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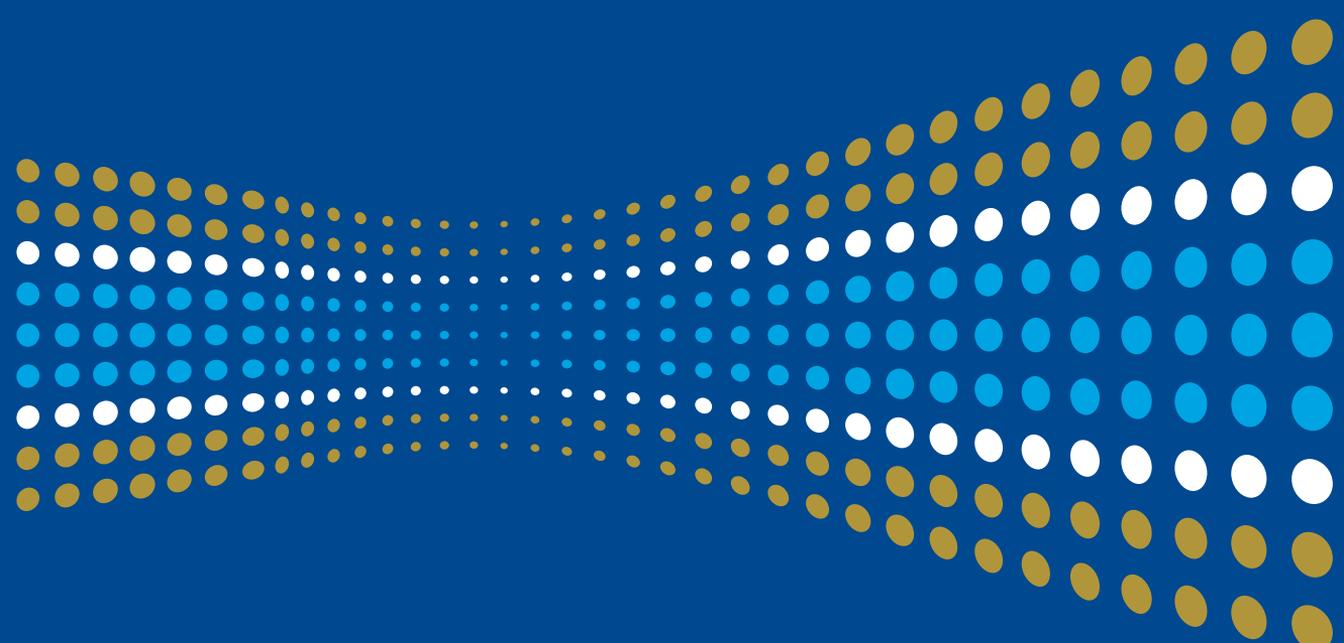
insight

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General insurance industry overview

Life insurance industry overview

Recovery planning for ADIs

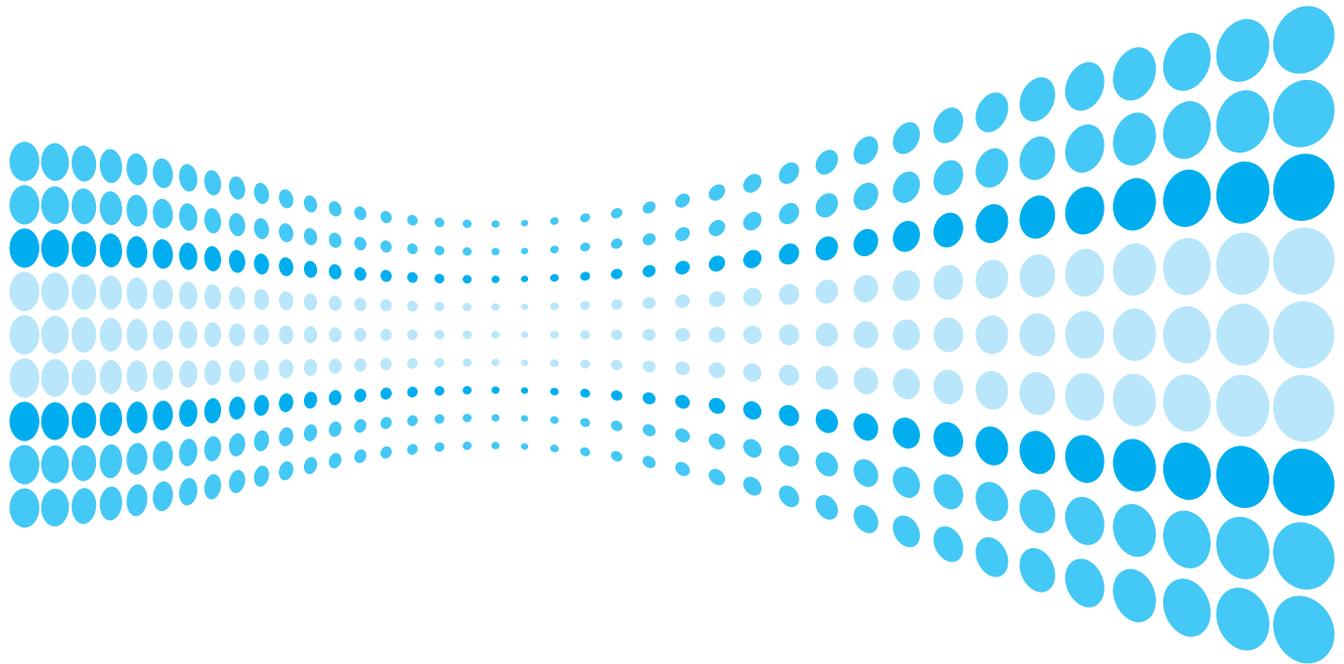




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GENERAL INSURANCE INDUSTRY OVERVIEW

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This article provides an overview of the operating environment for
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Australian general insurance industry and an update on the financial
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the position and performance of the industry for the year ended June
.....
2012. The article also provides an outline of some key industry risks on
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Introduction

The general insurance industry experienced another set of challenges over 2011/12, with a hardening in the property reinsurance market and large falls in interest rates having an impact on insurers' profitability and causing some insurers to reset their risk appetite.

Despite these challenges, the industry has continued to demonstrate resilient profitability and its solvency position remains strong.

The natural catastrophe events in the preceding year provided a live stress test of reinsurance arrangements. Whilst reinsurance arrangements functioned well at a high level, the experience did provide an opportunity for APRA to closely examine industry practice. In a review conducted over 2011/12, APRA found that insurers' Reinsurance Arrangements Statements (RAS) could be enhanced to improve their usefulness to Boards, senior management and APRA. APRA also considers insurers would benefit from a greater use of stress testing when developing their risk appetite and in setting reinsurance arrangements.

GENERAL INSURANCE INDUSTRY OVERVIEW

Catastrophe models are an important resource used by insurers when deciding on their reinsurance arrangements. The governance and risk management practices applied by insurers in their catastrophe modelling processes are currently being reviewed by APRA. Of particular interest to APRA is the level of understanding, challenge and debate at Board and senior management level on the limitations of models and the uncertainty around the outputs they produce.

Other areas of particular focus for APRA at present are the adequacy of insurers' pricing and reserving processes. Healthy competition and factors such as low interest rates are pressure points on insurers' pricing. In this environment, the maintenance of sound and responsive pricing and underwriting practices is important. On reserving, APRA notes that current industry challenges may increase the risk that some insurers may inappropriately weaken reserves to sustain short-term profitability.

Natural catastrophe events had a significantly reduced impact on the general insurance industry over 2011/12.

Operating environment

Natural catastrophe events had a significantly reduced impact on the general insurance industry over 2011/12. A storm event in Melbourne in late 2011 and flooding in parts of Queensland, NSW and Victoria early in 2012 again made natural catastrophe events a newsworthy part of the Australian summer. However, the gross claims on the industry from these events have been estimated at \$1.0 billion¹, which was low in contrast to the claims from natural catastrophe events in the previous year; the gross claims from the Australian flooding, storm and cyclone events in that year have been estimated at \$4.4 billion² while the Christchurch earthquakes resulted in gross claims estimated at US\$14.2 billion³.

A large portion of the industry's gross property claims arising from the previous year's natural catastrophe events were recovered from reinsurers. This resulted in a general hardening of reinsurance terms and premiums when insurers sought to renew their property catastrophe reinsurance arrangements. Many property insurers have responded to these changes in the property

1 Insurance Council of Australia, *Disaster Statistics* as at 11 September 2012

2 *ibid*

3 Swiss Re, *Investors and Media Briefing*, 10 September 2012. This refers to the gross claims for all general insurers arising from the Christchurch events, not only APRA-authorised insurers.

reinsurance market with premium increases and by reviewing their risk appetites – in some cases increasing risk retention levels in their reinsurance arrangements. This may result in increased earnings volatility for such insurers. In addition, some insurers decided to reduce their exposures to areas materially affected by natural peril activity if they could not achieve premium increases commensurate with the risk in those areas.

The size of increases in the cost of property reinsurance has generally moderated in the June 2012 reinsurance renewal period when compared to the 2011 renewals.

The availability and affordability of property insurance in areas impacted by natural perils, such as riverine flood and cyclone, has become an important issue for those communities most at risk. An element of the Government's response to this issue was the Natural Disaster Insurance Review (NDIR), an independent review into insurance for flood and other natural disasters in Australia. The affordability and availability of strata title insurance in northern Queensland was also the subject of a parliamentary inquiry in 2012.

Following the release of the NDIR panel's recommendations, the Government sought feedback on a proposal requiring all insurers to offer riverine flood cover in their home building and contents policies, while allowing consumers to opt out of flood cover. At the time of writing, the Government is considering feedback received on this proposal.

In response to community concerns, some personal lines insurers have made riverine flood cover more widely available, with a few insurers offering this type of insurance for the first time. Most insurers offering riverine flood cover are making it a compulsory part of their property insurance offering, with the resulting price rises in flood-prone areas leading to further criticism from affected customers.

GENERAL INSURANCE INDUSTRY OVERVIEW

Another development adversely impacting on the operating environment for general insurance is the significant fall in interest rates over the course of the year. General insurers invest predominantly in highly rated fixed-income securities and should the current low interest rate environment persist, insurers' investment income will suffer. This may be a driver of increased pricing in some classes of business, particularly in the long-tail classes.

Finally, regulatory change is also impacting on the industry as insurers implement APRA's changes to its general insurance capital requirements, which come into effect from 1 January 2013. These changes have been introduced to improve the risk-sensitivity and cross-industry alignment of APRA's requirements, and have been the subject of formal and informal consultation with industry since early 2010. In addition to technical reforms, an important component of APRA's revised framework for general insurers are new requirements for the Internal Capital Adequacy Assessment Process (ICAAP). APRA views a rigorous ICAAP, in which the Board is fully engaged, to be of fundamental importance to the sound management of an insurer.

Industry structure

As at 30 June 2012, there were 124 APRA-authorized insurers and reinsurers, of which 102 are actively writing business and 22 are in run-off.

The number of authorized insurers and reinsurers in the market has remained fairly stable in recent years (see Table 1). The main activity in the past year was the rationalisation by some insurance groups of multiple licenses arising from acquisition activity in prior years.

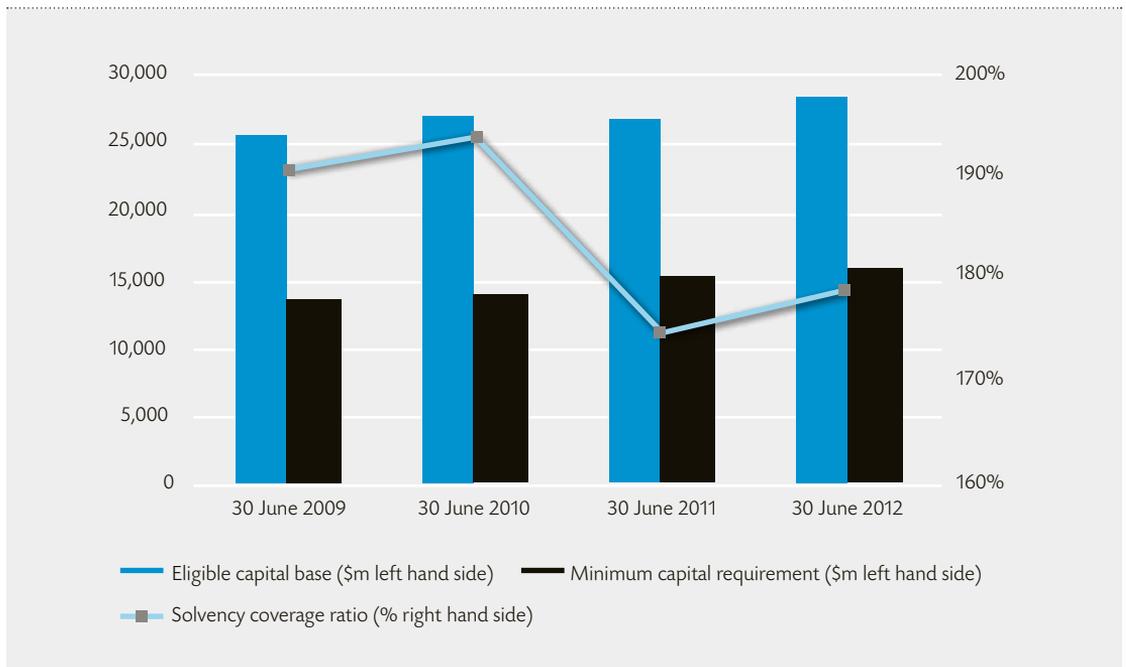
As at 30 June 2012, authorized insurers accounted for 89 per cent of the industry's \$118.2 billion in total assets.

Financial position and performance

The financial position of the general insurance industry has remained sound despite the challenging operating environment of recent years. As shown in Figure 1, the industry has a healthy 179 per cent coverage of APRA's minimum capital requirement (MCR) as at 30 June 2012. The improvement in the industry MCR coverage over the course of the year was driven mainly by an increase in the industry's eligible capital base to \$28.4 billion from \$26.7 billion, with insurers reporting a higher level of retained profits as at 30 June 2012.

Table 1: Industry structure

	30 June 2009	30 June 2010	30 June 2011	30 June 2012
Number of authorised insurers	116	118	115	112
Number of authorised reinsurers	16	12	12	12
Total authorised insurers/ reinsurers	132	130	127	124

Figure 1: Industry capital and solvency coverage

Source: Data for this chart was obtained from the *Quarterly General Insurance Performance Statistics Publication*. Note the capital base for branch insurers is represented by adjusted net assets in Australia.

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The industry reported a net profit after tax of \$3.7 billion in the year ended June 2012, which included an underwriting profit of \$0.5 billion. Table 2 outlines industry performance over the last four

years. It should be noted that there is a degree of double-counting of data such as gross claims in this table as the figures include data for both insurers and reinsurers.

Table 2: Industry financial performance

	(\$million)			
	30 June 2009	30 June 2010	30 June 2011	30 June 2012
Gross written premium	31,823	33,216	34,320	37,456
Net written premium	24,271	25,444		
Gross earned premium			34,288	36,947
Net earned premium			25,867	27,792
Gross incurred claims (current and prior years)	23,699	23,624	35,938	27,931
Non-reinsurance recoveries revenue (current and prior years)	1,879	2,307	2,438	2,409
Reinsurance recoveries revenue (current and prior years)	5,175	4,990	15,790	5,833
Net insurance claims (current and prior years) of which:	16,644	16,329	17,708	19,689
Current period net claims expense			19,008	19,410
Non-recurring items that are part of net claims			-1,299	274
Acquisition costs (prospective)	4,020	4,384		
Acquisition costs (excluding LAT)			2,011	2,183

Table 2: Industry financial performance (continued)

	(\$million)			
	30 June 2009	30 June 2010	30 June 2011	30 June 2012
Results of liability adequacy tests			17	59
Commission expense			3,018	3,317
Other underwriting expenses**	2,366	2,199	1,972	2,004
Total underwriting expenses	6,385	6,584	7,016	7,564
Underwriting result	118	2,570	1,141	540
Investment income	4,319	4,854		
Net investment income on assets backing insurance liabilities			2,368	3,440
Insurance result			3,509	3,980
Investment income on shareholders' funds			2,290	1,967
Other operating expenses	2,139	2,053	1,737	1,742
Other items	321	-672	-138	-507
Net profit/loss after tax	2,617	4,699	3,923	3,698
Average net assets (\$m)	27,360	29,530	29,818	30,304
Return on assets	10%	16%	13%	12%

* Figures from September 2010 are reported on AASB 1023 basis. Prior figures are based on a prospective reporting framework.

** Including levies and charges, and net of commission revenue

Source: Quarterly General Insurance Performance Statistics publication

The industry's gross earned premium increased eight per cent to \$36.9 billion in the year ended June 2012. The primary driver was an increase in the property classes of business with gross earned premium in the householders' class of business increasing by 13 per cent and in the fire

and industrial special risks (ISR) class increasing by 14 per cent. This was largely attributable to premium rate increases as insurers responded to the increases in the cost of property reinsurance following the 2010/11 natural catastrophe events.

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In the long-tail classes of business, growth in industry gross earned premium continued to be subdued. This was particularly the case in the professional indemnity and public and product liability classes of business.

The industry's gross incurred claims (current and prior years) fell over 2011/12 from \$35.9 billion⁴ to \$27.9 billion. Much of the change was due to the reduced gross claims arising from the lower incidence and impact of natural catastrophes in the year.

A factor negatively impacting on the industry's gross incurred claims in 2011/12 was an increase in the value of long-tail insurance liability provisions, following falls in the interest rates used to value these provisions.

Many insurers match the duration of their assets and liabilities in order to minimise the impact of interest rate movements on their operating results. Thus, while the decline in interest rates increases the value of insurers' long-tail insurance liability provisions, it also increases the value of their fixed-income investments. This matching is nevertheless imperfect. Furthermore, insurers typically hold a range of fixed-income securities, not only

Commonwealth Government Securities. Hence the widening of spreads over risk-free yields can cause mark-to-market losses on the fixed-income corporate bonds held by insurers.

Insurers' estimates of their future claims costs are reflected in their insurance liability provisions. These estimates are regularly reviewed as an insurer's claims experience develops and the assumptions underpinning the valuation of reserves are revised. These reviews can result in an insurer's reserves being strengthened, which will increase the insurer's gross incurred claims costs, or being released, which will reduce these costs.

The industry's property catastrophe reinsurance arrangements played an important role in its ability to maintain financial strength following the natural catastrophe events in 2010/11.

⁴ Claims costs from the Christchurch earthquakes are only included in this figure when the APRA-authorized (level 1) insurers and reinsurers underwrite or reinsure New Zealand risks. A number of the larger insurance groups have separately licensed New Zealand insurers and in these cases the claims costs are not captured in the aggregate level 1 industry figures.

Prior accident year reserve releases, particularly from the long-tail classes, continued to make a significant contribution to the operating results of some insurers. A key driver of reserve releases in recent years has been insurers' favourable claims experience following tort law reform, which impacted on the compulsory third party (CTP) and other liability classes. Looking forward, prior accident year reserve releases could still provide some support to insurers' profitability but the extent of this is likely to be less than in recent years.

Key risks

The industry's property catastrophe reinsurance arrangements played an important role in its ability to maintain financial strength following the natural catastrophe events in 2010/11. Given the fundamental importance of reinsurance, APRA has focused on three key related areas – reinsurance placement risk, reinsurance counterparty risk and the risk of inadequate governance and risk management practices being used in an insurer's catastrophe modelling processes.

APRA has also considered, from an industry-wide perspective, pricing risk and the adequacy of the reserves insurers hold to meet their insurance liabilities.

Reinsurance placement

APRA has examined the impacts on property insurers of the hardening property reinsurance market which followed the natural catastrophe events of 2010/11. This work involved targeted reviews of the reinsurance documentation lodged by insurers with APRA along with the relevant section of their business plans, capital management plans and Financial Condition Reports. Key areas of focus for the reviews were changes to the insurer's catastrophe reinsurance arrangements and capital triggers and the robustness of insurer stress testing, especially for natural catastrophe events.

The review found the sophistication of stress testing varied markedly across the selected insurers and all insurers had room for improvement.

Some of the insurers reviewed conduct stress tests simulating the impact of multiple catastrophe events on their solvency. These insurers are better placed to assess the potential response of their reinsurance programs to a sequence of catastrophe events. This type of stress testing is less relevant for insurers with significant reinsurance protection from global parents in a group reinsurance program, particularly where this protection is unlayered or has unlimited reinstatements. In these cases, it is more relevant for APRA-authorized insurers to consider the ability of the group to withstand a series of catastrophe events.

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More of a concern for local subsidiaries or branches of global insurance groups is the impact of multiple retentions on the lower capital base often held, particularly for branch insurers and those insurers that repatriate capital back to the parent at regular intervals.

APRA's revised capital requirements specifically target the risk of multiple significant natural catastrophe events in a single year. More generally, APRA's new ICAAP requirements should raise the robustness of risk management in relation to reinsurance and capital management.

APRA's supervision teams will monitor the extent to which stress testing has improved in light of the experience of recent years.

A number of recommendations for improving the quality of an insurer's Reinsurance Arrangements Statements (RAS) documentation have been also been identified. These recommendations involve changes that are intended to enhance the usefulness of this documentation for Boards, senior management and APRA. The recommendations include the following:

- insurers should ensure there are no gaps or inconsistencies between the RAS and their actual reinsurance documentation;

- the RAS should include commentary on key changes from the prior year. These changes can include changes in reinsurance structure, premium, coverage and counterparties;
- the RAS should be actively utilised by the insurer to inform the Board and senior management of such changes; and
- the RAS should include details on the catastrophe models used in calculating the insurer's probable maximum loss, any adjustments applied to the catastrophe model output and the reasons for these adjustments.

Strong governance and risk management practices are important controls in the catastrophe modelling process and in the use of model output produced by both internal and proprietary models.

Reinsurance counterparty exposure

Actual and potential counterparty risk to reinsurers is a key industry risk. APRA undertook a 'one-off' data collection in early 2011 to assess whether the failure or a material rating downgrade of a major reinsurer was a material risk for the industry. This collection confirmed that the industry is well diversified in terms of reinsurance counterparties from a geographical standpoint and across APRA-authorized and non-APRA-authorized reinsurers. Furthermore, most reinsurance counterparties were highly rated.

This 'one-off' collection was a valuable exercise. For this reason, APRA intends to develop a regular data collection on reinsurance counterparty exposure and will consult further with industry on this in 2013.

Catastrophe modelling processes

Catastrophe models are a key resource used by insurers in determining appropriate reinsurance arrangements.

Strong governance and risk management practices are important controls in the catastrophe modelling process and in the use of model output produced by both internal and proprietary models. Poor practices in this area can result in inappropriate levels of reinsurance protection,

which naturally can have significant impacts on insurer profitability and realised risk appetite as well as leading to inappropriate pricing and inadequate capital targets.

APRA is concerned that, in some cases, boards and senior management may rely too heavily on catastrophe modelling output when setting the insurer's catastrophe reinsurance cover, without sufficient challenge and debate taking place. In particular, Boards and senior management need to recognise the limitations of the models used and the uncertainty in model results when designing their reinsurance arrangements.

APRA is currently assessing the catastrophe modelling governance practices of a number of insurers to understand the range of industry practice. At a minimum, these findings will inform APRA's supervisory approach to this issue across the industry.

Pricing processes

Reviews of insurer pricing processes and controls form a key part of APRA's supervision of the general insurance industry. APRA sees heightened pricing risk in various areas.

GENERAL INSURANCE INDUSTRY OVERVIEW

The challenges involved in pricing riverine flood risk are significant and, arguably, more pronounced for small and medium sized insurers that may be offering riverine flood insurance for the first time. To effectively price this risk, insurers need to be able to measure their exposures to riverine flood risk and the damage the risk can cause. The larger personal lines insurers have made considerable investment in developing their own flood pricing models and, in doing so, have drawn upon an extensive amount of proprietary claims data and experience.

In response to the NDIR panel's report, the Government expressed support for better coordination of flood risk information and improved public availability of this information. It has charged Geoscience Australia with responsibility for implementing a central national access point containing all existing flood risk information. This resource may benefit insurers as an input in flood risk assessment and flood pricing.

APRA continues to monitor the development of price comparison platforms (or 'aggregators') in the general insurance market. These platforms are most prominent in the personal lines market (e.g. motor insurance). Aggregators highlight to consumers the lowest premium being offered for

their particular risk characteristics. The influence of aggregators can lead to increased customer-switching behaviour and apply pressure on insurer profitability. While strong competition continues to be a feature of the domestic motor insurance market, aggregators have not had a material impact on this segment to date since larger insurers have been unwilling to participate. Likewise, it is too early to assess the impact of commercial lines aggregators on the broader commercial insurance market. Nevertheless, it remains important in this environment for insurers to maintain sound pricing and underwriting practices.

A sustained low interest rate environment is likely to cause upward pressure on premiums, particularly in the long-tail classes of business. However, strong competition and subdued demand in some of these classes may hinder an insurer's willingness or ability to seek premium rate increases, potentially leading to new business of poor profitability.

APRA's reviews of pricing processes and controls suggest that there is room for improvement in the development of technical prices and in the monitoring of prices achieved compared to those technical prices.

Adequacy of reserving

The strength of the reserves that insurers hold to meet their insurance liabilities plays a fundamental role in the industry's financial stability. Inadequate reserving can expose insurers to large losses should their claims experience deteriorate.

As noted earlier in this article, the conditions impacting on insurers' operating results are clearly mixed. Insurers' underwriting results in the short-tail classes are improving due to increases in property insurance premiums, moderating reinsurance cost pressures and lower natural catastrophe claims costs. However, there are still threats to profitability, particularly in the long-tail classes where an environment of low interest rates poses challenges.

The strength of the reserves that insurers hold to meet their insurance liabilities plays a fundamental role in the industry's financial stability.

APRA is concerned that current industry challenges may increase the risk that releases from reserves will be used to support short-term profitability, when (as referred to earlier) the recent drivers for such reserve releases are likely to become less influential.

APRA is undertaking an internal review of the relative reserving strength of a number of insurers. The focus of this review is on the underlying reserving assumptions and methodologies these insurers are applying in key classes of business. APRA will be assessing whether any of the insurers are unreasonably taking a significantly more aggressive reserving approach relative to the selected peer group.

LIFE INSURANCE INDUSTRY OVERVIEW

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This article provides an overview of the life insurance industry
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(including friendly societies) together with a discussion of the key
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prudential risks that face the industry.
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Introduction

Over the last couple of decades, there has been a significant contraction in the number of life insurers and friendly societies servicing the Australian life insurance market. This has come about through a combination of ongoing mergers and acquisitions and the steady withdrawal of foreign insurers from the local market. During this period, the industry has also witnessed a steady but significant decline in its share of the broader wealth management sector. For life insurers, only risk premium revenue has continued to provide growth opportunities over this period. For friendly societies, growth has mostly arisen from funeral fund business.

While the industry profile continues to evolve, the institutions within it find themselves operating in an economic and regulatory environment that is increasingly competitive, dynamic and unpredictable and more interconnected than probably any time in the past. It therefore follows that industry participants and APRA must be particularly adept at understanding and managing the risks that face the industry.

LIFE INSURANCE INDUSTRY OVERVIEW

Capital, superannuation and advice reforms, as well as other international regulatory changes, are expected to occupy the minds of boards and management of life insurers and friendly societies throughout 2012/13. The strategic, operational and compliance issues that flow from these reforms as well as the impacts on their business and distribution models will be significant. While the industry is better prepared to manage investment market disruption than it was in 2008/09, capital adequacy in the face of future asset valuation shocks will remain a key risk and an area of focus for APRA for the foreseeable future.

Furthermore, life insurers and friendly societies will need to keep their strategies, business models, pricing and reserving bases under review to ensure they remain appropriate in the face of current uncertainties about global growth prospects and accompanying investment market volatility.

Other areas where APRA has specific concerns are:

- data management, worsening claims experience, and group life pricing standards; and
- governance practices underpinning the rapid growth in directly marketed risk products.

Overview of the industry**Consolidation and market concentration**

As at 30 June 2012, there were 28 life insurance companies in Australia. There is a mix of large life insurers selling a diversified range of products, a small number of mid-sized risk or investment specialists, a handful of small underwriters servicing specialist or captive markets, and seven reinsurers¹. Four of the largest life insurers are owned by the major banks² while the listed financial services group AMP currently retains two licences (AMP Life and National Mutual Life Association (NMLA)).

At that same date, there were 13 friendly societies, most having a small asset base. In aggregate, they represent only a small share of the whole life insurance industry. They primarily offer investment, education and funeral bond products.

The formal conclusion to AMP's acquisition of NMLA in early 2011 was the latest instance in a period of over 20 years of sustained merger and acquisition activity of life insurance and friendly society licences. The rationalisation of multiple licences that were acquired from earlier

¹ One life insurer and one reinsurer are inactive.

² CBA owns CMLA (branded as Comminsure), NAB owns MLC, Westpac owns Westpac Life and ANZ owns Onepath.

Table 1: Life insurer and friendly society licences (30 June)

	1992	2002	2012
Direct writers	55*	36	21
Reinsurers	6	6	7
All life insurers	61	42	28
Friendly societies	109	39	13
Total	170	81	41

Source: June 2012 *Life Insurance Quarterly Performance Publication* and APRA *Annual Reports*

* Includes five state government-owned offices.

activity continues, while transfers and changes of ownership of the smaller entities also occur from time to time. Apart from the entry of an international reinsurer into the Australian life insurance market in 2011, there has only been one new life insurer licensed since 1990³. The rapidly declining trend in number of life insurance and friendly society licences over the last 20 years is shown in Table 1.

APRA's primary concern with merger and acquisition activity is that it exposes the entities concerned to new risks as they manage their way through the changes to their business. Entities must put in place complex and lengthy projects to address the transition and rationalisation of products and systems as well as managing communications and training for management and staff. Policyholders need to be informed or consulted when decisions affect them, while the market and regulators also need to be kept regularly informed.

³ For a comprehensive review of the changes to the life company landscape since 1990, refer to the article 'Life insurance industry consolidation' published in APRA *Insight*, Issue 1, 2011.

LIFE INSURANCE INDUSTRY OVERVIEW

In terms of assets, the top five financial services groups holding life insurance licences represent about 88 per cent of the life insurance industry. The five largest friendly societies account for 81 per cent of total friendly society assets. That said, at least on very broad measures, there does not appear to be unusual concentration relative to other Australian financial service industries. On the other hand, compared to the European market and especially the United Kingdom, Australia does appear to have a relatively concentrated market.

Asset growth

Life insurers (excluding friendly societies) and reinsurers accounted for approximately \$233 billion of assets at end June 2012. After a 16 per cent decline of total statutory fund assets during 2008 from around \$250 billion to \$210 billion, the life insurance industry has struggled, in terms of both premium income and assets under management, to re-emerge as a growth industry (see Table 2). For many years, even prior to the global financial crisis, net cash flows had been negative. Growth in assets, when it has occurred, has been derived almost entirely from investment earnings.

Friendly societies accounted for another \$6.1 billion of assets at end June 2012, which is less than three per cent of combined life and friendly society industry assets. The two largest societies together account for about one half of friendly society industry assets. Most friendly societies have less than \$500 million in assets and a few of these less than \$100 million. Friendly society assets are roughly evenly divided between investment-linked and non-investment-linked business.

Friendly society policy payments exceeded premium income by \$0.13 billion in 2011/12. This compares with net policy outflows of \$0.17 billion in 2010/11 and \$0.14 billion in 2009/10.

*...the life insurance industry has
struggled...to re-emerge as a
growth industry...*

Table 2: Life insurer statutory fund cash flows (12 months ending June)

	2009 \$b	2010 \$b	2011 \$b	2012 \$b
Premium income	40.6	39.5	42.7	41.4
Policy payments	-38.5	-37.7	-41.2	-41.7
Net policy cash flow	2.2	1.8	1.6	-0.3
Operating expenses	-6.1	-6.8	-6.7	-6.9
Net cash flow	-3.9	-5.0	-5.1	-7.2
Investment income	-21.8	21.7	18.3	6.5
Asset growth	-25.6	16.7	13.2	-0.7
Other movements ⁴	2.2	-3.4	-5.8	3.2
Net asset growth	-23.4	13.4	7.4	2.5
Total assets (eoy)	209.8	223.2	230.6	233.1

Source: June 2012 *Life Insurance Quarterly Performance Publication*

*Rounding may cause differences in totals.

4 Net capital transfers, dividends and tax payments.

Product trends and developments

Investment-linked business

Investment-linked annual premium revenue has declined over the last three years. This is consistent with the life insurance industry's reducing market share of aggregate superannuation assets. Most financial services groups for many years have preferred to write their wealth management business through entities other than a life insurer.

Aggregate superannuation assets have been growing at almost 12 per cent per annum on average over the last 20 years while life insurer superannuation assets have been growing at only about 6 per cent per annum. The result has been that, from a peak of 44 per cent of superannuation assets 20 years ago, the life insurers' share reduced

to 14.8 per cent by June 2012. In contrast, over the same period, the superannuation assets of the life insurance industry have come to dominate their total assets under management. They now represent a little over 90 per cent of statutory fund assets from a level of 65 per cent over 20 years ago.⁵

APRA sees no competitive or strategic reasons why this downward trend in market share might reverse. This is because Australia's superannuation wealth base is increasingly represented by either retirees who seek to manage their affairs through self-managed superannuation funds (SMSFs), or funds that do not invest via a life policy (except to provide insurance cover).⁶

Table 3 shows a break-up of the life insurer premium revenue (excluding friendly societies) for the four year period up to end June 2012 according to major product groupings.

5 This subject was discussed in 'Life insurance industry consolidation' published in *APRA Insight*, Issue 1, 2011, p10.

6 For a comprehensive review of superannuation trends, refer to the article 'Superannuation Industry Review' published in *APRA Insight*, Issue 1, 2012.

Table 3: Life insurance net premium revenue by product group (12 months ending June)

	2009 \$b	2010 \$b	2011 \$b	2012 \$b
Investment-linked ⁷	28.7	27.5	30.0	26.2
Other non-investment-linked investment ⁸	7.2	5.8	5.9	8.5
Traditional whole life/ endowment	0.4	0.4	0.3	0.3
Total investment	36.3	33.7	36.2	35.0
Death/TPD lump sum	3.8	4.3	4.8	5.1
Disability Income	1.0	1.4	1.6	1.7
Individual Risk	4.9	5.7	6.4	6.9
Death/TPD lump sum	2.3	2.3	2.5	2.9
Disability Income	0.5	0.5	0.6	0.7
Group Risk	2.8	2.9	3.1	3.6
Total insurance risk⁹	7.6	8.6	9.4	10.5
Total net premium revenue	43.9	42.2	45.7	45.5
Growth rates pa				
<i>Investment-linked</i>		-4%	9%	-13%
<i>Total investment</i>		-7%	8%	-3%
<i>Individual risk</i>		18%	12%	8%
<i>Group risk</i>		4%	6%	18%
Total insurance risk		13%	10%	11%

Source: APRA Statistics

7 Includes both pre-retirement superannuation accumulation savings as well as post-retirement allocated pension and deferred annuity balances.

8 Includes investment account business and annuity business.

9 Insurance premium revenue is net of reinsurance as APRA does not collect gross premium revenue by product group. Nonetheless, as most reinsurance occurs locally and reinsurers are themselves APRA-regulated life companies, the figures shown should be broadly equivalent to industry gross direct premium revenue by product group.

LIFE INSURANCE INDUSTRY OVERVIEW**Annuities**

The certainty and low investment risk of income of annuities suggest they would be appropriate investments for the many retirees with modest risk appetites. However, general investor resistance to annuities has remained very high for a variety of reasons associated with tax and social security rules, and an inability to access capital (lifetime annuities). The current market environment of low interest rates leads to low annuity rates that may also be a material deterrent to some investors, particularly for long term or lifetime annuities. Nonetheless, annuity sales (included in 'Other non-investment-linked' business in Table 3) have been growing in recent times, albeit off a low base following a collapse of sales at the height of the global financial crisis in 2008/09. Since then, investors have shown renewed interest in annuities with sales continuing to strengthen through 2011/12. Fixed short term annuities, some versions of which are similar in nature to term deposits, continue to be much preferred over lifetime annuities.

The life industry itself has demonstrated some general reluctance to provide annuity products with longevity and long-term investment guarantees attached. The reasons pertain to pricing risks and capital requirements. Even so, some companies continue to seek to develop products that are attractive to consumers while satisfactorily addressing these issues.

Insurance risk business

Life insurance risk business remains one of the few market segments to record growth during 2011/12, albeit at a slightly subdued aggregate level compared to previous years.¹⁰

It is important to note, though, that most life insurers have products that automatically generate premium increases up to eight per cent or more per annum as a result of indexation and premium rates increasing with age. Any premium rate increases resulting from a worsening claims experience also contribute to increases in premium revenues. All these factors cloud any assessment of the extent to which the observed growth in premiums can be attributed to persons voluntarily increasing their life insurance or taking out life insurance for the first time.

Group business premium revenue growth in 2011/12 was substantially up on the previous 12 months while individual business premium growth was significantly down. The growth in group business premiums is continuing despite a recent market report that suggested group insurance prices for re-tenders had fallen a further five per cent during 2010/11¹¹. Some of the increase in revenue may be due to increases in levels of cover arising from benefit redesigns when re-tendering.

10 Friendly societies underwrite negligible amounts of individual risk insurance business and no group insurance business.

11 Rice Warner's 2011 *Wholesale Insurance Market Report* published August 2011.

Key, systemic drivers of group risk premium growth are the increasingly easy access to higher default levels of insurance cover via superannuation and the extension of salary continuance benefits to more superannuation funds.

It could be that some potential individual sales have been replaced by group insurance sales through superannuation that is simpler and cheaper to obtain, particularly as schemes offer greater amounts of cover without underwriting. These days, high net-worth individuals who receive regular advice are likely to be the main source of individual business, with directly marketed business becoming more significant.

Key, systemic drivers of group risk premium growth are the increasingly easy access to higher default levels of insurance cover via superannuation and the extension of salary continuance benefits to more superannuation funds.

Friendly societies

Specialisation is a prominent characteristic of friendly societies: one society accounts for the bulk of education products on the market while another accounts for a significant proportion of prepaid funeral bond premiums.

For many years, the friendly society industry has attempted to reinvigorate itself by seeking to develop new products but so far generally without material success. That said, certain friendly societies offering funeral bonds and/or short term investment-linked products have experienced some growth.

LIFE INSURANCE INDUSTRY OVERVIEW

Financial trends

Capital

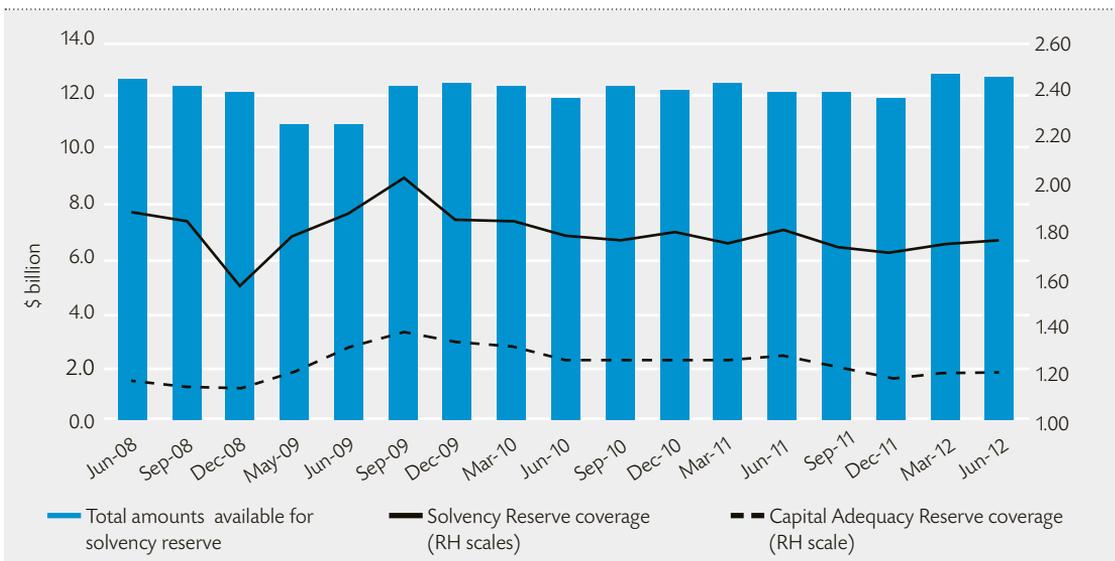
Life insurers

Figure 1 shows the life insurance industry coverage ratios – the ratio of assets in excess of base policy liabilities to solvency or capital adequacy reserves, respectively – for non-investment-linked statutory funds. This business incurs more capital strain in adverse investment markets than does investment-linked business.

The life insurance industry coverage ratios for non-investment-linked business have been relatively stable at around 1.4 for capital adequacy and 1.8 for solvency. These levels are broadly consistent with ratios prior to the global financial crisis.

For investment-linked business, the coverage ratios are of lesser relevance to assessing financial strength since policyholders retain all investment risk. General (i.e. shareholder or management) funds tend to either hold non-life insurance

Figure 1: Financial strength – coverage ratios (non-investment linked)



Source: June 2012 Life Insurance Quarterly Performance Publication

business or are repositories of additional surplus and so coverage tends to be very idiosyncratic. It is important to note that there is no single 'right' coverage ratio. In practice, APRA focuses more on understanding the strength of capital management policies of individual insurers and friendly societies and how effectively they manage their capital resources in accordance with those policies.

Friendly societies

Over the period 2009-12, there has been considerable variation in the amounts available for friendly society capital reserves, and consequently coverage ratios for capital adequacy and solvency have also been variable. In addition, the prudential capital coverage for management funds in aggregate has, for the main part, been maintained at between 2 to 2.5 times for the last three years.

Revised capital standards

Over the last three years, APRA has undertaken a major review of minimum capital requirements under its life and general insurance capital review project. The new standards come into effect on 1 January 2013.

The possible impact of the revised capital standards on coverage ratios has been analysed using data collected in a Quantitative Impact Study (QIS) during 2011. The range of outcomes across entities is quite large, as one might expect from new capital requirements that are more risk sensitive, particularly given the diversity of business profiles. Broadly speaking, many entities are only marginally impacted while a smaller number have incurred material impacts. Transitional arrangements and capital management actions by insurers are likely to mitigate the overall impact of these reforms.

Margins and profitability

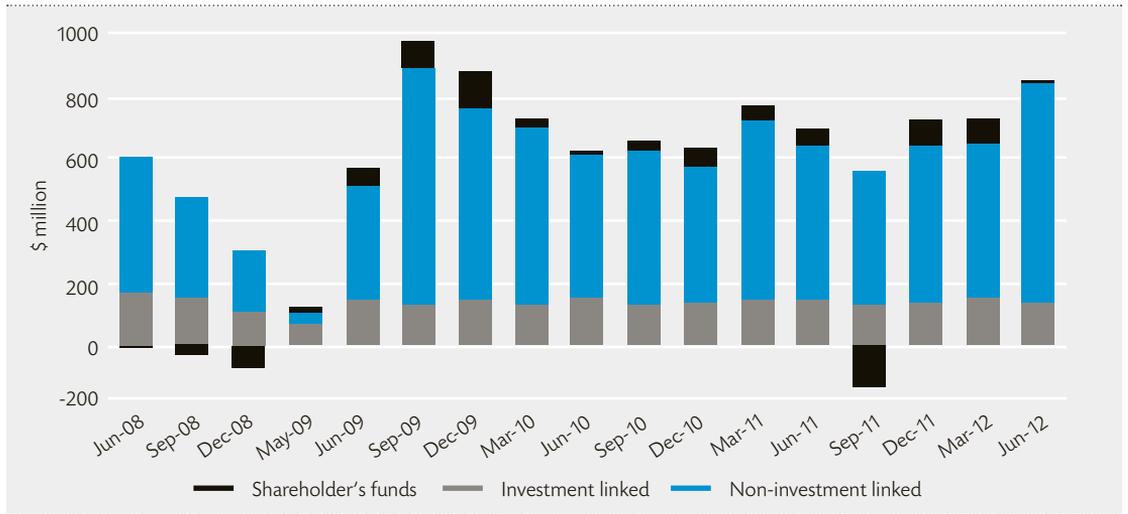
Figure 2 shows life insurance industry shareholder profitability by quarter in the 2008-12 period, which reflects the investment market turmoil over that time. Investment gains/losses on assets backing non-investment-linked business is the most significant contributor to life insurer profit volatility, although variations in claims experience profits is also an important contributor.

Investment gains/losses on assets backing non-investment linked business is the most significant contributor to life insurer profit volatility...

Friendly societies incurred an overall loss in 2008/09 due primarily to the impact of the global financial crisis on investment-linked business. However, as shown in Figure 3, there was a return to profitability in the last three financial years, albeit at a reduced level in 2011/12. The level of profitability in the friendly society industry can be volatile, particularly for investment-linked business, due to fee revenue that is driven directly by the total value of fund investments.

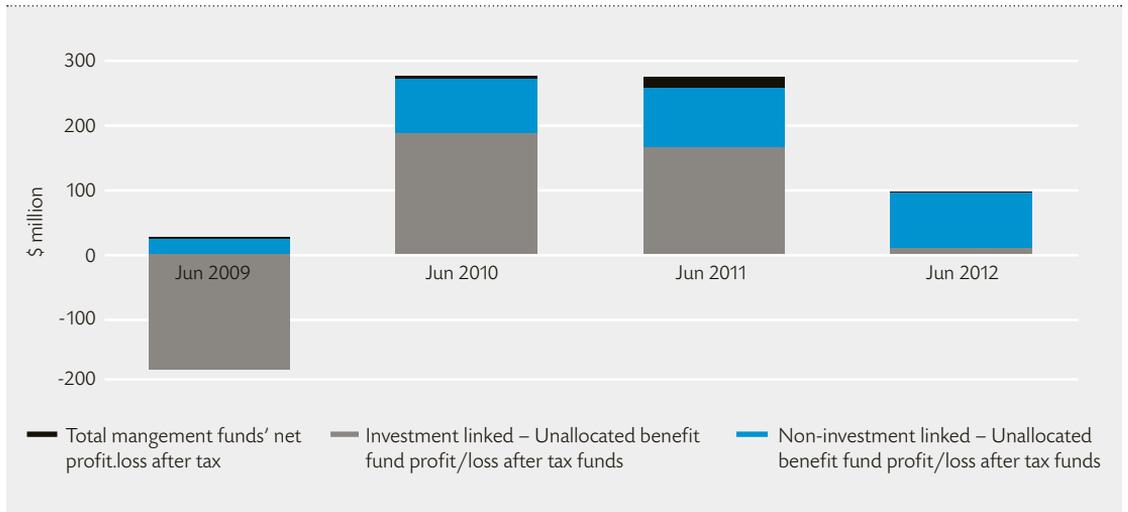
Looking ahead, market statistics for the wealth management industry show that there is clearly a shift to cash and fixed-interest investments that could lead to lower asset growth and downstream impacts on revenue, although the impact for individual companies would vary depending on their mix of business and business model.

Figure 2: Statutory fund net profit (all total business)



Source: June 2012 *Life Insurance Quarterly Performance Publication*

Figure 3: Friendly societies - Net profit (all business)



Source: June 2009 - 2011 *Annual Friendly Society Bulletin* (revised in October 2012)

LIFE INSURANCE INDUSTRY OVERVIEW

Profit by product group

Figure 4 illustrates changes in life insurer profits by product group, for financial years 2010-12. It shows that, while investment business was the dominant source of premium income, around 50-60 per cent of life insurer product profits were generated by risk insurance business (individual and group insurance). In contrast, investment-linked business, long a mainstay of life insurers, contributed only around 20-25 per cent of total industry product profits. Nonetheless, since investment-linked business requires relatively little prudential capital, its return on capital has been attractive.

While group insurance business has accounted for a steady one third of total risk insurance premiums (including individual insurance) in recent years, it has been delivering a rapidly declining share of total risk insurance profits – from over 20 per cent in 2009/10 to about 10 per cent in 2011/12. This may be partly a reflection of downward pressure on margins and a worsening of claims experience in group insurance business. The decline highlights the importance of economies of scale for group business through acquiring and retaining a large pool of diversified group policies to ensure it is a sufficiently robust and profitable business line.

Operating expenses

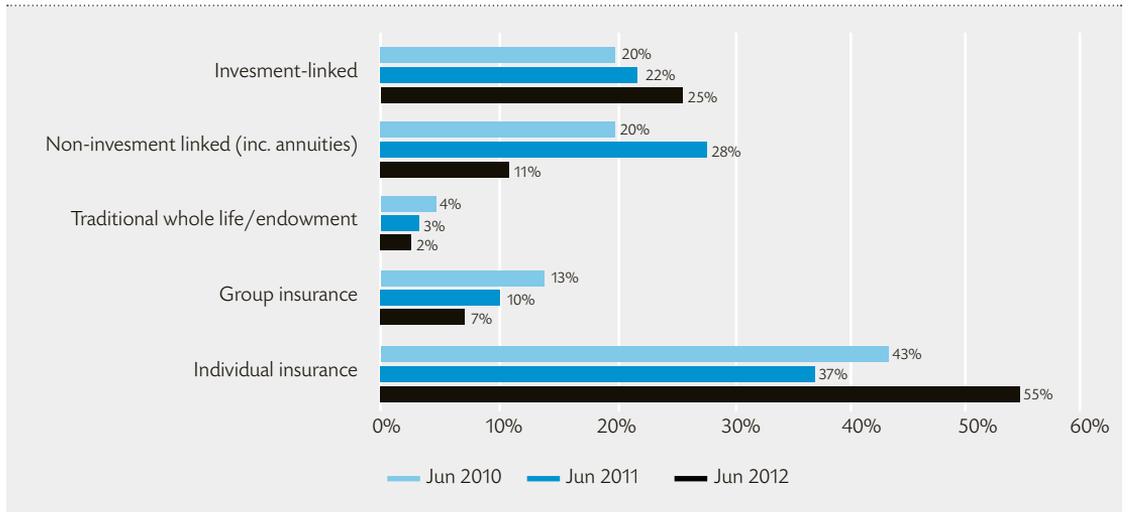
Figure 5 shows trends in aggregate operating expenses of life insurers. Further analysis suggests that most of the increase in commission shown in Figure 5 derives from new or increased business as distinct from renewal commissions.

A large part of 'Non-commission expenses' relates to staff remuneration and IT costs. It is difficult to draw any meaningful conclusions about trends in such expenses due to significant differences across the industry in strategy, scale, growth rates, business mix and maturity. What can be said though is that legacy business and systems, for some parts of the industry, will continue to dampen attempts to improve overall operational efficiency and effectiveness.

Insurance risk management

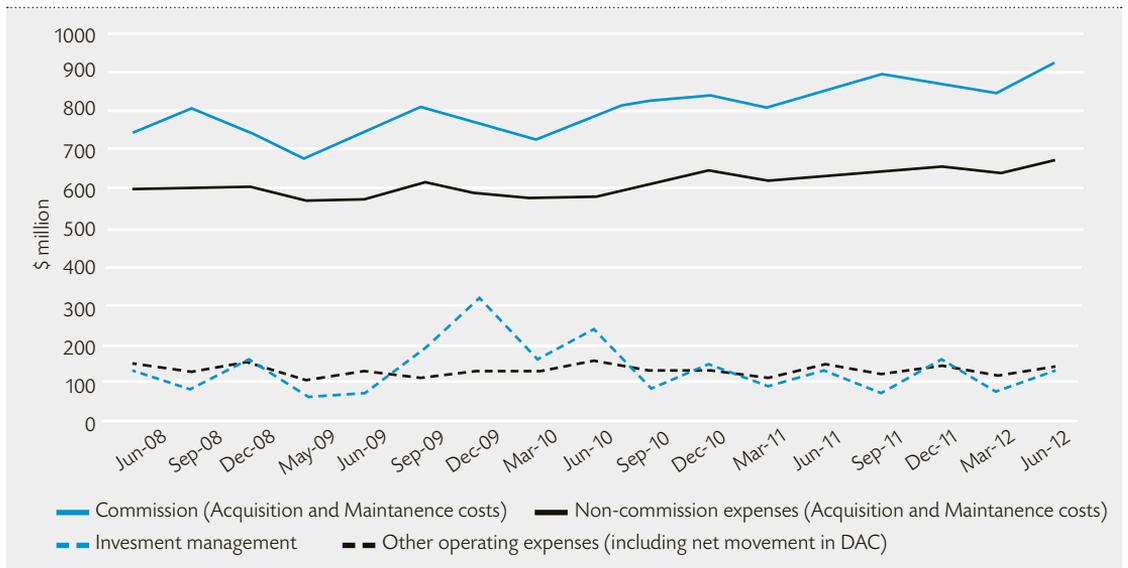
The underwriting of insurance applications and the assessment and management of claims are core skills of insurance companies. APRA is keen to ensure that life insurers maintain and apply these skills with the utmost diligence, care and foresight.

Figure 4: Life insurers – Net profit mix by product group



Source: APRA Statistics

Figure 5: Life Insurers - Operating expenses (by type)



Source: June 2012 Life Insurance Quarterly Performance Publication

LIFE INSURANCE INDUSTRY OVERVIEW**Underwriting and claims management**

For some parts of the industry, insurance risk profit margins are under considerable pressure, particularly for disability income benefits (both individual and group products). This partially reflects widening policy benefits, the changing mix of business from underwritten to guaranteed acceptance (especially for group insurance business) and possibly the softening of underwriting practices.

In the last few years, life insurers have made significant changes to their non-medical underwriting limits, both in individual and group insurance. At the same time, benefits have been broadened with little evidence that premium rates have been adjusted to compensate. Disability benefits payable to age 65 (and even age 70) have become a common benefit feature. Reduced profitability may be attributed to claims management, including approaches such as a lack of early intervention at the beginning of the claim period or an excessive focus on claims incidence rather than claims termination.

The industry's general lack of ability to analyse claims experience by level of underwriting means that reasons for profitability trends are difficult to identify. APRA is encouraging the industry to improve investigations, data quality and data volumes to help identify causes and trends.

Good underwriting and claims management skills have been in short supply for a number of years now and come at a high cost relative to other skilled persons. Shortages in income protection (IP) or group salary continuance (GSC) claims management skills are a growing concern as IP and GSC claims numbers are increasing sharply. Some life insurers are trying to address these skills shortages through increased use of technology (such as automatic underwriting systems) but there are limitations as to how far this can be driven. Such solutions also come with their own risks and the need for different skill sets to maintain and develop. At least one reinsurer has been placing some of its own claims management staff in the offices of insurers to fill the gaps or address concerns, some on a full-time basis for several months.

Developments and trends in underwriting practices in overseas jurisdictions also need to be monitored closely because they inevitably find their way into Australia.

Reduced profitability may be attributed to claims management, including approaches such as a lack of early intervention at the beginning of the claim period or an excessive focus on claims incidence rather than claims termination.

Reinsurance

In 2007, the proportion of industry direct risk insurance premium ceded to local reinsurers was 28 per cent¹². By 2012 this proportion had fallen to about 18 per cent while premium volumes concurrently increased. Life insurers have recaptured some of the risk and have reduced their dependency on reinsurance. This trend is consistent with the move towards larger entities with greater diversification and capacity to bear insurance risk. Nonetheless, reinsurance remains an essential tool of life insurers in managing their insurance risk and capital.

Some local subsidiaries of overseas reinsurers are dependent upon the financial support of their parent through reinsurance arrangements and supply of capital. The well publicised stresses in some overseas jurisdictions means that there is a risk of a diminution in the creditworthiness of some overseas domiciled entities. APRA is monitoring this situation closely and, at this point, considers this particular risk to be low.

¹² Australian life insurers, with some minor exceptions, reinsure with the local subsidiaries of international reinsurers.

Key risks and issues

Capital monitoring and stress testing

Significant falls in investment markets could stress the capital position of some life insurers and friendly societies, as has occurred in the past, particularly those institutions considered to have higher capital sensitivity to investment market movements. This need not just be due to falls in share markets but also to significant changes in yields, widening spreads or falling property values. Further, lower government bond rates also impact on those companies with long term guaranteed liabilities, due to their exposure to reinvestment risk.

Life insurers and friendly societies generally responded to the global financial crisis by de-risking asset portfolios, obtaining capital injections and/or enhancing their internal monitoring processes. A return to increased investment market weakness and uncertainty during 2011 resulted in closer oversight by APRA, which has continued to the present time.

The ongoing possibility of investment markets retracting or declining sharply means that life insurer and friendly society boards and management must maintain vigilance over their target surplus positions and their capital management policies. While the capital position of the industry is quite robust, APRA will continue to maintain close supervisory oversight. Stress tests are being progressively incorporated into the financial condition reports (FCR) of appointed actuaries and these will be reviewed by APRA to identify any area of weakness or sensitivity in the capital position or surplus policy. APRA has incorporated the requirement for stress testing in the Internal Capital Adequacy Assessment Process (ICAAP) that is required under revised life and general insurance capital standards that come into effect on 1 January 2013.

Group risk insurance

A large proportion of the group risk premium pool is derived from a few large industry funds and master trust insurance schemes that have the potential to be tendered in the market every three years. Concentration risk arises for the smaller insurers where a single scheme can account for a large proportion of total revenue. Small insurers may face capital constraints while reinsurance capacity can be a challenge to ensure counterparty risk limits are not exceeded. Skill shortages in GSC claims management is a growing concern, as previously mentioned.

The life industry is coming under increased pressure to outsource a number of functions to superannuation fund administrators. Further, there are competitive pressures to overhaul systems and customer interfaces in order to be able to offer state-of-the-art underwriting, claims and administration services. Both these trends have high associated operational risk, either in the changeover phase or in day-to-day processes.

APRA has concerns about the sustainability of pricing for large group risk schemes given the substantial reductions in premiums and generous profit sharing arrangements that have been offered recently as part of tenders for this business. Limited data (particularly for new benefits) along with unreliability of data for pricing purposes reduce the margin for error for life insurers. Unsustainable pricing leads to losses and erosion of capital.

Increasing intensity of competition in the group risk pricing space can make informed and thoughtful decision making harder. APRA has been reviewing actuarial advice regarding product development and reinsurance arrangements. While APRA has observed improvement in this area in more recent times, the quality of actuarial advice will continue to be a supervisory focus.

LIFE INSURANCE INDUSTRY OVERVIEW

APRA will continue to maintain and monitor a register of the larger schemes that are won (including those retained) or lost and regular discussions will be held with life insurers and reinsurers involved. Discussions have also been extended to the superannuation industry, noting that most business is in respect of insurance provided through superannuation funds. APRA's concerns regarding group schemes will be escalated to relevant industry forums and associations where appropriate.

APRA has released draft prudential guidance to support the new superannuation prudential standard for insurance and is developing a prudential practice guide for insurers on data management and tenders for group life insurance.

Changes to business environment

Insurers continue to face a demanding environment in the form of significant regulatory changes at the same time as challenging economic and business conditions.

Planning for implementation of APRA's revised capital standards on 1 January 2013 appears well advanced, although work on ICAAPs has continued well into December 2012. Some insurers may find that their previously estimated impacts of the capital review are incorrect. APRA is working with

insurers requiring transitional relief from the new arrangements to achieve the desired outcome in the shortest practical time. Some companies may need to turn to the market (or their parent) to raise additional capital. APRA will maintain very close contact with all insurers during the implementation phase to ensure as smooth a transition to the new standards as possible.

Relevant insurers have projects in place to deal with the Future of Financial Advice (FOFA) reforms. These reforms pose significant strategic and operational challenges for some insurers.

Stronger Super continues to be a point of focus. Many insurers report that, to the extent that statutory and regulatory requirements are not finalised, implementing system and process changes to accommodate these requirements is at high risk of not being achieved in the appropriate timetable. Readiness for MySuper applications, however, seems to be progressing well.

More recently, the implications of the planned introduction of the US anti-tax avoidance measures for non-US entities under the Foreign Account Tax Compliance Act (FATCA) is being acknowledged as a significant challenge in terms of system and process readiness.¹³

¹³ This requires possible additional reporting requirements and some withholding of taxes from US taxpayers' investment gains.

Japan's 'lost decade' is the key exhibit demonstrating the painful adjustment required to a period of low interest rates. Today, the life insurance industry's profitability in Japan appears to have been restored, with new products that better reflect perennially low interest rates making up an increasingly larger share of portfolios. Even though the types of products in Japan might have been more vulnerable to the risk of low interest rates, the potential impacts of such a scenario on their businesses, and how they might respond in order to protect policyholder (and shareholder) interests, need to be considered by Australian life insurers.

APRA is encouraging life insurers and friendly societies to consider a low interest rate scenario and address such risks in the ICAAP and capital plans.

APRA is encouraging life insurers and friendly societies to consider this scenario and address such risks in the ICAAP and capital plans required of entities under revised capital standards. APRA will also raise the risk generally in dialogue with industry bodies and relevant professional groups.

Direct channels and marketing

According to external research, Australia is now one of the leading countries for direct life insurance sales, and it is the fastest growing channel in the industry. Direct sales channels now account, on some measures, for perhaps 20 per cent or more of total individual risk insurance sales in Australia.

The rapid growth along with the high visibility of the distribution model (e.g. high levels of television advertising), the vulnerability of the target market (particularly for funeral insurance) and the nature of the products (e.g. customers may end up paying substantially more in premiums than the sum insured) means that there is the potential for significant reputational risk to suppliers of these products. Given these issues, strong governance is required to ensure that the business complies with the insurer's risk appetite.

APRA will continue to monitor the developments in this market both by reviewing pricing advice and by monitoring new product developments, including by conducting targeted insurance risk reviews of these product lines.

RECOVERY PLANNING FOR AUTHORISED DEPOSIT- TAKING INSTITUTIONS

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This article provides an overview of APRA's work to date on recovery
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planning for authorised deposit-taking institutions (ADIs). Such work
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has its origins in a new framework for systemically important financial
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financial institutions developed by the Financial Stability Board in
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conjunction with the Basel Committee on Banking Supervision. APRA
.....
expects that recovery planning will become an important part of its
.....
ongoing supervision.
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Introduction

One of the major themes to emerge from the global financial crisis was the need to ensure that financial institutions have the capacity to recover from a destabilising event or can be resolved cost-effectively if recovery is not possible. This theme has been encapsulated in the concept of a 'living will'.

There are two essential components to a living will: a 'recovery plan' and a 'resolution plan'. A recovery plan focuses on the timely actions a financial institution could undertake to enable it to survive a crisis, by outlining strategies for raising additional capital, accessing liquidity, reducing the size of the balance sheet or disposing of non-core business. Recovery plans are being prepared by financial institutions in a number of jurisdictions in accordance with guidelines or requirements set out by supervisory authorities.

A resolution plan focuses on actions that would enable a cost-effective resolution of the institution by the authorities where recovery is not possible. Although it is connected with recovery planning, resolution planning is best approached separately, given the heightened complexity and extensive additional information requirements. Resolution plans are generally developed by supervisory authorities.

RECOVERY PLANNING FOR AUTHORISED DEPOSIT-TAKING INSTITUTIONS

In recent years, work on recovery planning has commenced in the United Kingdom, other European jurisdictions, North America and Japan, as well as Australia. Some of these jurisdictions have also commenced work on resolution planning. During 2011, APRA established a pilot program for recovery planning, focused initially on the larger ADIs. These ADIs have made considerable progress with recovery planning over the past year and have now completed their initial plans.

It may seem unusual for a financial institution to undertake a planning process that essentially contemplates its mortality, rather than its success. However, such a mindset is necessary for the task of recovery planning; its very purpose is to identify the means by which an ADI could restore itself to financial soundness in the face of relatively severe losses and associated liquidity stresses. In these circumstances, an ADI would be confronted with some difficult choices because its viability as a stand-alone institution would be in serious question. In order to survive, an ADI might need to make decisions in relation to the restoration of its capital and funding position that it would not normally contemplate in a business-as-usual environment.

Systemically important financial institutions

The work undertaken by the the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision on reforms designed to minimise the risks posed by systemically important financial institutions provided context for APRA's work on recovery planning.

The FSB's material on crisis resolution – particularly the *Effective Resolution of Systemically Important Financial Institutions*¹ and the *Key Attributes of Effective Resolution Regimes for Financial Institutions*² – sets out the elements for recovery and resolution plans.

These elements call for, amongst other things, concrete and practical recovery and resolution actions that can be implemented in a timely manner. The actions also need to be relevant to the specific characteristics of the institution and based on a range of sufficiently severe stress scenarios, both idiosyncratic and market-wide. The scenarios should address both capital shortfalls and liquidity pressures.

1 www.financialstabilityboard.org/publications/r_110719.pdf - July 2011
2 www.financialstabilityboard.org/publications/r_111104cc.pdf - November 2011

In 2011, APRA established a pilot program on recovery planning for a number of the larger ADIs.

The identification of the actions needed to strengthen a financial institution's capital and liquidity positions is integral to recovery plans. In addition, institutions should:

- identify possible restructuring strategies for their business operations;
- assess possible disposal of subsidiaries and business units, together with the pre-conditions, necessary steps and associated risks with implementing such a restructuring; and
- develop an effective communication strategy with financial markets and other stakeholders to alleviate concerns about their viability.

Institutions should ensure effective preparation for these actions by indicating the concrete steps they have either implemented or will implement if necessary.

APRA's recovery planning pilot program

As with other areas of prudential regulation, APRA's approach is to tailor the implementation of recovery plans to the circumstances of the Australian financial system.

In 2011, APRA established a pilot program on recovery planning for a number of the larger ADIs. The pilot commenced with APRA meeting with the Chief Risk Officers of these ADIs to discuss the concepts and potential scenarios on which recovery planning was to be based. A working group of ADI representatives was established, which met regularly with APRA during the preparation of the pilot. The working group operated collaboratively and progressed and resolved a number of issues.

The primary objective of the pilot program was for participant ADIs to prepare a comprehensive recovery plan, to be approved by the board, setting out a menu of recovery actions that could be deployed to restore financial soundness within a reasonable period of time, consistent with the need to quickly restore market confidence.

RECOVERY PLANNING FOR AUTHORISED DEPOSIT-TAKING INSTITUTIONS**Planning scenario**

To guide the preparation of recovery plans, APRA and the participant ADIs agreed a broad scenario that involved a major depletion of the ADI's capital and associated funding and liquidity pressures. The scenario was influenced by actual destabilising events experienced in Australia over time. These included the substantial lending losses and resultant deterioration in capital positions incurred by some Australian banks in the early 1990s and, more recently, the dislocation to global funding markets during the global financial crisis.

A planning scenario is a useful device for purposes such as this. However, there are two key points to bear in mind when considering scenarios.

Firstly, a scenario needs to be severe enough to require major recovery actions to be taken to restore the ADI to soundness, but not so severe as to render the ADI unrecoverable. This balance implies a severe loss of capital, but not so large as to cause the ADI to become insolvent. The magnitude of capital loss and associated dislocation to funding required for recovery planning purposes is towards the tail end of the probability curve, particularly by reference to Australian experience.

Inevitably, this engenders discussion on the likelihood of such a scenario ever occurring. However, for the purpose of recovery planning, the focus needs to be on how an ADI would seek to recover from a severe destabilising event, rather than assessing the probability of such an event occurring. Such events need to be assessed in terms of their impacts on capital and funding positions, as well as on the ADI's share price and credit rating, where impacts may be substantial.

Secondly, APRA considers that recovery plans should be applicable to a range of stress conditions rather than being scenario-specific, and that a 'menu' of recovery actions could be deployed in both idiosyncratic and/or market-wide stress scenarios. This is due to the uncertainty in predicting economic or market conditions in advance, and the reality that the threat to an ADI's ongoing viability may have causal factors other than a severe capital shock, ranging anywhere from unauthorised trading to an acute liquidity crisis. Accordingly, APRA's approach in the pilot program was to consider a very high-level scenario, focusing on the assumed impacts on capital and liquidity, without getting into details on causality.

Recovery plan expectations

APRA requested the participant ADIs to base their recovery plans around the development of a comprehensive menu of recovery actions, focusing on the actions that could make a material difference to the ADI's capital, liquidity and funding position. This approach is consistent with the approach taken internationally.

APRA made no distinction between recovery actions that add directly to the capital base and those that reduce the need for capital by reducing the size of the balance sheet; both are equally valid.

APRA regards a comprehensive menu of plausible recovery actions as being integral to the credibility of a recovery plan. The menu should, in terms of its cumulative impact, exceed the capital and funding needed to respond to a given scenario, and provide flexibility to select alternative actions in any given circumstances.

The participant ADIs were requested to include projected recovery outcomes based on selected recovery actions. This recognises that not all actions might be available in certain circumstances, due to their execution risk and/or timeframes. Additionally, some actions might not meet estimated realisation levels. These alternative projected recovery outcomes are intended to assist an ADI in demonstrating the flexibility to select alternative actions from the menu that can be executed in a reasonably quick timeframe.

APRA also emphasised that recovery actions should be credible and realistic, and documented in sufficient detail to give the ADI's board, and APRA, confidence that the actions could be implemented in practice. It was also emphasised that, for the recovery actions to be of practical use in the kinds of scenarios being considered, and to be credible, they need to be capable of complete implementation within a period of months rather than years.

APRA did not issue a prescribed format for the recovery plans. However, these plans were expected to cover the following areas:

- an overview of the legal and operational business structure;
- analysis of the separability of core and non-core business functions;
- a menu of credible recovery actions with a financial, operational and strategic assessment, and financial projections of the cumulative impact of these actions;
- non-financial actions, including a media and communications strategy; and
- roles and responsibilities for developing, reviewing and activating the plan.

RECOVERY PLANNING FOR AUTHORISED DEPOSIT-TAKING INSTITUTIONS**Draft recovery plans**

Draft recovery plans were received from the participant ADIs at the end of 2011.

APRA's review of the draft plans focussed on the ADI's proposed menu of recovery actions, their likely financial impact, the estimated timeframes for execution and key dependencies, legal and operational considerations, necessary approvals, and the risks associated with the execution of each action.

A core element of a recovery plan needs to be the identification of possible recovery actions and the development of capability (and intent) to act quickly.

The draft plans were generally well advanced in scoping out potential recovery actions. These actions involved some combination of the following:

- *liquidity actions*, such as entering into repurchase arrangements for categories of assets, the sale of liquid assets, or securitisations;
- *capital raising* (e.g. a rights issue, institutional placements or strategic placements) and *capital preservation* (e.g. cutting dividends);
- *balance sheet reduction*, particularly through reducing business volumes in more capital-intensive lending portfolios, thereby reducing the need for capital and funding;
- *business management actions*, such as cutting salaries and bonuses and major projects; and
- *changes in business operations*, such as the sale of lending portfolios, business lines, strategic investments and domestic and offshore subsidiaries.

While satisfied that the draft plans were reasonable comprehensive, APRA identified areas in need of further development before the final plans were submitted in July 2012. In particular, ADIs were asked to consider more fully how the actions with most material impact could be delivered within a reasonable timeframe to have a credible impact on market confidence. The general theme was the need for a greater focus on the immediate actions required in response to the stress scenario.

The draft plans also highlighted the possible need for ADIs to consider preparatory steps that could be taken to further mitigate execution risk in order to improve the deliverability of recovery actions. Often referred to as 'pre-positioning', such preparatory steps might, for example, include possible changes to organisational or legal structures or the preparation of documentation ahead of time to facilitate potential transactions or capital initiatives. Some of these preparatory steps are relatively low cost and APRA expected they would have been given careful consideration before the boards of the participant ADIs approved their recovery plans.

Completed recovery plans

When the ADIs completed their final plans there were few major additions or changes to the proposed recovery actions. However, a number of the underlying assumptions and estimates were revisited. The main area that was expanded was the provision of projections for financial recovery.

The completed plans were comprehensive, with all participant ADIs developing extensive menus of recovery actions. Furthermore, most provided alternative projections of recovery using various selected actions that address the capital and liquidity recovery objectives envisaged in the planning scenario.

In reviewing the recovery plans, APRA considered it important that the ADIs look beyond the cumulative impact of their proposed actions and consider alternative options in the event that the primary recovery actions do not sufficiently restore financial soundness. This is particularly relevant for larger actions, such as 'cornerstone' capital-raising, that have a greater financial impact in terms of achieving recovery objectives.

RECOVERY PLANNING FOR AUTHORISED DEPOSIT-TAKING INSTITUTIONS

The recovery projections have enabled APRA to consider the impact of changes in business operations and other balance sheet actions that target reduced growth in more capital-intensive portfolios, thereby reducing the need for capital and funding. The projections indicate that these actions are supplementary in impact to capital-raising initiatives, but do provide additional flexibility in the menu of actions.

APRA expects the larger ADIs to continue to develop their recovery plans in the context of their normal stress testing and ICAAP processes.

The capital initiatives in the plans, supplemented by balance sheet actions, if all available and realised at their estimated values, would achieve restoration of the ADIs' capital ratios to prudential minimums within six months. Although it did not set out an expected recovery point, such as a target capital ratio and timeframe as part of the pilot program, APRA does consider this a desirable objective for any recovery plan. Target recovery levels and timeframes required for restoration to financial soundness will be factored into future recovery planning initiatives as APRA further develops this element of the supervision framework.

The execution of the capital-raising and balance sheet reduction actions were typically estimated to be completed within six months after the stress event. However, the timeframes for more fundamental changes in business operations tended to be much longer, depending on such factors as the complexity of organisational structures and the functional separability of IT systems.

A core element of a recovery plan needs to be the identification of possible recovery actions and the development of capability (and intent) to act quickly. In the face of stress envisaged by recovery planning scenarios, an ADI might need to make decisions that it would not normally contemplate in a business-as-usual environment. This 'last resort' approach to executing recovery actions is key in recovery planning; recovery will obviously take longer if the cornerstone capital-raising actions do not realise the expected benefits in the envisaged timeframe. In these circumstances, a number of smaller actions would be needed to achieve recovery. However, executing multiple recovery actions within a short space of time would present a further complexity challenge. On the other hand, stretching out the projected recovery timeframe would not be conducive to restoring market confidence. The focus therefore needs to be on the key recovery actions that ADIs can complete in the required timeframe to restore their institution to financial soundness.

A broader role for recovery planning

Due to their evolution during the global financial crisis, recovery plans are inevitably associated with crisis resolution activities. However, their use within an ADI should be more pervasive than that.

ADIs should consider how their recovery plan integrates with their core governance and risk management processes, such as their Internal Capital Adequacy Assessment Process (ICAAP), stress testing, contingency funding and crisis management plans. This is a logical extension of current capital and liquidity management processes. ADIs should ensure their recovery plans are reviewed and updated, both on a regular cycle and in the event of material changes to business operations.

Recovery plans are also a means by which an ADI's board, and APRA, can further assess the adequacy of the ADI's existing risk management framework, business structures, connectivity and separability issues, intra-group contagion and capital levels.

Whilst not one of its specific objectives, it is likely the pilot program has given the larger ADIs some further insight into the operational linkages and dependencies within their institutions and the optimal, or otherwise, allocation of capital and funding to their business activities.

RECOVERY PLANNING FOR AUTHORISED DEPOSIT-TAKING INSTITUTIONS

Recovery planning will become a permanent component of APRA's supervision activities, as one of the requirements that regulated institutions must meet.

Summary

APRA considers the recovery planning pilot program for the larger ADIs to have met its objectives. The completed recovery plans are consistent with APRA's expectations.

The pilot has highlighted the strategic and operational complexities associated with planning for and implementing recovery actions. This has only reinforced APRA's view that it is imperative for ADIs to demonstrate through their recovery plans the capability to act quickly and effectively in a stressed environment.

Now that the pilot program is complete, APRA expects the larger ADIs to continue to develop their recovery plans in the context of their normal stress testing and ICAAP processes. This is likely to involve consideration of alternative and potentially more severe events, such as a liquidity crisis of longer duration or deeper impact than that envisaged by the pilot scenario.

Recovery planning will become a permanent component of APRA's supervision activities, as one of the requirements that regulated institutions must meet. APRA is extending the recovery planning exercise to medium-sized ADIs and is considering its extension to the larger general insurers and life insurers in 2013.

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