A View from “Down Under”

Recent Developments in General Insurance Actuarial Work in Australia

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Agenda

- The Approved Actuary Role
  - Background
  - July 2002 Reforms
  - Practical Issues in Developing the Role
  - HIH – Professional Consequences & Royal Commission Findings
  - Stage 2 of the Reform Process
- Other Developments
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The Developing Regulatory Role of The Actuary in Australia- Background

- Previous Regulator (The ISC)
  - The Insurance and Superannuation (*i.e.Pensions)* Commission maintained a good rapport with the IAAust during the early 1990’s and discussed a number of areas of potential reform, including a risk-based approach to capital management
- “Wallis Report”
  - The Federal Government asked the Wallis Committee to report on potential changes to regulation of the financial services industry in the mid-1990’s. Their report, which had very little specific input on the general insurance industry, advocated regulation of banking, credit unions,insurance, friendly societies and superannuation under a single authority
- Establishment of APRA
  - Following adoption of the large majority of the Wallis recommendations, the Australian Prudential Regulation Authority was formed (1998) to supervise the financial services industry. Unfortunately, for a number of reasons, much of the intellectual capital and experience in general insurance was lost shortly afterwards.
- Legislative Reforms
  - A series of financial sector reforms (notably including the General Insurance Reform Act 2001) were enacted to support the revised regulatory process. The GIRA was aimed at updating the 1973 Insurance Act, and included the introduction of a risk-based minimum capital requirement, stronger governance requirements (including the “Approved Actuary” role) and mandatory re-authorisation of all existing general insurers.

The Developing Regulatory Role of The Actuary in Australia- July 2002 Reforms

- A “Three Tier” Structure of Reform
  - Reform was founded upon revision of the underlying legislation (i.e. the Insurance Act as well as other relevant acts). These were supplemented by a range of “Prudential Standards” on capital adequacy, assets, liability valuation, risk management, reinsurance strategy and other relevant matters. Further to these PS’s were provided a series of “Guidance Notes” which supplied advice on how insurers could apply the Standards.
- Based on Appropriate Principles
  - The reforms emerged from a lengthy consultative process between various industry bodies and APRA. A clear outcome from the discussions was a need for a principle-based regulatory process rather than one that depended on too much prescription of rules.
- The Role of the Approved Actuary
  - An Approved Actuary is required for each (re-) authorised general insurance entity (with some exceptions). The Actuary is required to give written advice to the Board of Directors of the insurance entity at least annually. The Actuary may either be internally employed by the insurer, or may be retained as a consultant. The advice needs to include determination of the valuation of central estimates for both outstanding claim liabilities and “premium” (i.e. unexpired risk) liabilities. It also needs to include a margin sufficient to secure the overall liabilities at a 75% level of sufficiency (on a discounted basis). There is no obligation on the Board to accept the Actuary’s advice. However, in such a case, the Board must fully disclose it’s reasons to APRA. The Approved Actuary also has a formal risk management role.

The Developing Regulatory Role of The Actuary in Australia- Practical Matters

- What Comes First – the Chicken or the Egg?
  - There was significant doubt, both within and without the profession in Australia, whether the skills and experience of actuaries would meet the demand from the reforms. (In the early 1990’s there were very few full-time general insurance actuaries in the Australian market and although that number had grown steadily during the decade, by definition very few had substantial experience in the industry. APRA also required a minimum of 5 years’ “experience in the general insurance industry”. There were over 160 authorised insurers at the time the reforms took effect.
- The Proof of the Pudding…..?
  - Today, there are over 150 actuaries working exclusively in the general insurance industry. There has been no perceived problem in meeting the demand for Approved Actuaries. Many actuaries have multiple Approved Actuary accreditations. In any case, most larger insurers consist of groups of subsidiary insurance entities, and it often makes sense for the same actuary to be AA for each of the group’s entities.
  - From a situation before the reforms where many (shorter tailed?) lines of business didn’t receive an actuarial opinion on outstanding claims, the large majority of portfolios now benefit from such advice. Also, premium liabilities can almost be described as a new industry for actuaries and there is much more consistency across the industry on risk margins (including diversification effects).
- The Jury is Still Out?
  - Whilst the thirst for Approved Actuaries appears to have been assuaged, there is still heavy reliance on an IAAust-commissioned report on risk margins and one could argue that – in these relatively “pressure-free” hard market days - the real test of actuarial advice has yet to be met.

The Developing Regulatory Role of The Actuary in Australia- HIH, “The Actuarial Story”

- Actuarial Review was only Part of the Process
  - HIH (and FAI) obtained actuarial advice on a range of issues. By and large, the reserving advice was obtained from external consultants, and – increasingly, over time - pricing advice was provided internally. However, the advice was patchy (in terms of the lasses of business covered) and tended to be overlooked on a regular basis. In addition, it was clear that certain areas of the business (mainly relating to longer tailed, more uncertain claims) were considered “sacrosanct”
- Data was/were not Ideal
  - Even when the actuaries were involved, the data upon which they based their opinions tended to be relatively lacking in detail and not necessarily easy to verify. This clearly supported the tendency to give less weight to actuarial advice and made it easier for Senior Management to apply pressure to actuaries for them to supply the “more convenient” advice. And no evidence was provided in the Royal Commissioner’s report to support the successful application of such pressure.
- The APRA Reforms Hadn’t Happened
  - The demise of HIH (early in 2001) was during the planning stage for the introduction of the reforms and was therefore before the standing of the actuary in general insurance was “upgraded” through the introduction of the Approved Actuary role. Whilst there was still criticism about the lack of “whistle blowing” (or, at least, the volume of the whistle!) it appeared clear that the absence of such a formal whistle blowing role made things more difficult.

The Developing Regulatory Role of The Actuary in Australia- HIH, The Royal Commission's Findings

- There was No Single Reason for the Failure
  - Inadequate reserving (in turn leading to inadequate pricing) was certainly part of the story. However, the breakdown of internal governance processes, resulting in an apparent "blind faith" in the leadership (and the CEO in particular) was an important factor. As was the insatiable hunger for growth (within Australia but more especially international expansion). Other factors were also highlighted, including the lack of a robust premium control process and other financial management issues.
  - The IAAust was largely delegated the responsibility for dealing with any professional misconduct issues (although a number of potential criminal and civil prosecutions remain outstanding)
- 61 Recommendations for Change
  - The Royal Commissioner, Justice Owen, previously inexperienced in general insurance matters, raised a large number of areas for recommended change, including a significant amount of additional legislative and regulatory reform. APRA, though not blamed for the insolvency, did not escape unscathed. The actuarial profession emerged with a significant additional responsibility to minimise the chance of a "future HIH"
- They are (Slowly) Being Implemented
  - Many of the Commissioner's recommendations are being incorporated in "Stage 2" of the regulatory reform process. APRA and the industry are again undertaking a consultative process. This time though, there is perceived to be more prescription in APRA's aims, and there has already been some significant pushback on the initial amendments to governance. Nevertheless, the proposal to add a "Financial Condition Report" requirement to the Approved Actuary's responsibilities seems certain to go ahead. As does the requirement for a formal capital management planning process.

The Developing Regulatory Role of The Actuary in Australia- Stage Two of the Reform Process

- "Further Work is Required to Strengthen the Prudential Framework for General Insurers"
  - The initial discussion paper (November 2003) – or Stage 2 of the reform process - acknowledged the influence of the HIH Royal Commission and introduced the potential for a raft of technical reforms and more detailed governance standards. Although the discussion process continues, and may even spring a "Stage 3" on top of a revision to Stage 2, actuaries are perhaps mostly focused on two main areas of change
- Capital Management Plan (CMP)
  - The intention of this proposal is to (at least) improve the documentation and monitoring of existing compliance with the risk-based Minimum Capital Requirement (MCR). The result would likely be an actuarial report on the appropriate capital adequacy level for an individual insurer and its ability to maintain an appropriate margin above the MCR over a period of at least 3 years into the future
- Financial Condition Report (FCR)
  - The proposed FCR is required to not only support "current balance sheet" issues such as technical liabilities, asset valuation, asset/liability "matching" (management?) and concentration risk, but also potentially some "future balance sheet" issues such as premium adequacy and risk management systems and controls. There is significant debate in the market about the Approved Actuary's ability to carry out such a role. However,, APRA appears adamant and an IAAust Working Group has already drafted guidance on the production of FCRs

International Accounting Standards

- Adoption by Australia of Phase 1 of International Financial Reporting Standard (IFRS4) on 1 January 2005
  - Applies to reporting periods beginning on or after 1 January, but companies need to be able to provide relevant figures from the previous year for comparison purposes. The focus is now on "insurance contracts (previously "general insurance activities")
- Taking One Step Backward…..?
  - In the existing standard, assets are recorded at market value. Under the revised standard some choice is allowed between the "fair value model" and the "cost model". This implies some confusion in a previously unambiguous area (although there is little "room for movement" when considering assets backing the technical provisions).
- To Take Two Steps Forward?
  - In the existing standard, there is only limited (and indirect) allowance for "additional unexpired risk through the DAC offset. Under the revised standard such risk should be recognised under the "liability adequacy test" (albeit still indirectly). Ambiguity has also been taken out of the definition of the discount rate to be used for valuing liabilities.In the current standard all outstanding claim liabilities (beyond 1 year) are discounted at a "market-determined, risk adjusted rate of return". The revised standard requires "risk free" discount rates. Additionally specific risk margins are required for both claim and "premium" provisions. Greater disclosure is another potential plus point. Full "fair value"implications are awaited as part of Phase 2 (2007?)

DFA Modelling Development

- Most of the major insurers have sophisticated internal DFA modelling structures
  - Insurers were already active in the development of DFA applications before the July 2002 APRA Reforms. However there appears to be little doubt that the optional "Internal Model" capability for the determination of minimum (and working) capital levels as part of the new Prudential Standards has accelerated the development of modelling capabilities for at least four of the major five general insurers. No insurer has yet chosen to apply for authorisation of its "Internal Model" for APRA purposes, although a regular "user group" meets in APRA's offices to discuss various modelling aspects every six months or so.
- These models are being used for a range of extended applications
  - Beyond the basic capital adequacy need, the models are being used for a range of internal management support functions, including capital allocation (for a number of reasons), reinsurance programme selection, asset/liability management, new business planning etc.

    Capital adequacy modelling enables a company to examine a "comfortable" level of capital measured against some of the objective features of risk appetite (and which may be displayed as a multiple of MCR?)

    Capital allocation is useful for understanding appropriate profit loadings and targets by class and/or area of business and for building new business models.

    DFA modelling helps illustrate the "capital servicing vs cost" comparison for reinsurance programme selection.

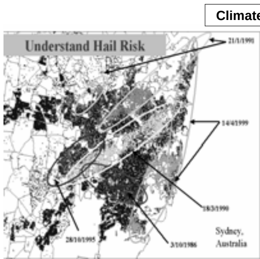
    Asset/liability modelling enables efficient asset portfolios to be demonstrated more easily.

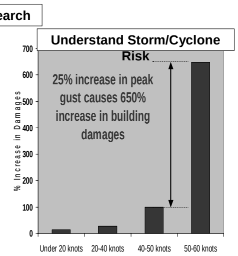
So why is an insurance company interested in climate change?

Insurance spreads cost of risk across community but

climate change is expected to increase that risk

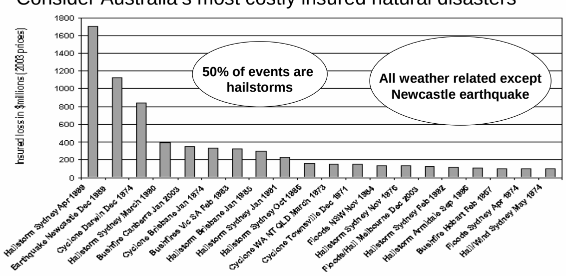
Climate Research



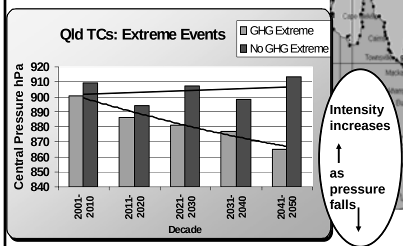


Weather and climate are core business

Consider Australia's most costly insured natural disasters



IAG modelling suggests more extreme cyclones (& further south)



TC “Dinah” Jan – Feb 1967