

INSURANCE CAPITAL REQUIREMENTS make progress

APRA's current review of the capital requirements for life insurance has involved extensive consultation with the industry which hopes for a well-balanced outcome.

THE REVIEW of life insurance capital standards by APRA comes at a time when capital standards for financial institutions around the globe are being reviewed by regulators, most notably Basel III which is currently being rolled out globally for banks, and Solvency II which is applicable to life insurance companies in Europe.

"Whilst the Australian regulatory capital review was not born directly out of the Basel III accord, Solvency II or its earlier versions, it has borrowed from them, most notably the three-pillar framework," Green says. The adoption of such a framework in Australia is clearly compatible with APRA's stated objective for the insurance capital review.

The three pillar structure first appeared as part of the Basel II accord which was initially published in 2004. Since then the framework has been refined and implemented, with the latest incarnation being Basel III.

Solvency II – or "Basel for insurers" as it is commonly known – is not directly related to the Basel accords (which applied to banks only) but it does have the same three-pillar structure as the Basel accords.

Solvency II, when finally rolled out, will introduce economic-risk-based solvency requirements which will enable a better coverage of the real risk run by any particular insurer.

Green says it was clear as early as the 1990s that an overhaul of the solvency framework was required, and by 2004 a series of consultations and discussions began, culminating in the Solvency II proposal of July 2007.

Since then, significant development and industry consultation has occurred, including numerous draft revisions. Solvency II is due to be implemented in the EU from 2013.

With regard to the local Australian regulatory capital review, it is clear from the papers that APRA has published so far that there is an alignment between the revised capital requirements in Australia Basel III and Solvency II, even if some of the underlying calculations are unique to Australia.

Green expects APRA will continue to monitor these overseas developments closely, and "where they deem it appropriate, reflect the learnings of their global regulator peers" in the developing of Australia's own standards.

"Insurance companies in

Australia are currently preparing to release the results of the second Quantitative Impact Study (QIS 2) to APRA on July 29," Green says, "and whilst there are still a number of potential issues which are yet to be fully resolved, the general feeling is that QIS 2 indicates a more balanced approach that better reflects the objectives set by APRA than the initial draft QIS 1."

The first QIS was done in 2010 and resulted in a much larger than expected proposed increase in industry capital requirements. Following extensive and open consultation, which has been appreciated by the industry, APRA refined its proposal, released as QIS 2 in May 2011.

Whilst the two QISs have provided a substantial amount of detail around the possible structure of the first pillar, the practical application of the remaining two pillars is relatively less clear, incorporating the new supervisory adjustment and the Internal Capital Adequacy Assessment Process (ICAAP).

Green adds that "APRA should be congratulated on their extensive consultative process to-date which has allowed the industry to respond in a meaningful way to the initial regulatory capital proposals". ■



Damien Green ... better coverage of real risk

BASEL BACKGROUNDER

A reform of the capital requirements for banks was initiated in 1988 when the Basel Committee on Banking Supervision (made up of representatives from central banks around the world, which met in Basel, Switzerland) developed a set of minimum capital requirements.

This set of minimum requirements was known as the Basel Accord and became law for 6-10 countries in 1992. Basel I is now widely considered to be outdated. Basel II was initially published in 2004 and attempted to require banks to hold capital that more appropriately reflected the underlying risks within a bank.

This accord introduced the three-pillar structure:

PILLAR 1: deals with the amount of regulatory capital required, and covers the three major risk components: credit, operational and market risk.

PILLAR 2: deals with the regulatory response to Pillar 1 by providing a framework for regulators and banks to deal with other sorts of risks such as systemic, concentration, reputational, liquidity, etc, through the incorporation of a risk management framework.

PILLAR 3: deals with disclosure.

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