Refinements to the General Insurance Prudential Framework

APRA has finalised amended Prudential Standards and Prudential Practice Guides which are now on the APRA website (www.apra.gov.au). The Standards are effective from 1 July 2008 except for changes to how foreign reinsurance is treated which are effective from 1 January 2009. The amendments follow a period of consultation with industry following enactment of the *Financial Sector Legislation Amendment (Discretionary Mutual Fund and Direct Offshore Foreign Insurers) Act* 2007. APRA has modified some of its original proposals but not all. APRA's Response Paper "Refinements to the General Insurance Prudential Framework - Final Response to Industry" dated June 2008 summarises the last round of consultation including industry's response and APRA's final decision.

Some of the more significant changes relate to reinsurance, especially with a non-APRA authorised insurer. Other important refinements deal with the capital buffer, corporate agents and kangaroo bonds.

Categories of Insurer

APRA has implemented the following categories of insurer within its general insurance prudential framework based on differing risk profiles:

- Category A – locally incorporated insurer;
- Category B – wholly owned subsidiary of a local or foreign insurer;
- Category C – foreign insurer operating as a foreign branch;
- Category D – association captive insurers; and
- Category E – sole parent captive insurer.

The definition of each category of insurer is contained in Prudential Standard GPS 001, which provides the definitions that apply in the revised Prudential Standards. Some prudential requirements differ according to the category of insurer – for example GPG 248 provides that reinsurance cessions should be no more than 90% for Category D and E insurers and 60% for other categories.

Reinsurance

Security of Reinsurance Recoverables

For all reinsurance arrangements incepting from 31 December 2008:

- after a grace period an increased capital factor will apply on all unsecured reinsurance recoverables. The factors will range from 20% to 100% depending on the counterparty rating of the reinsurer. The grace period ends on the second balance date after the end of the financial year the event giving rise to each recoverable occurred or, for a claims made policy, the second balance date after the end of the financial year in which the claim was notified.
- a 100% capital factor will apply to reinsurance recoverables that have been due and payable for more than 6 months but remain unpaid;

For reinsurance arrangements incepting prior to 31 December 2008, there are no additional capital requirements although APRA expects greater scrutiny by actuaries, management and the board in relation to the likelihood of recoverability or possible impairment.

Where a recoverable has become a receivable (ie it is due and payable) and is overdue for more than six months since the payment request was made to the reinsurer, a 100% capital charge will apply.

Reinsurance Contracts

Reinsurance contracts must stipulate that an Australian jurisdiction is the governing law of the contract and any disputes that reach a court must be dealt with in an Australian court. Where contracts do not meet these requirements reinsurance recoverables will be deducted from capital.

Cession Limits

During the consultation period APRA proposed that the total amount of premium an insurer may cede to reinsurers is not expected to exceed 60% of gross written premium for Category A, B and C insurers.

Category D and E insurers are not expected to cede more than 90% of gross written premium. After consultation with industry, APRA has included reference to these cession limits as guidance in GPG 245 Reinsurance Management Strategy (as opposed to a mandatory requirement in a Standard). This means that there will be flexibility in relation to cession limits, although APRA expects insurers to work progressively towards APRA's normal limits.

Capital Buffer

APRA's informal policy of requiring a buffer of at least 20% above the minimum capital requirement (**MCR**) has been formalised and inserted into the relevant Prudential Practice Guide (GPG 110 Capital Adequacy:Capital Management). The higher buffer of 50% is expected for Category D and E insurers where the MCR is less than $5 million. The required 50% buffer for medical indemnity insurers is also specified in GPG 110.

Corporate Agent

As of 1 July 2008, amendments to the *Insurance Act* 1973 will permit a foreign insurer or its subsidiary to appoint either an individual or body corporate as agent in Australia under the Act. Previously an individual had to be appointed. The Board of a corporate agent for a Category C insurer must have a minimum of three directors at all times, and must contain a majority of directors who ordinarily reside in Australia. Senior managers must all be resident in Australia. The Directors and senior managers of a Category C insurer's corporate agent in Australia must be assessed under the insurer's fit and proper policy.

Assets held by a corporate agent will not be treated as assets in Australia where that agent engages in any business or commercial activity other than activities in its capacity as agent in Australia (refer to Prudential Standard GPS 120 Assets in Australia paragraph 33). The purpose of these proposals is to ensure that the corporate agent does not carry on other business that might detract from its duties as agent or put the assets it holds for the foreign insurer at risk.

Kangaroo Bonds

APRA will now allow Kangaroo bonds to be included as assets in Australia where certain criteria are met. The criteria are that:

1. the underlying bond is legally owned by Austraclear Ltd or a nominee for Austraclear Ltd and is lodged in the Austraclear system; and
2. the register recording legal ownership of the underlying bond is kept in Australia and;
3. the bond is created by a deed poll which is sealed, or deemed by its governing law to be sealed, and the deed poll is governed by Australian law and kept in Australia; and
4. the debt under the bond is expressed to be payable in Australia except for payment in Australia is prohibited by law (provided that if, at any time, such payment in Australia is prohibited by law, the debt under the bond shall be excluded from being an asset in Australia for so long as that payment is prohibited).

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