to the board by the approved valuation actuary should comply with the prudential standards for liability valuation".

There should therefore be a mechanism for the board to disagree with the actuarial advice provided, in conjunction with suitable safeguards such as disclosure. It should also be noted that the actuary may not always be in a position to reconcile how the actuarial advice provided flows through to the final accounts. While they can certify that their advice complies with the valuation standard, it may not always be practical to certify that the actual provisions adopted by the company so comply. If the actuary is to have "whistle blower" responsibilities, similar protection will also be required as is provided to auditors.

The IAA broadly supports the proposed increase in **disclosure** requirements, however reiterates the need for comparability of disclosed information, and appropriate education of potential users of that information. The IAA also supports the concept of the **Financial Status Report** for companies nearing minimum solvency, subject to appropriate guidance being developed for its completion. Unlike for life insurance, the IAA does not believe that actuaries are currently in a position to be solely responsible for preparing the FSR, since in many cases the actuary's role in general insurers does not encompass all the relevant areas. The IAA believes that the issues of independence and accountability are important for APRA to consider in determining who should be responsible for the FSR.

The IAA has some practical concerns with the proposal put forward by APRA to deregulate reinsurers. These are expanded in our detailed comments, but the main concern is the impact on capital requirements of direct insurers, and the potential for regulatory arbitrage.

ii. A New Statutory Solvency Standard for General Insurers

The IAA supports the development of a solvency standard that is more responsive to the individual risk profiles of insurers. The default test proposed adheres quite closely to the structure put forward by the IAA's DSSGI working group, and the alternative option for insurers to use their own internal model is also supported. In developing the formulaic default test, the IAA believes it will be critical for the credibility of the new standard that a thorough, defensible analysis is prepared to support the **risk factors** that will apply to each of the components of the test.

It will also be critical to ensure that the **overall statutory minimum capital level** to which the test is calibrated, is supported by sound reasoning and analysis. For example, the test could be calibrated to approximate the current minimum capital requirements across the industry, or could be calibrated to a higher or lower level. The paper does not disclose APRA's view on this point, but it will be critical to the industry both in terms of its overall capital structure and its competitiveness. It will be particularly important given the "one-tier" solvency approach proposed, that any resulting change in the excess of actual capital over the statutory minimum, either for the industry or individual insurers, is carefully considered.

It will also be essential to relate the formulaic test in some meaningful way to the requirements for any **internal model**. It may be possible to equate the formulaic test to a benchmark scenario survivorship test which would form the "statutory minimum" level in an insurer's internal model. The insurer's internal model would then essentially have two tiers, one at the statutory minimum level and one at the level at which the Board and management of the insurer intend to operate.

A clear statement of principles for the internal modelling alternative would be extremely helpful to assist insurers in determining whether or not to explore this alternative. These principles should include such matters as

the criteria that will be applied in assessing the suitability of an internal model

whether and to what extent the default test is intended to be a tougher solvency standard than the internal model alternative

The technical challenge of developing a sound risk-based minimum capital formula, testing this across the industry and setting up appropriate guidelines for the use and assessment of internal models, cannot be underestimated. The IAA looks forward to assisting APRA in this task, and believes that actuaries are well placed to contribute significantly to the technical development of the standard. We believe, however, that the IAA's role should be more in the nature of a technical review capacity than in conducting detailed testing. Considerable detailed testing will be required at various stages of the development of the standard, for example in developing the theoretical risk factors for a "first cut" of the standard, then in testing the impact of the standard on individual insurers and on the industry as a whole. Because of the resources required to undertake this work, and the commercial sensitivity of the data, we feel that APRA should conduct the work internally, in conjunction with external resources and skills if required.

The IAA also notes that it will be important to consider transitional provisions, particularly given the number of insurers currently sitting at or near the absolute statutory minimum level of $2 million.

iii. A Statutory Valuation Standard for General Insurers

The IAA supports the concept of a valuation standard as described. The standard needs considerable expansion and we are already discussing this with APRA. We will be providing more specific input as this standard is developed, and discussing with APRA the process and time frame required for the IAA to develop guidance for members asked to provide advice under the proposed standard. A sufficient lead time will be required for the IAA to develop this guidance in consultation with members, particularly guidance on the estimation of unexpired risk and risk margins.

We note that the proposed valuation construct, although it does not use the terminology of fair value, is essentially the same as fair value in substance. The CROC working group recommended a move to this paradigm as a framework for achieving greater consistency, however considerable work is still required to reach agreement on the technical method of estimating fair value.

The IAA is committed to working closely with APRA in developing the valuation standard further, in particular in achieving an acceptable but technically sound approach to the estimation of the risk margin and greater consistency in provisions.