

**Perspectives on the Australian prudential framework
from someone who wears both AA and EPR hats**

Tim Spicer FIAA FNZSA

History of the Australian regime: *areas affecting actuaries*

- 2001
 - HIH collapse and Royal Commission of Inquiry
- 2002 - 2005
 - Introduction of prudential standard for liability valuations (GPS210) including introduction of the 75th percentile risk margin for prudential reporting purposes
 - Approved Actuary concept in similar form as today (approval by APRA)
 - Upgrades to actuarial professional standard (PS300)
 - Minimum Capital Requirements (MCR) for insurers (a prescribed factor based approach)
- 2006 - 2009
 - Upgrade of GPS210 to GPS310 (and of PS300), tweaks to MCR calculations
 - Introduction of FCRs and EPRs and associated professional standards (PS305 and PS100)
 - Fit and Proper policy → AA now stands for Appointed Actuary
 - Formal documentation of capital and risk management in Business Plan and other docs
- 2010
 - APRA consults on reforms to prudential supervision planned for 2012
 - MCR prescription substantially modified (aiming for greater risk sensitivity)
 - Greater focus on capital and risk management articulation (→ ICAAP reports)

What happened for actuaries over this time?

- Insurance Liability Valuations
 - From “best estimate” to “central estimate plus risk margin”
 - Liabilities arising out of unearned premium (premium liabilities)
 - Increased focus on the valuation process
- Financial Condition Reports (FCRs)
 - AAs required by regulator (APRA) to oversee production of the FCR
 - AA giving insurer Board an independent opinion of opportunities and threats
 - Much greater involvement of AAs in the insurer’s business activities
 - Some “discomfort” for actuaries with broadness of the role – it fades with time?
 - Finalised after audit clearance and no formal reviews of FCRs to date
- External Peer Review (EPR)
 - “Audit-plus” documented in a formal actuarial report
 - Formal communication between AA, auditor/audit actuary and insurer Board (and APRA)
 - Outcomes have been mixed; “territorial” and “pedantry” issues
- Other
 - Assistance with business projections (and stress testing) for Business Plan
 - Assistance with investment strategy concepts (e.g. duration and basis matching)

So what's in an FCR?

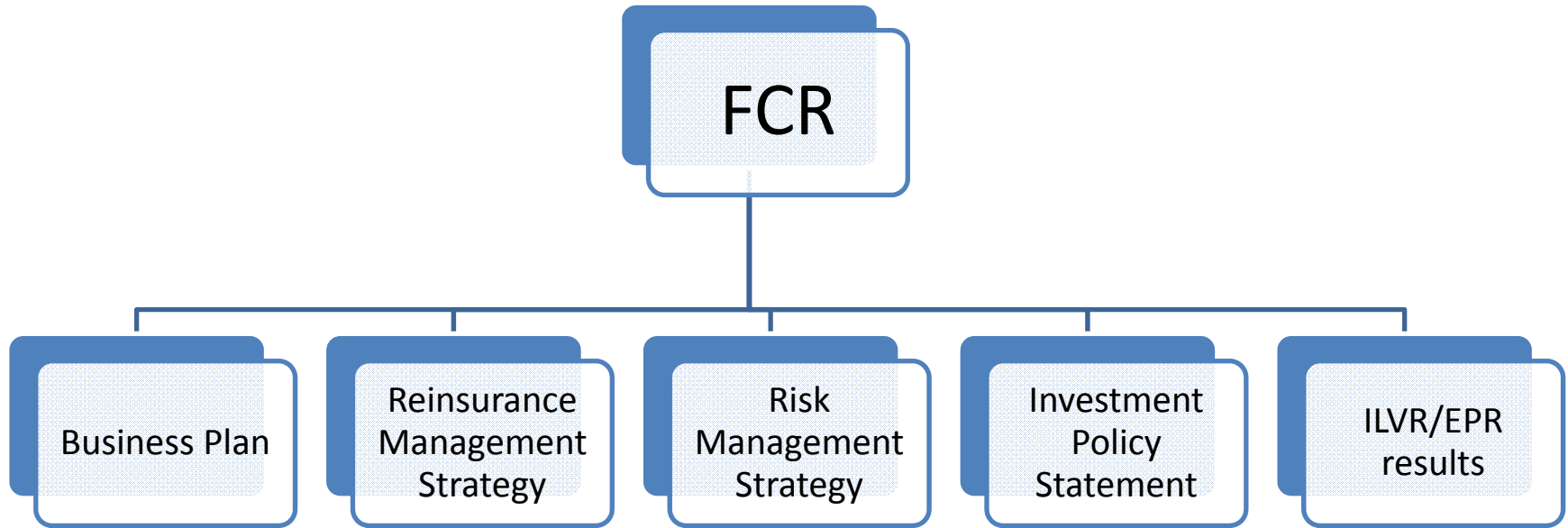
Prescription (PS305)

- Nature of insurer's business
- Recent experience and profitability
- Liability valuations and adequacy
- Pricing and premium adequacy
- Reinsurance
- Assets
- Capital adequacy
- Risk management

Examples of coverage in the FCR

- Classes underwritten, staff hierarchy, ownership, Board composition, brief history of company
- Trends in loss ratios/profits, reasons for trends and consequences (e.g. exchange commission on QS reinsurance)
- Underwriting protocols and risk selection
- Rating reviews and anti-selection effects
- Claims management practices
- Performance based commissions
- Testing the efficacy of reinsurance arrangements
- Matching asset-liability strategies
- Stress testing projected balance sheets to identify risks (upside and downside) and risk maps
- Risk appetites and tolerances
 - *Pr*(no profits in a year)
 - *Pr*(need to raise more capital)
 - Target ranges for solvency ratio
 - Triggers for management actions

FCR an “umbrella” document



- Challenge is to do more than just paraphrase the existing corporate documents
- Talk to a wider range of personnel in the business
- “Options available to...” rather than excessive “I recommend...”
- Remember the target audience is the Board (especially), Management and Regulator

EPR/audit dramas (like a trip to the dentist?)

- Communication
 - Failure of AA and EPR/audit actuary to talk face to face at key points in the process
 - EPR/audit actuary raising issues without discussing with AA
 - AA ignores/delays reviewing actuary leaving reviewing actuary too little time to do their review
 - Emotive language in EPR report
- Pedantry (usually the reviewing actuary)
 - *“the display of useless knowledge or minute observance of petty rules or details”*
 - Excessive commentary (or just commentary itself) on immaterial issues
 - EPR reports exceeding page counts of ILVRs
- Adamancy (both AA and reviewing actuary capable of this)
 - *“utterly unyielding in attitude or opinion in spite of all appeals, urgings, etc”*
 - Some valuation assumptions are notoriously highly prone to contention
 - Items on the boundary of materiality (remember “material” is often as defined by the actuary)
- Territory squabbles
 - AA may resent an intrusion on a previously undisturbed relationship with insurer
- Other
 - Insurer may take resentment of more compliance out on the reviewing actuary
 - No link between EPR frequency (annual for all) and prior individual insurer outcomes

What will happen in Australia in 2012?

(NZ shortly after?)

- **Changes to the existing regulatory capital requirements**
 - Insurance liability risk charges largely unchanged except for
 - removal of distinction between treaty and facultative reinsurance
 - Travel and LMI classes moved to higher risk categories
 - Asset risk charges – 8 balance sheet stress tests rather than just “ Σ factor x asset value”
 - Mismatching stress tests included
 - Correlated sum approach provides some “diversification discount”
 - Broadening of the Maximum Event Retention (“MER”) calculations
 - “Vertical” component (i.e. 1 in 200 year losses) for all classes (changed from 1 in 250 year)
 - “Horizontal” component – based on 1 in 6 year and 1 in 10 year losses – property classes only
 - Combine property and non-property MERs when non-property MER > 70% property MER (or vice versa)
 - Must articulate PML and show how reinsurance reduces PML to MER
 - Aggregation benefit on combining total asset and total insurance risk charges
 - Explicit Operational Risk Charge (based on Solvency II formula)
 - A formula based on total Gross Earned Premium, total Gross Insurance Liabilities and changes thereon
 - Supervisory Adjustment (APRA discretion)
- **Internal Capital Adequacy Assessment Process (“ICAAP”)**
 - Greater detail than existing Business Plan around how capital is managed and monitored
 - Links between capital management and risk management
 - Economic capital versus Regulatory capital
 - Links between risk appetite and limits
 - Expect this report to be a key input into any Supervisory Adjustment

Q&A

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