



General Insurance Capital Framework: AASB 17 and LAGIC

This d'finitive reviews the changes APRA is making and what general insurers need to do next.

In December 2021 APRA released a Quantitative Impact Study (QIS) and draft Prudential and Reporting standards aimed at integrating AASB 17 into the capital and reporting frameworks for insurers. The QIS and any feedback is due by 31 March 2022.



What has happened?

AASB 17 is the new accounting standard that will apply to insurance in Australia for reporting periods starting 1 January 2023.¹ APRA has previously communicated its intention to align APRA reporting requirements with the new accounting standard.

In December 2021 APRA released a consultation package including draft Prudential and Reporting standards and a Quantitative Impact Study (the **current QIS**). This followed on from a consultation package released in December 2020 (the **previous consultation**) and from an invite-only QIS that ran from November 2020 to March 2021 (the **previous QIS**).

APRA will use industry feedback and responses to the **current QIS** to inform the development of final Prudential and Reporting standards, which are expected to be released later in 2022, and will come into effect from 1 July 2023.

The table below summarises the materials released by APRA in December 2021, the proposed changes and the QIS requirements for general insurers:

APRA consultation package	<p>APRA's December 2021 consultation package has three components:</p> <ul style="list-style-type: none"> • Response Paper: APRA's response to industry feedback from the previous consultation and refinement of their proposals. There is also a high-level summary contained in an information paper for Board members and executives. • Draft Prudential and Reporting Standards: Marked up and clean versions of draft standards • Quantitative Impact Study (QIS) package: QIS workbooks, an instruction document and Q&A related to the QIS.
QIS	<p>The QIS is to be completed by Level 1 insurers, and is due by 31 March 2022. The QIS is not mandatory, but APRA is strongly encouraging all insurers to participate. The QIS includes:</p> <ul style="list-style-type: none"> • Financial reporting based on AASB 17 • An assessment of regulatory capital adequacy • A response letter addressing qualitative areas such as significant judgements made, assumptions used and a reconciliation of differences.
Proposed changes	<p>There are a number of changes to the Prudential and Reporting frameworks that will be captured through the QIS, including:</p> <ul style="list-style-type: none"> • Proposed changes related to integrating AASB 17 into Capital frameworks • Adopting reporting forms which align to AASB 17 • Changes to the capital calculations aimed to keep the move from AASB 1023 to AASB 17 reporting largely capital neutral • Changes to a number of LAGIC calculations and requirements, which are independent of AASB 17.
Next steps for insurers	<p>Insurers should decide whether or not they will participate in the QIS. If participating, responses are due to APRA by 31 March 2022.</p> <p>Post QIS, we expect insurers will have a better understanding of the financial, reporting, and any capital impacts of the proposed changes.</p>

¹ For an insurer with a 31 December balance date this means their first AASB 17 accounts would be prepared as at 31 December 2023. For an insurer with a 30 June balance date their first AASB 17 accounts would be prepared as at 30 June 2024.

Quantitative Impact Study

Should insurers participate?

The **current QIS** is not mandatory, however, APRA is strongly encouraging all general insurers to participate. The QIS is to be completed by Level 1 insurers only.

The QIS will provide feedback to APRA on the potential impact of AASB 17 on general insurers, as well as allowing APRA to validate that the draft changes to Prudential standards operate as intended. The QIS (and response letter) provides insurers with an opportunity to highlight any areas in the draft Prudential and Reporting standards that could be improved, as well as allowing insurers to assess their readiness for preparing AASB 17 financials.

What do insurers need to submit?

Insurers will need to complete and submit a package of Excel workbooks. The workbooks are designed around existing APRA reporting forms. Some of the forms are very similar to the existing forms and only require additional information to be split out (for example, GRS 115.0, the Outstanding Claims Liabilities – Insurance Risk Charge), while some have been completely reworked to take into account AASB 17 (for example, GRS 300s – All Financial Statements).

The returns should be completed based on the 2021 full financial year (i.e. for most insurers the year ending 30 June 2021 or 31 December 2021), but 31 December balancing insurers can use the year ending 31 December 2020 instead.

In addition, insurers will need to submit a response letter addressing qualitative areas such as an explanation of significant judgements made, assumptions used, taxation assumptions, and reconciliations of differences (if any) between the actual Capital Base as at the balance date and the Capital Base calculated for QIS purposes.

The QIS is to be prepared on a best endeavours basis.

Finity view

While changes in many of the standards are minor, there are significant changes to the 300 series of forms (the financial statements). Insurers will need to prepare these forms by applying AASB 17.

For general insurers adopting the PAA many of the entries will be similar to, or rearrangements of, existing financial reporting entries (for example, when using the PAA, insurance revenue for direct business should be broadly the same as gross earned premium).

However, insurers with the following features may require additional analysis and information:

- Insurers writing multi-year direct business or purchasing multi-year reinsurance, particularly if they will not be able to use the Premium Allocation Approach so must use the General Model.
- Insurers with a mix of onerous and non-onerous contracts
- Insurers with complex investments or capital structures
- Insurers writing D&O or Cyber business, as these products must now be separately reported.

Even for simpler insurers, participation in the QIS will require time and resources to become familiar with the requirements, and then gather, analyse and populate the QIS with the required information. Insurers should begin work on the QIS as soon as they can in order to meet the 31 March timeframe.

We expect that insurers will benefit from participating as it allows insurers the opportunity to assess their own preparedness to adopt AASB 17 and manage the changes proposed to the capital and reporting frameworks.

Who should be involved?

In order to ensure involvement from sufficiently senior stakeholders, APRA requires the CFPO and AA to “have oversight over the process for producing the QIS data and sign off the QIS workbooks and response letter to APRA.”

As the QIS is to be prepared on a best endeavours basis, the QIS workbooks do not need to be audited.

Finity view

The QIS workbooks require a range of information. We would not expect the CFO and AA to be ‘signing off’ on every number in every workbook. We expect the AA should ‘sign off’ on actuarial figures, and the CFO should ‘sign off’ on accounting figures. Good practice would be for the CFO and AA to set out in the response letter how they have been involved with the QIS.

When is it due?

The QIS is due by 31 March 2022. APRA has noted they are working to a relatively tight timeline to release the final standards later in 2022, and are therefore unlikely to offer extensions to insurers to submit completed QIS workbooks after the due date.



Changes to capital frameworks

There are two sets of changes to the regulatory capital framework:

- Changes due to the introduction of AASB 17
- Other changes that are not AASB 17 related, but are refinements of the existing LAGIC rules

Changes due to the introduction of AASB 17

APRA proposed a number of changes in the **previous consultation** paper, many of which have been confirmed as part of the current package. APRA's intent is to largely retain the existing capital requirements, and leave the level of capital held by insurers as broadly unchanged.

Consultation area	Details
Regulatory adjustment to capital base: Additional regulatory adjustments to maintain capital neutrality are proposed.	<p>A number of elements of the APRA Capital Base are calculated with respect to accounting assets and liabilities. Because AASB 17 will lead to new assets and liabilities, APRA has redefined elements of the Capital Base such that the value of the Capital Base should remain unchanged (illustrated below).</p> <p>APRA has clarified that, when <i>deducting</i> deferred tax assets from the Capital Base, the deferred tax assets should include any tax effect impact from surplus technical provisions that have been added to the Capital Base.</p> <p>APRA has also clarified how the 'four quarter dividend test' rule would apply once AASB 17 is in force. Under AASB 17 and AASB 9 insurers may have the option to use Other Comprehensive Income (OCI) to report changes in the fair value of financial assets, and components of the insurance financial results. If insurers use OCI for these items, and the values are negative over the previous four quarters, then after tax earnings must be reduced by the negative amount for the purpose of the four quarter dividend test.</p>
Expense basis: Clarification on definition of CHE and PAE to promote consistency.	<p>In the previous consultation APRA had proposed making significant changes to claims handling and policy administration expense allowances. Following industry feedback, APRA has concluded that significant changes are <i>not</i> required. Instead, in order to promote consistency in approach across the industry on treatment of expenses, APRA has provided proposed clarifications for claims handling expenses and policy administration expenses.</p>
Risk margin: Apply existing requirements	<p>For <i>capital purposes</i>, Insurers must continue to apply existing GPS 340 risk margin requirements. APRA acknowledges that the risk adjustment required for AASB 17 and the APRA risk margin may differ.</p>
Discount Rate: No illiquidity premium	<p>For <i>capital purposes</i> insurers must continue to apply the existing GPS 340 definition of risk-free discount rate for discounting cash flows, and may not add an illiquidity premium.</p>
Reinsurance default risk: Continue to assume all RI is recoverable.	<p>When <i>calculating GPS 340 liabilities</i> insurers must continue to assume that all reinsurance is fully recoverable, and should not include any allowance for expected reinsurance default. Instead, the risk of default will continue to be allowed for in the Asset Risk Charge for capital purposes.</p>
Unclosed business: Include unclosed business.	<p>Insurers must continue to include unclosed business for the GPS 340 liabilities calculation.</p>
Projection period: Continue with existing practice.	<p>Insurers must apply the existing GPS 340 requirements to align gross and reinsurance cash flows and retain the existing approach to projecting liabilities i.e. project cash flows, to reflect the ultimate payments of the outstanding claims and to the expected expiry of the benefit for the premium liabilities.</p>



Finity view

APRA's intention to maintain the current framework for the capital base calculation can be illustrated using the following simple example.

Consider a simple insurer with only Tier 1 capital, that has an APRA capital base under the existing standards that is made up of:

- Net accounting assets (\$100)
- Plus surplus technical provisions (\$20)
- Less deductions (eg., intangibles, goodwill, deferred tax assets) (-\$10).

For an insurer writing profitable business, the APRA net Premiums Liabilities will generally be less than the AASB 1023 net unearned premium. This leads to the surplus technical provision (which is added to the Capital Base). The following chart shows the make up of the capital base.

Figure 1 – Capital Base starting from AASB 1023

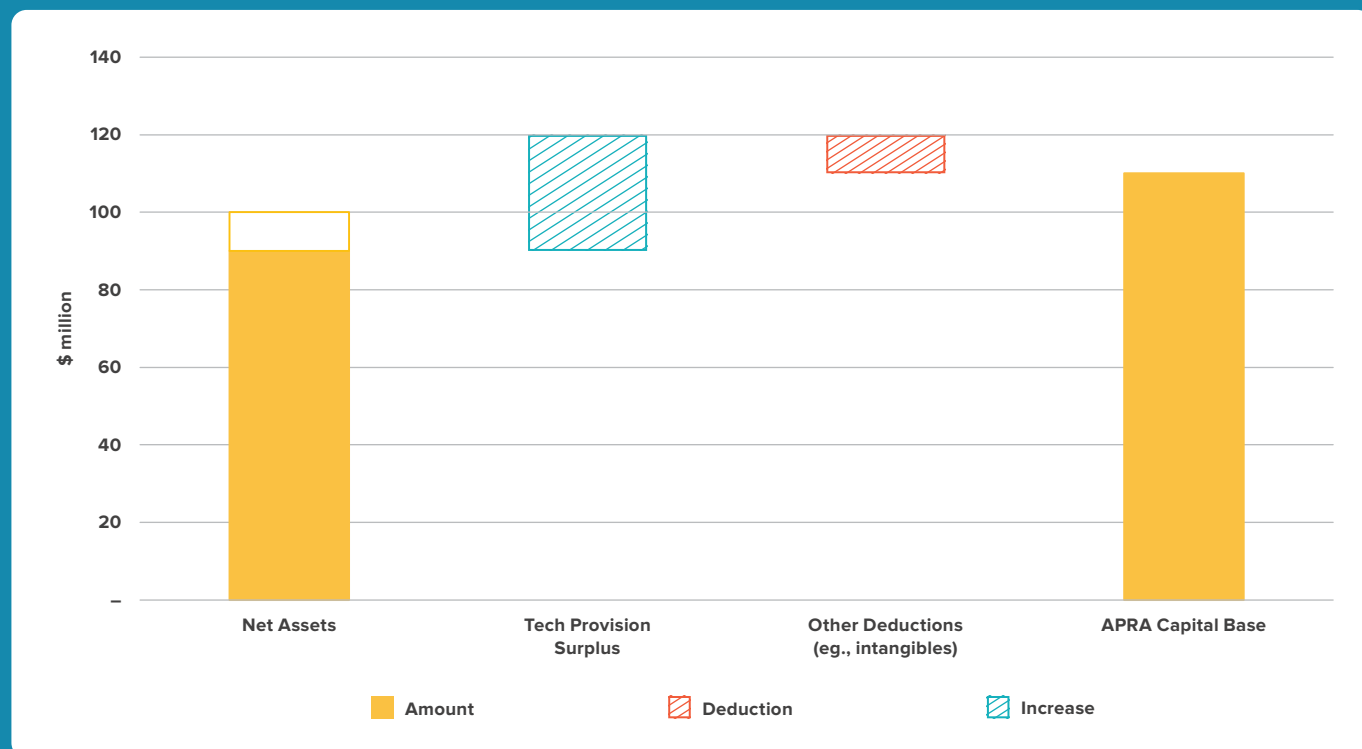


This gives the insurer an APRA capital base of \$110.

APRA's changes to the regulatory adjustment to the capital base is designed to retain an equivalent adjustment. If the impact of AASB 17 on this simple insurer was that accounting insurance liabilities became \$10 *higher*, then opening net assets would be \$10 *lower*. The APRA net premiums liabilities, however, should not change. Therefore, the surplus technical provisions should be larger (a *higher* accounting liability will be compared to the *same* APRA Premiums Liability).

The following chart restates the example following the introduction of AASB 17.

Figure 2 – Capital base starting from AASB 17



The surplus technical provision adjustment should offset the impact of AASB 17 on any insurance liabilities, leading to the same capital base of \$110.

APRA has noted that, based on the **previous QIS**, capital levels are expected to remain broadly unchanged.

When completing the QIS it will be important for insurers to confirm whether they have any change in their capital base. If they do have a change they should highlight the difference and the reasons why to APRA so that APRA can consider if any additional changes to the Prudential Standards are required in order to achieve capital neutrality.



Other changes to LAGIC (not linked to AASB 17)

APRA has taken this opportunity to propose updates to the LAGIC framework to address issues that have been identified since the implementation of the framework in 2013.

APRA requirement (in brief)	Comments
Real interest rate and expected inflation stresses (GPS114): Real interest rate subject to minimum up and down stresses based on a 3% interest rate floor. Allow for negative nominal interest rate in inflation stress, with less than 1% nominal interest rate subject to smaller relative stress.	<p>APRA's view is that the Asset Risk Charge calculations do not produce robust outcomes in a low or negative interest rate environment.</p> <p>APRA has acknowledged that introducing minimum shock values for the real interest rate stress (based on a 3% interest rate floor), may increase an insurer's Asset Risk Charge and therefore overall capital requirements, but believes that this is the most effective approach to dealing with low or negative interest rates.</p>
Dollar value exposure limits (GPS114 and GPS117): Inflate existing dollar value exposure limits by historical inflation, but no future indexation at this stage.	<p>The dollar value limits within the capital standards have remained unchanged for some time. APRA has reviewed and proposed to adjust them for historical inflation.</p> <p>An example is the Asset Concentration Risk Charge limit where asset limits for related-party APRA regulated counterparties will become \$22.5 million, or 100% of capital base. Currently the limit is \$20.0 million or 100% of capital base.</p>
Default stress – whole of account QS (GPS114): Apply a charge to the net (rather than gross) of quota share position for unpaid premiums and unclosed businesses.	<p>Insurers currently apply default risk charges to unpaid premiums, unclosed business, and non-reinsurance recoveries. For insurers with a whole of account quota share APRA proposes that the default risk charges apply to the net of quota share position for these items.</p> <p>This should reduce double counting of these items in the capital framework.</p> <p>While some general insurers may not have access to appropriate data to determine their net of quota share position, for those that do the option is available and allows for a better reflection of their net risk position.</p>
Capital instruments (GPS112): Introduce consistency with ADI capital instrument measurement rules.	<p>APS 111 (the Banking capital standard) has undergone several revisions since LAGIC was introduced, so APRA has proposed several changes to GPS 112 to better align it with APS111.</p> <p>APRA has stated they do not anticipate that the proposed changes would impact the eligibility of capital instruments. Nonetheless, insurers, particularly those with Additional Tier 1 or Tier 2 capital instruments, should carefully consider the changes and whether there may be any impacts on their Capital Base calculation.</p>
Insurance risk charge (GPS 115): Multi-year quota share	<p>The 'two month and six month' rule for reinsurance placement and documentation has been revised to require terms and coverage to be finalised at inception, and wordings to be finalised, stamped, and signed within two months.</p>
Internal Capital Models	<p>Insurers will no longer be permitted to use Internal Capital Models to determine regulatory capital requirements. APRA encourages insurers to continue to develop and use internal capital models for risk profile modelling and to support internal risk and capital management decisions.</p>

Finity view

The majority of these changes proposed by APRA should be relatively minor for most insurers. However, an important aspect of the QIS is to test whether any of the proposed changes do have significant capital impacts for insurers, and to highlight these impacts to APRA if they occur.

Changes to reporting framework

New data collection solution

In September 2021, APRA introduced a new data collection solution, APRA Connect, to progressively replace the Direct to APRA (D2A) platform. In line with APRA's data strategy, the revised reporting standards have been designed on the APRA Connect Platform. The QIS is also structured to be compatible with the APRA Connect data collection approach to give industry an early view of this new environment and opportunity to provide feedback.

Changes to reporting

APRA has proposed the following key changes to the reporting forms, including the financial statement reporting (the GRS 300 series of forms):

- The GRS 300 series of forms (the financial reporting forms) have been restructured to follow AASB 17 requirements.
- New product groups: Directors and Officers (D&O) and Cyber insurance will be new, separate APRA classes for general insurance. Other APRA classes for general insurance remain unchanged.
- Product groups allocation principles for reporting to APRA: If insurers need to allocate accounting results down to APRA classes APRA has proposed principles for how the allocation should occur. Allocation approaches can be based on allocation drivers such as premium income or expected claims determined based on accounting and /or actuarial judgements. Most general insurers should be able to retain their existing approach to APRA class reporting (especially if they are using the simplified Premium Allocation Approach for AASB 17), although additional allocation may be required to the new D&O and Cyber classes.
- Changes to some of the capital reporting forms to collect additional information (eg., the Claims Handling Expense provision in GRS 115), and to facilitate regulatory adjustments to the Capital Base in GRS 112.
- Supplementary data collection: Gross written premium, deferred reinsurance expense, amounts due on reinsurance contracts and other items will continue to be separately collected, even though under AASB 17 these amounts will no longer separately appear in the balance sheet.

APRA is expected to make further changes in this area and may refine its approach prior to finalising the draft reporting standards. For example, APRA is still considering collecting data suitable for performance monitoring purposes such as Loss Ratios and Combined Operating Ratios used by general insurers.



Finity's AASB 17 Team

Finity is Australia and New Zealand's leading actuarial and management consulting firms. Finity specialises in general and health insurance, working closely with large and niche insurers as well as government agencies to deliver world-class actuarial, pricing and strategic advice. We provide Appointed Actuary services to around 37 APRA and RBNZ-regulated general insurers and over 30 APRA and RBNZ-regulated Private Health Insurers insurers.

Our AASB 17 team has extensive knowledge of the new insurance standard, and is passionate about helping guide our clients through the switch to AASB 17. Our AASB 17 team has been participating in the industry adoption since 2016 and continue to do so today. We combine our experience, industry insight, and research with rigorous technical analysis to help your implementation.

Please contact one of our AASB 17 experts if you have any questions or comments on this newsletter.

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