Risk based Supervision including Off-site analysis and On-site inspection

FSI Regional Seminar for Supervisors in Africa on Risk Based Supervision

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Australian Regulators

Four distinct regulators, each aligned to different potential sources of market failure

ACCC

- Anti-competitive behaviour

ASIC

- Disclosure
- Market integrity
- Consumer protection
- Corporations

APRA

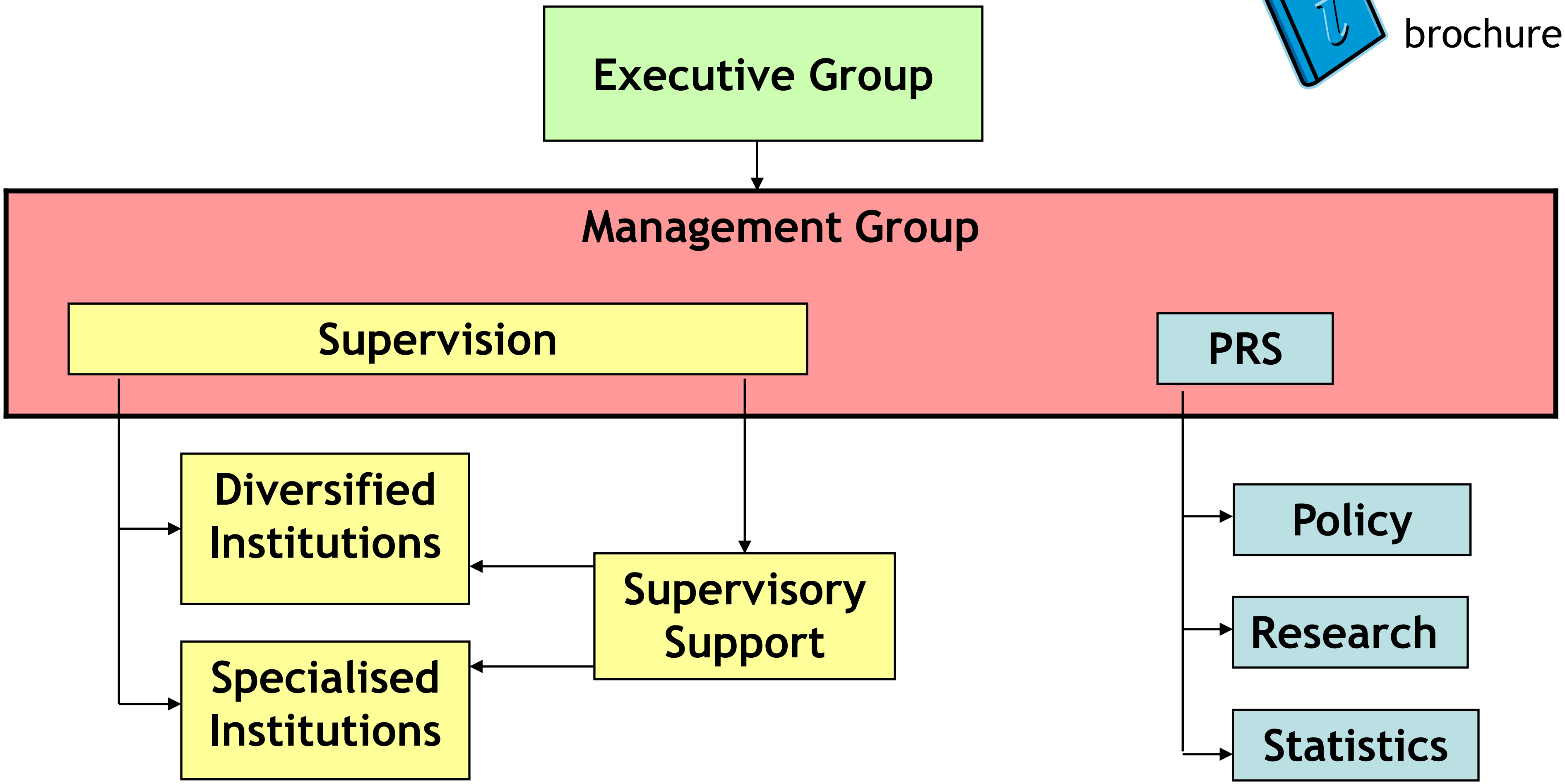
- Prudential regulation of financial institutions – banks, life insurers, non-life insurers, superannuation

RBA

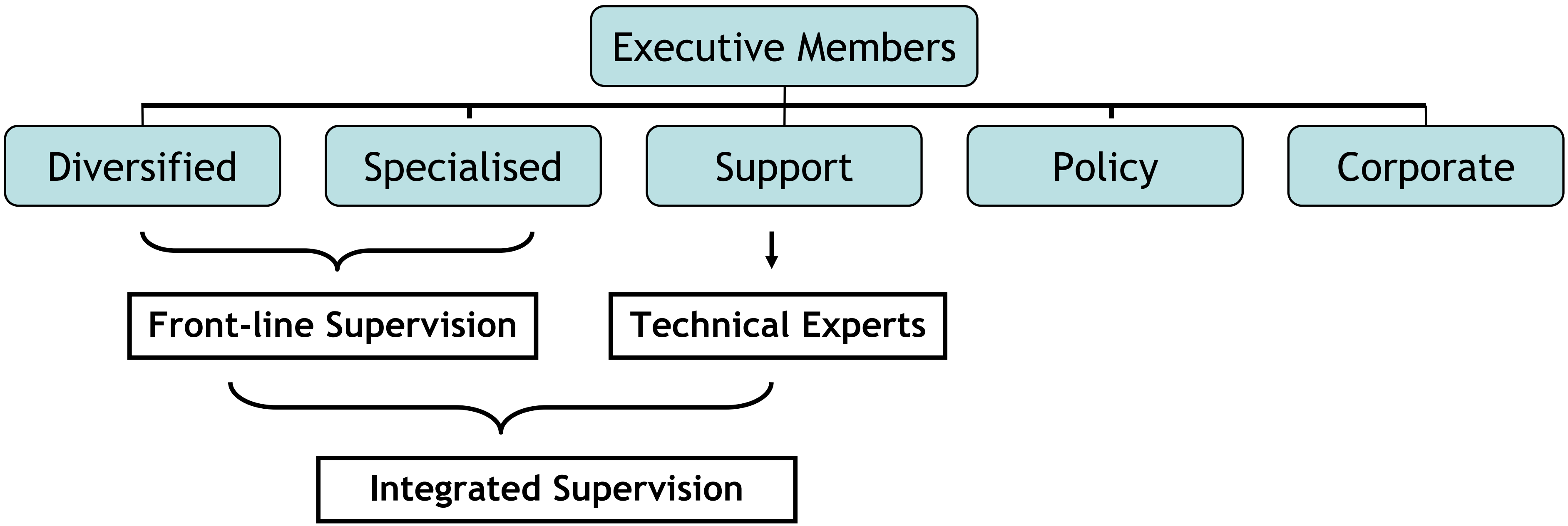
- Monetary policy
- Stability of banking system
- Payments system

APRA's Structure

APRA
brochure



Structure in the Context of Supervision



APRA's Mission

- APRA's mission is to:
  - Establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions APRA supervises are met within a stable, efficient and competitive financial system

Objectives of Supervision

- Ensuring the ability to meet financial promises
- Minimise failure – but do not guarantee zero failure
- Financial promises vary from industry to industry
- Must be prepared to intervene to protect beneficiaries' interests
- Financial compensation schemes and government guarantees

Our supervision approach

APRA’s Supervisory Framework (ASF)

Our supervisory approach is

Supervision blueprint

- Forward-looking
- Risk based
- Consultative
- Consistent
- In line with international best practice

- This approach also recognises that management and boards of supervised institutions are primarily responsible for financial soundness

- Our supervision is conducted under the APRA Framework for Prudential Supervision

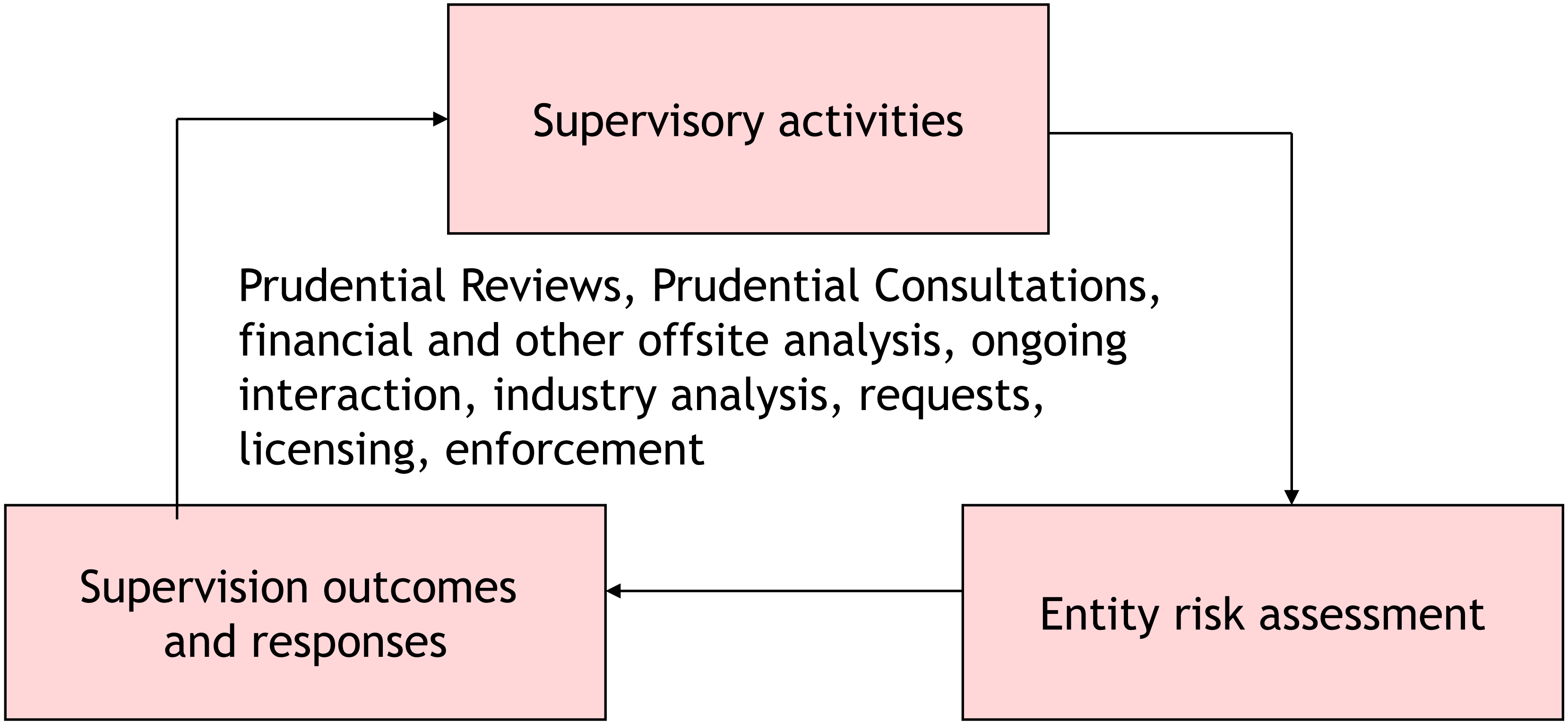
APRA's Framework for Prudential Supervision

- All activities, supporting procedures, processes, systems and guidelines that are used in forming risk assessments and supervision strategies

- Central to supervision is entity risk assessment and appropriate supervisory outcomes

- Form these views by undertaking:
  - APRA-initiated supervisory activities
  - Institution-initiated requests
  - Overall assessments of industries and the financial sector

Supervision Cycle



SOARS - Supervisory response

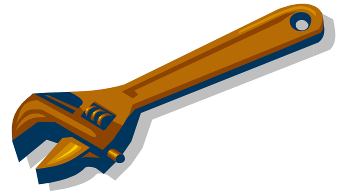
Normal
Oversight
Mandated Improvement
Restructure

PAIRS

Assessment of probability of failure
Measurement of impact
Appropriate supervisory action plan

Probability and Impact Rating System (PAIRS)

- Dynamic risk assessment tool



- Determine the probability of failure, by rating
  - Quality assessment
  - Significance weight
- Measure the impact of potential consequences of failure
- Drives supervisory action

PAIRS

- Board
- Management
- Risk Governance
- Strategy & Planning
- Liquidity Risk
- Operational Risk
- Credit Risk
- Mkt & Inv. Risk
- Insurance Risk
- Capital - Coverage
- Capital - Earnings
- Capital – Access to Add

Probability and Impact Rating System (PAIRS) - (continued)

- Assessments of:
  - Inherent risks
  - Management and control
  - Capital

- All types of supervisory analysis and assessment have the potential to result in a revision to PAIRS

PAIRS

- Board
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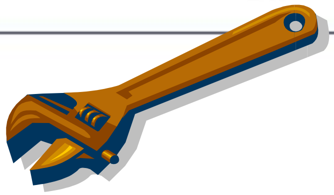
Supervisory Oversight and Response System (SOARS)



- A result of the PAIRS assessment
- Determines the 'supervisory stance' for a regulated entity as:

Probability Rating

Impact Rating

	GI assets	Low	Lower Medium	Upper Medium	High	Extreme
Extreme	>13 bil					
High	<13 bil	NORMAL	OVERSIGHT		MANDATED	RESTRUCTURE
Medium	<1.3 bil				IMPROVEMENT	
Low	<133 mil					

- Ensure we take sufficient supervisory action based on our assessment of the likelihood and potential impact of failure

Levels of Supervision

- **Normal Supervision**

  Work in line with ASF and baseline supervision
- **Oversight Supervision**

  Institution not considered likely to fail

  Supervision focuses towards risk areas
- **Mandated Improvement**

  Not a permanent classification

  Management still in charge

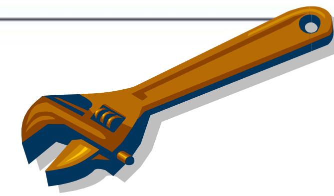
  Defined action plan
- **Restructure**

  Use full enforcement powers available to protect beneficiary interests

  Legal entity may or may not continue

  Possible disqualification of individuals

Data Collection Requirements

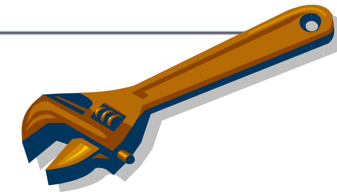


- Level 1 insurers have quarterly and annual statistical reporting requirements under the Financial Sector (Collection of Data) Act 2001
- Level 2 insurance groups now have half-yearly and annual statistical reporting requirements under the same Act
- Both sets of data are submitted to APRA electronically, via our system Data 2 APRA (D2A)
- Data collected includes (inter alia):
  - Capital base and minimum capital requirements
  - Profit & Loss
  - Balance Sheet

Most recent publications

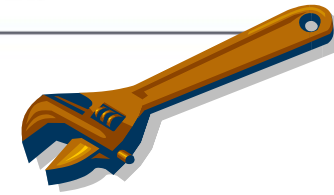
- APRA publishes data on a quarterly basis; and half-yearly basis:
  www.apra.gov.au/Statistics/General-Insurers-Statistics.cfm

Prudential Reviews of Insurers



- Prudential reviews of insurers are a cornerstone of APRA’s assessment
- APRA reviews and assesses:
  - Reinsurance
  - Pricing
  - Underwriting
  - Claims
  - Independent review
  - Liability valuation
  - Product design
  - IT and business continuity management
  - Operational risk
  - Investment risk

Key Documentation under standards

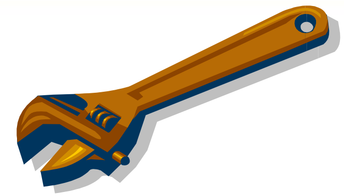


- Prudential standards require insurers to provide a number of key documents typically linked to timing of the submission to or approval by the Board.
- APRA reviews and assesses:
  - Reinsurance Management Strategy
  - Reinsurance Arrangements Statement
  - Reinsurance Declaration
  - Actuary’s Insurance Liability Report
  - Actuary’s Financial Condition report
  - Risk Management Framework and Strategy
  - Three year Business plan
  - Material Outsourcing notification and summary of risk evaluation

Major supervision activities

- Prudential Review – On-site
- Prudential Review – Off-site
- Prudential Review – On-site with Supervisory support technical experts
- Prudential Review – Commissioned Expert
- Quarterly Analysis
- Annual Analysis
- Off-site review of documentation required under prudential standards
- Additional reporting and meetings (Board)
- External Party Liaison – auditors, actuaries

Supervisory Action Plans



Entity details

Entity Name	Probability Rating	Impact Rating	SOARS Stance	Total Assets
ABC Bank Ltd	Lower Medium	Extreme	Oversight	$213 464 684 987

Planned supervisory actions

Key Risk/Issue	Activity	Scoping	Timing	Additional resources
Risk-based				
Growth in impaired exposures to corporates	Prudential review	Review problem asset management	Mar 09	SSD - credit risk
	Internal management report - impaired assets		Monthly until advised	
	Quarterly discussion with CRO	Ensure regular discussion with relevant senior executives to track issues	Quarterly until advised	
SME credit deterioration (industry risk)	Offsite analysis- review loan portfolio composition and management reports		Jul 09	
Prudential Consultation			Apr 09	
Financial analysis			Quarterly	
Annual submission			Annual	

Risk-based prudential reviews - completed

Activity	Date
Prudential reviews	
- Credit Risk	Mar 08
- BS&MR	Feb 06
Prudential consultation	Apr 08

	Name and Position	Signature	Date
Prepared by			
Reviewed by			
Approved by			

Focus on risk/issue

Clear scope for assessment

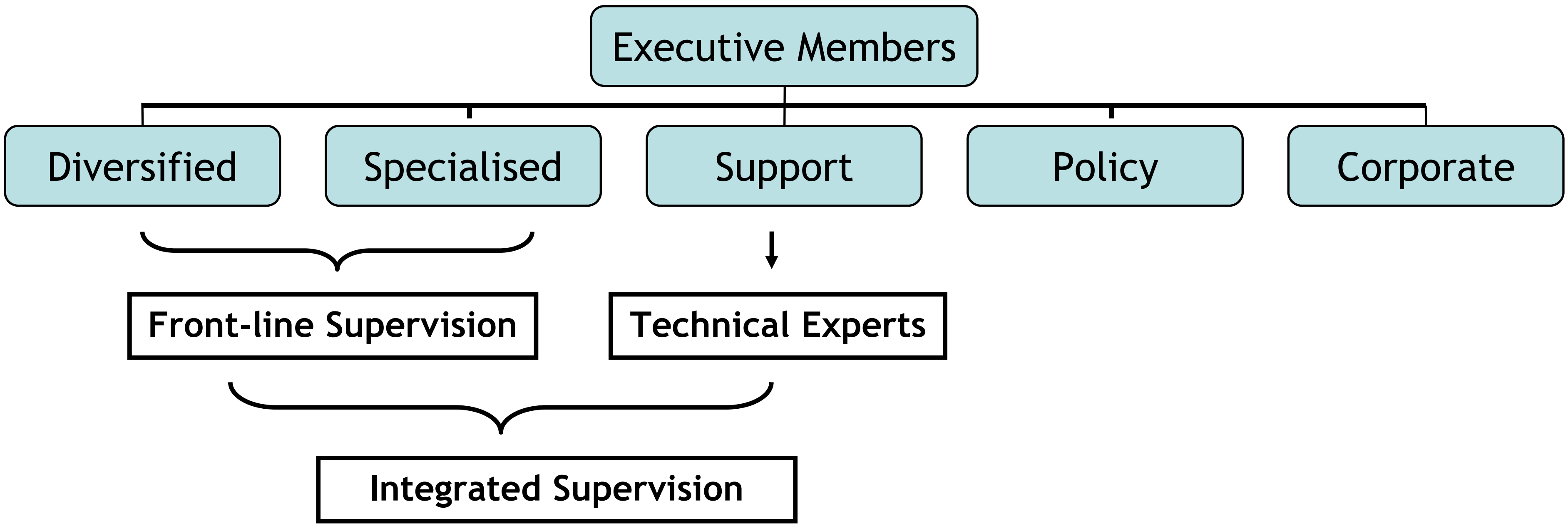
Activity targeted to risk/issue type

Incorporates baseline activities

Developed in the context of most recent supervision activities

Sign-offs consistent with PAIRS

Structure in the Context of Supervision



Baseline Supervision Requirements

PAIRS Impact rating Activity	Extreme	High	Medium	Low	Other	Tolerance
Review PAIRS and supervisory action plan	12 months					3 months
Prudential review	12 months	24 months	36 months		Not mandated	
Prudential consultation (excluding super)	12 months	24 months	36 months		36 months	
Financial analysis	3 months					
Information mandated by Prudential Standards	As submitted					

PAIRS model

PAIRS Category	Inherent Risk	Management and Control	Net Risk	Significance Weight
Board	SW applied to 'Net Risk'		(0-4)	%
Management			(0-4)	%
Risk Governance			(0-4)	%
Strategy and Planning	(0-4)	(0-4)	(0-4)	%
Liquidity Risk	(0-4)	(0-4)	(0-4)	%
Operational Risk	(0-4)	(0-4)	(0-4)	%
Credit Risk	(0-4)	(0-4)	(0-4)	%
Market and Investment Risk	(0-4)	(0-4)	(0-4)	%
Insurance Risk	(0-4)	(0-4)	(0-4)	%
Net Risk Total	'Net Risk' is the simple average of Inherent Risk and Management and Control		**(0-4)**	**100%**
Coverage/ Surplus			(0-4)	%
Earnings			(0-4)	%
Access to Additional Capital			(0-4)	%
Capital Support Total			**(0-4)**	**100%**
Overall Risk of Failure			**(0-4)**	

Modules and PAIRS are aligned

PAIRS	APRA Supervision Framework Modules
Board	Board
Management	Management
Risk Governance	Risk Governance
Strategy & Planning	Strategy & Planning
Liquidity Risk	Liquidity Risk
Operational Risk	Operational Risk
Credit Risk	Credit Risk
Mk & Investment Risk	Mkt & Investment Risk
Insurance Risk	Insurance Risk
Capital - Coverage	Capital
Capital - Earnings	
Capital – Access to Add	

Modules and Topics

Module 1 Board	•Board Composition •Fit and Proper		Module 2 Management	•Management Structure •Fit and Proper
Module 3 Risk Governance	•Role of Board •Risk Governance of Board •Board Committees •Decision Making Process - Risk Management	•Compliance Framework •Management Information System •Independent Review - Internal Audit (IA) •Independent Review - External Audit (EA)	Module 4 Strategy & Planning	•Strategic Risk •Strategic Planning •Business Plan •Implementation & Execution •Monitoring its own progress
Module 5 Capital	•Coverage / Surplus •Earnings •Access to Additional Capital		Module 6 Liquidity Risk	•Liquidity Risk •Board and Management Awareness •Liquidity Risk Management •Independent Review of Liquidity Risk

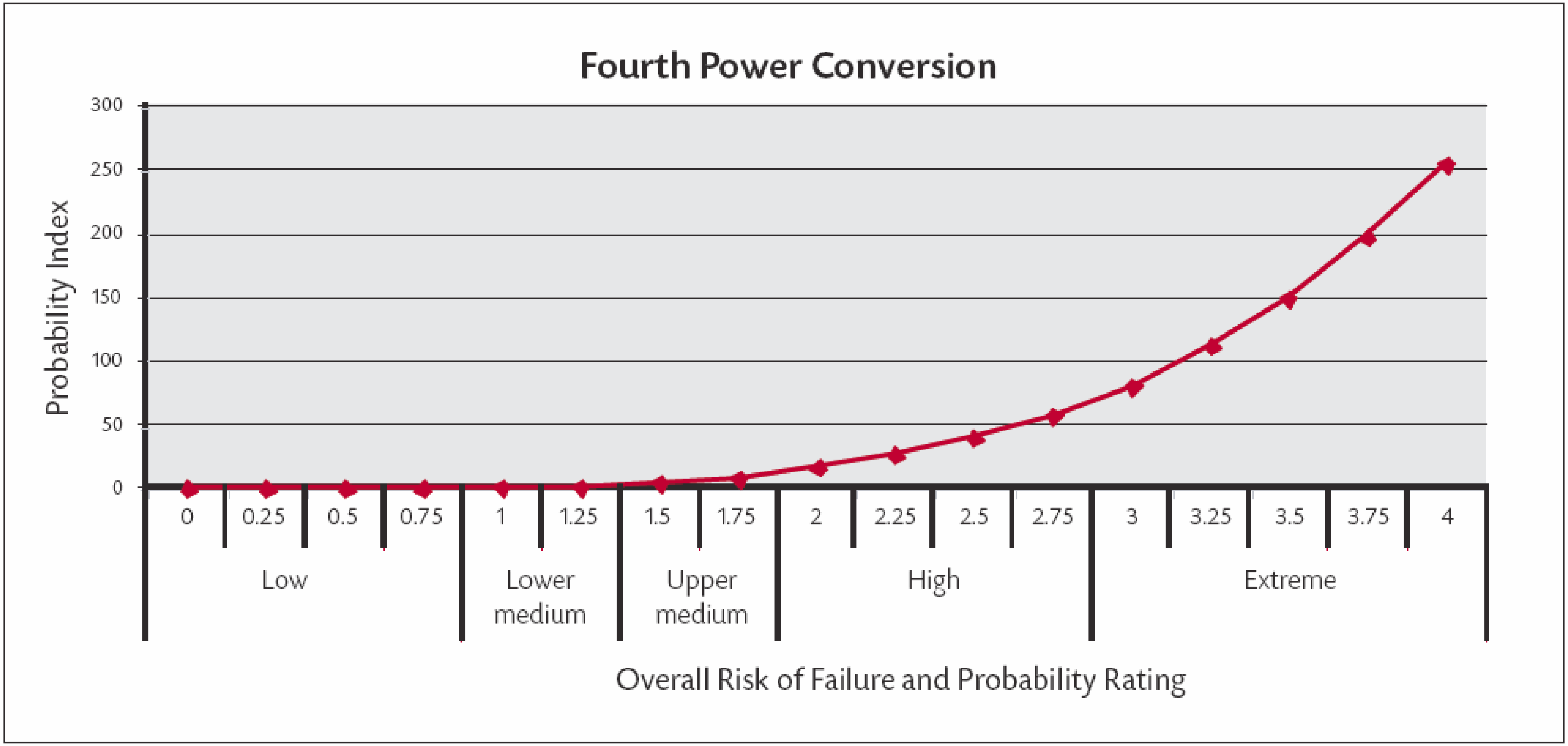
Modules and Topics

Module 7 Op Risk	•Nature and Complexity •Internal & External Fraud •IT Systems •Business Disruption •Board and Mgt Awareness •Operational Risk Mgt Framework •Outsourcing Arrangements	•Administration •Information Technology •Business Continuity Management •Project Management (IT) •New & Varied Products •Independent Review of Operational Risk	Module 8 Credit Risk (reinsurer focus)	•Credit rating / financial standing of reinsurers •Concentration and large exposures •Impact of downgrade or default on insurer	• Credit policy • Concentration Regular monitoring, review and reporting • Payment and collections
Module 9 Market and Investment Risk (MIR)	•Asset Liability Mismatch Risk •Investment Risk •Risk of Asset Valuation	•Board and Mgt Awareness •Asset and Liability Risk Mgt •Invest. Risk Mgt •Controls on Asset Valuation •Independent Review of Market Investment Risk	Module 10 Insurance Risk	•Insurance Risk •Credit Risk •Board and Management •Product Design •Pricing •Underwriting	•Claims •Liability Valuation •Reinsurance •Distribution •Independent Review of Insurance Risk

Language of PAIRS Rating

Rating Band	Inherent Risk (ignoring any controls)	Management and Controls
0 - 0.5	Very Low	Strong
0.6 - 1.0	Low	Sound
1.1 - 1.5	Low Medium	Adequate
1.6 - 2.0	High Medium	Vulnerable
2.1 - 3.0	High	Weak
3.1 - 4.0	Extreme	Extremely Weak

Probability of failure



Quality and control

- Education and training
- Sign off protocols
- System validations
- Reporting and monitoring
- Benchmarking sessions
- Peer reviews

Supporting prudential framework

General Insurance Prudential Regulation Framework

- Prudential framework it comprises:
  - Amended Insurance Act 1973;
  - GI Prudential Standards;
  - Prudential Practice Guides (PPGs)
  - GI Reporting Standards

- commenced on 1 July 2002, introducing risk based capital regime when requirements in relation to governance, financial soundness and risk management were either introduced or significantly strengthened

- Additional requirements in 2006 relating to governance and fit & proper and outsourcing

GI Framework (continued)

- Refinements in 2006 relating to risk, financial management, reinsurance and FCR
- In 2007 Prudential Practice Guides replaced GI Guidance Notes (GN);
- Refinements in 2008 relating to categories of insurers and capital charges on reinsurance & equity/property
- Introduction in 2009 of requirements for Level 2 insurance groups
- New remuneration requirements, effective on 1 April 2010
- New performance reporting introduced , effective 1 July 2010

Policy Development

- Capital review (Life & general insurance)
- Level 3 conglomerates framework

Prudential Framework

Insurance Act & Regulations

Prudential Standards

- GPS 110 Capital Adequacy
- GPS 120 Assets in Australia
- GPS 220 Risk Management
- GPS 222 Business Continuity Management
- GPS 230 Reinsurance Management
- GPS 310 Audit & Actuarial Valuation
- GPS 410 Transfer and Amalgamation of insurance Business
- GPS 510 Governance
- GPS 520 Fit and Proper

- Guidelines on Authorisation
- Prudential Practice Guides

Prudential Practice Guides (PPG's)

PPGs are recommended better practices rather than PS requirements. PPGs are not legally enforceable.

- GPG 200: Risk Management
- GPG 220: Credit Risk
- GPG 230: Operational Risk
- *PPG 231: Outsourcing*
- GPG 232: Custody Arrangements
- *PPG 233: Pandemic Planning and Risk Management*
- GPG 240: Insurance Risk
- GPG 245: Reinsurance Management Strategy
- GPG 250: Balance sheet & Market Risk
- *GPG 510: Governance*
- *GPG 520: Fit and Proper*

Risk Management

- A general insurer must have:
  - A risk management framework, which is documented in a risk management strategy
  - Dedicated risk management function
  - Three year business plan
  - Submit a risk management and financial information declaration

Reinsurance Management

- A general insurer must:
  - Have a reinsurance management framework, which is documented in a reinsurance management strategy
  - Have a process for documenting reinsurance arrangements
  - Submit a reinsurance arrangements statement
  - Submit a reinsurance declaration
  - Submit Limited Risk Transfer Arrangement details to APRA for prior approval

Audit and Actuarial

- The Board must appoint an actuary and auditor to ensure that the Board and senior management of an insurer are provided with impartial advice in relation to its operations, financial condition and insurance liabilities.

- The Appointed Auditor's primary role is to:
  - provide an independent and objective view on the truth and fairness of the insurer's financial statements; and
  - assess the insurer's systems, procedures and controls used to address compliance with prudential requirements.

Audit and Actuarial (continued)

- The Appointed Actuary's primary role is to:
  - Provide advice on the insurer's insurance liability valuation (note that this includes discounting of insurance liabilities)
  - Provide an impartial assessment of the overall financial condition of the insurer

- The Reviewing Actuary's primary role is to undertake a peer review of the Appointed Actuary's ILVR

Governance

- This Prudential Standard sets out minimum foundations for good governance of regulated institutions. It aims to ensure that regulated institutions are managed in a sound and prudent manner by a competent Board of Directors, which is capable of making reasonable and impartial business judgements in the best interests of the regulated institution and which gives due consideration to the impact of its decisions on policyholders.
- This standard has applied to Authorised Non-Operating Holding Companies since October 2006
- The standard allows some concessions for insurers whose parents are prudentially regulated

Governance (continued)

- Main requirements
  - Board size of at least 5 directors; majority independents and independent chair
  - a Board Audit Committee must be established
  - regulated institutions must have a dedicated internal audit function
  - certain provisions dealing with independence requirements for auditors
  - the Board must have a policy on Board renewal and procedures for assessing Board performance

Assets in Australia

- The Insurance Act requires all insurers (both subsidiaries and branches) to maintain assets in Australia to the value that equals or exceeds the total amount of the insurer's liabilities in Australia. This requirement ensures that the total value of assets held within the jurisdictional reach of APRA and the Australian courts is sufficient to meet a general insurer's liabilities in Australia.

  The objective of GPS 120 Assets in Australia, is to specify certain assets that are excluded as "assets in Australia".

  The assets excluded are those which would otherwise fall within the definition of "assets in Australia" but which APRA considers to have doubtful or no value to policy holders in Australia in the event of a general insurer becoming insolvent.

Business Continuity Management & Outsourcing

- BCM Prudential Standard ensure that the general insurer implements a whole of business approach to Business Continuity Management (BCM) appropriate to the nature and scale of its operations. BCM increases an insurer's resilience to business disruption arising from internal and external events and reduces the impact on the insurer's operations, reputation, profitability, policyholders and other stakeholders.

- Outsourcing Prudential Standard aims to ensure that all outsourcing arrangements involving material business activities entered into by a general insurer are subject to appropriate due diligence, approval and on-going monitoring. All risks arising from outsourcing material business activities must be appropriately managed to ensure that the general insurer is able to meet both its financial and service obligations to its policyholders.

Questions

Appendix: Fit & Proper

- Fit and Proper Prudential Standard sets out minimum requirements for these institutions in determining the fitness and propriety of individuals to hold positions of responsibility (Responsible Person).

- Key requirements
  - Fit and Proper Policy
  - Assess responsible person prior to initial appointment and then re-assessed annually (or as close to annually as practicable);
  - take all prudent steps to ensure that a person is not appointed to, or does not continue to hold, a responsible person position for which they are not fit and proper;
  - additional requirements must be met for certain auditors and actuaries; and
  - certain information disclosures to APRA

Appendix: Capital Adequacy

- An insurer must maintain a capital base in excess of its Minimum Capital Requirement (MCR).
- Capital base:
  - Defined in GPS 112
  - Tier 1 includes ordinary shares, retained earnings and innovative instruments)
  - Tier 2 includes preference shares, convertible notes and subordinated debt.
  - deductions to be made from the eligible capital (goodwill, intangibles, expected dividends)
  - insurance liabilities held on the balance sheet at a probability of sufficiency greater than 75% count as Tier 1 capital (net of tax)

Appendix: Minimum Capital Requirements

- Prescribed Method or Internal Model Based Method (or combination)
- Prescribed Method sets risk based capital requirements based on three main categories
  - ***Insurance risk*** - actual value of net insurance liabilities could be greater than the estimated amount
  - Calculated by applying a capital factor to the net outstanding claims provision and net premium liabilities (at 75% probability of sufficiency)

Direct Classes of Business	OCP	PL
Houseowners / Householders Commercial Motor Vehicle Domestic Motor Vehicle Travel	9.0%	13.5%
Fire and ISR Marine Aviation Consumer Credit Mortgage Other Accident Other	11.0%	16.5%
CTP motor vehicle Public and Product Liability Professional Indemnity Employers Liability	15.0%	22.5%

Appendix: Minimum Capital Requirements 2

- ***Investment risk*** - the risk of an adverse movement in the value of an insurer's assets and/or off-balance sheet exposures due to credit risk, market/ mismatch risk and liquidity risk
- Calculated by applying a capital factor to the quality of the assets on the balance sheet, including investments and reinsurance recoverables
- For example,
  - Cash is 0.5%
  - AA- reinsurance recoveries from APRA authorised reinsurers is 2%
  - AA- reinsurance recoveries from non-APRA authorised reinsurers is 3%
  - Fixed interest security issued by A rated bank is 4%
  - Listed Equities is 16%

Appendix: Minimum Capital Requirements 3

- ***Concentration risk*** - accumulation of exposures to a single catastrophic event or single cause (net of reinsurance).
- Firstly, the insurer calculates the Probable Maximum Loss (PML), the largest gross loss due to a concentration of risk exposures, set to be a 1 in 250 year event.
- The insurer then calculates potential reinsurance assets to derive the Maximum Event Retention (MER)
- The risk charge is equal to the MER plus the cost of one reinstatement of the catastrophe reinsurance program.
- Lenders Mortgage Insurers have a prescribed MER scenario, based on a three year economic downturn