In last month's edition of *Actuary Australia*, Rebecca Johnstone, Policy Consultant for the Institute, provided an overview of the discussions held at the Insurance Capital Review Seminar on 9 June 2011. In this article we will discuss the impact of the capital review changes for businesses.

Solvency II and 'LAGIC' – what it means locally

Solvency II, the new risk-based capital regime development continues to gain momentum for European insurers, as it heads towards its planned implementation date of 1 January 2013. The annual Deloitte UK Solvency II survey shows that in the next six months, European insurers will have as their priorities:

- implementation planning,
- embedding the changes into culture via personal incentivisation and rewards,
- risk management and setting risk appetites, and
- data handling and infrastructure.

Additionally we are starting to see the capital changes having real implications for businesses tactically and strategically – there has been restructuring of businesses (to maximise capital efficiency), and potential M&A activity to inorganically support changes in product mix strategy (redesigning, repricing or in particular we see a number of insurers looking to move away from long term guaranteed products, which attract heavy capital requirements).

In Australia, APRA's Life and General Insurance Capital (LAGIC) standards also continue to gain momentum, with strong parallels to Solvency II through the 3 pillar regulatory approach, as well as local parallels to APRA's requirements for ADIs.

The planned implementation date for LAGIC is also 1 January 2013.

APRA has been active within the industry – it released its 31 March 2011 Response to Submissions following the industry's Quantitative Impact Study 1 (QIS1) and followed this up with a number of industry Q&A sessions; the most recent on 9 June 2011. Whilst APRA did not divulge much new information about the shape of future requirements at the 9 June 2011 session, it was a good opportunity for APRA to get a sense of the ongoing concerns from the industry ahead of the industry submissions to APRA after QIS2 (submissions to APRA due 31 July 2011).

In short it is clear APRA has heard the industry's concerns on a number of significant issues. Its new proposals aim to reduce aggregate industry capital requirements (relative to QIS1), complexity and pro-cyclicality in a number of areas. However, on other topics, APRA continues to hold its cards close to its chest. For example, the industry continues to press for more information on supervisory adjustments, the ICAAP process, and allowances for liquidity premiums. Each of these is covered in more detail below.

Nature and reasons for supervisory adjustments to Pillar 1 capital

Whilst the possibility of supervisory capital adjustments is not new to ADIs, it is causing concern amongst insurers. Concern is due to the perceived lack of transparency as to how it will be set by APRA and for what reasons. This makes it hard for insurers to advise their Boards on how to avoid any adjustment. In APRA's Q&A session on 9 June 2011, APRA reiterated that there would be significant dialogue with the insurer on this topic, that there will be transparency to the insurer as to the reasons for any adjustment so that appropriate action could be taken. APRA highlighted that there would be opportunity for such insurers to improve their operations and processes to avoid any proposed supervisory adjustment to Pillar 1 capital.

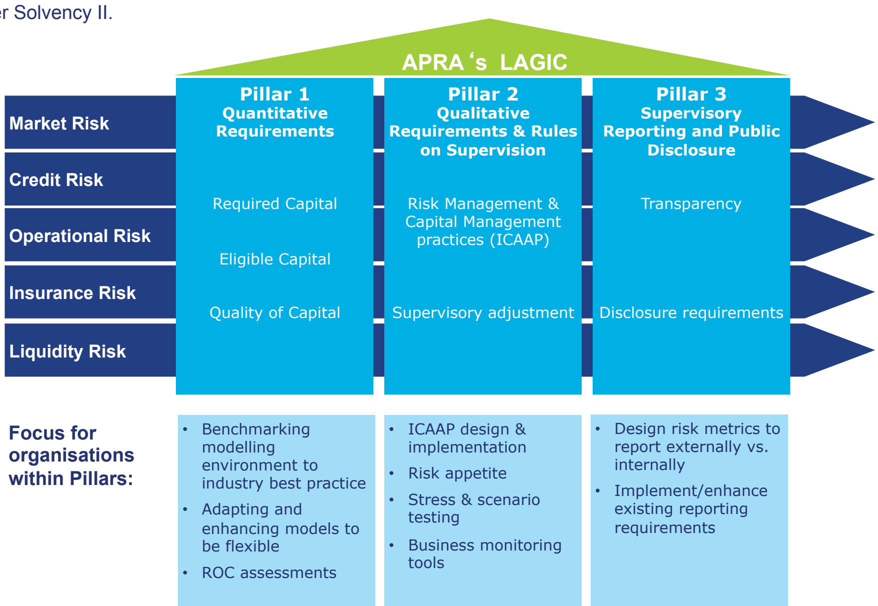
As any supervisory adjustments are not to be disclosed publicly, they will be reviewed on a case by case basis. The rule of thumb is that Pillar 1 assumes an entity is well managed, has sound governance, has effective risk management, and has an adequate ICAAP. In such a situation it is unlikely that a supervisory adjustment would apply. Examples where one might be applied include where the insurer's risks are very specific and not adequately allowed for in Pillar 1, the insurer has high growth plans, a changed strategy, and/or an unusual risky business model.

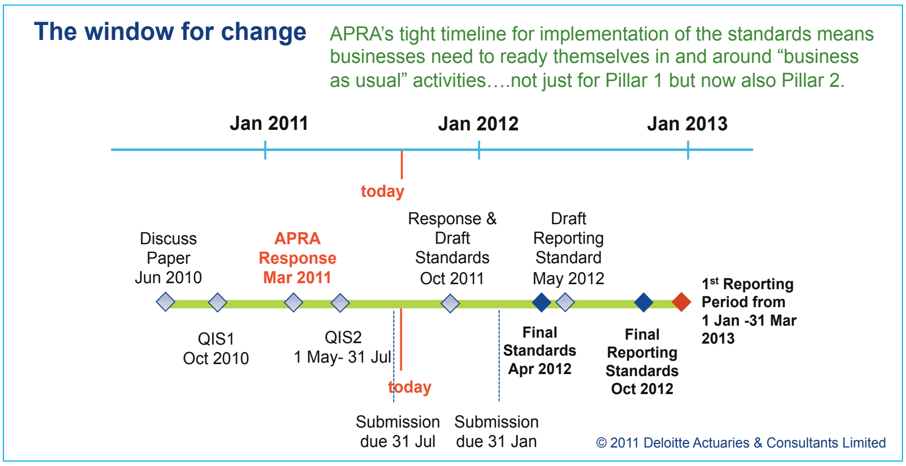
Life & General Insurance Capital (LAGIC)

Exploring the implications

Source: Deloitte Actuaries and Consultants 2011

APRA's 'LAGIC' is Australia's Life and General Insurance equivalent for regulatory capital requirements. It is a three pillar approach mirroring APRA's requirements for ADIs and international capital requirements under Solvency II.





Pillar 1 quantitative proposal on liquidity premiums

APRA is still considering whether to allow a liquidity premium margin to the capital requirement risk free rate for certain products. Without this, capital requirements for annuities in particular will become significantly more onerous than before. APRA appears to be more visibly working with the Institute in this area, and in addition has stated that it is monitoring global developments. However liquidity premiums will only be allowed if APRA can find some objective and reasonably robust way to measure this (particularly in times of stress) and if it does find a basis to use, it is likely that such basis will be prescribed to ensure consistency.

Internal Capital Adequacy Assessment Process (ICAAP)

The ICAAP is the process an insurer will now need to go through to internally assess the adequacy of their capital. APRA has stated that it is not just the process it is interested in, but also the outcomes from it.

The process needs to be owned directly by the Board with a report of the ICAAP being submitted to APRA annually. The process covers both risk management and capital management aspects and it should particularly include:

- Risk appetite setting and review process, with supporting risk metrics/buffers and planned actions should those buffers be breached i.e. it needs to be embedded into the day to day operations of the business.
- Target surplus policy and details with regards to how the business will be managed when capital falls below target surplus levels. To understand where to set its target surplus levels, the insurer needs an assessment of the capital which it believes it should hold for the risks it bears (i.e. the 'economic' capital, which will usually be different to the regulatory capital). On this APRA has indicated that the level of sophistication in modelling would be expected to vary depending on size and complexity of the insurer.
- Capital projections for at least three years, which should be based on scenario testing. APRA raised the concept of 'reverse' stress testing; where the insurer should consider the situation(s) where it may be vulnerable to a breach of its target surplus and then stress test the process, and assess outcomes of that stress test.

Insurers who are part of a conglomerate group are sensibly looking to leverage off the ICAAP processes that already exist from its related ADI entity. In doing this, insurers need to bear in mind not only that insurance risk and interest rate risk are more important to it than the ADI, but that the ICAAP must be owned by the insurer's Board and managed to the operations of the insurance entity. This is clearly a complex set of interactions to get right by the business as it requires stakeholder communications and collaboration across a number of different business functions within the insurance arm (actuarial, finance, risk management, IT) as well as the relevant ADI.

More will be said by APRA in October 2011 in its response to the industry after QIS2. However we believe that an insurance working group (and stakeholders from the related ADI where relevant) needs to perform a gap analysis, and start designing and planning for implementation of Pillar 2 now.

Our view of the challenges ahead…

- **There's much to do in a short period of time:** Insurers have finalised QIS2, with submissions to APRA handed in by the end of July 2011. ICAAP design and planning needs to start in earnest now. Insurers need to be ready for the October 2011 changes to Pillar 1, and implementation of models following that. Pillar 3 requirements will be coming out in late calendar 2012, leaving little time to implement reporting and disclosure requirements before 1 January 2013. All this needs to be planned and done around 'business as usual'.
- **Complex interactions to manage within the insurance functions and with the ADI where relevant:** The multi-disciplinary requirements of the Pillar 1 changes (actuarial, technology and systems) and Pillar 2 changes (board ownership of risk and capital management, risk functions, actuarial functions, processes and operations, remuneration) requires strong communication and program management.
- **Real business implications from these changes are firstly tactical, but the insurers who will get the most out of these regulatory changes will be the ones who prepare themselves strategically:** there are strategic challenges in terms of product (relative capital requirements changing) and cultural change including ownership of ICAAP and involvement of Board in scenario setting.

The next sixteen months will hold a number of significant challenges, however there is also an opportunity for insurers to manage a tight program of change and to gain deeper insights into the risks they face moving forward. Most importantly, the most successful programs will go beyond compliance and will maximise the possible strategic and competitive benefits from the work completed. ▲

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Sources:
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2. APRA's Response to Industry Submissions on Life & General Insurance Capital (LAGIC): Commentary and Implications, 7 April 2011
3. APRA Insurance Capital Seminar, 9 June 2011