SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

September 2012 – Issue 90

ICAAP – The New Risk and Capital Management Framework

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This article was first published on the blog, www.actuarialeye.com, and is reprinted here with permission. The acronym, APRA, referenced in the article stands for Australian Prudential Regulation Authority.

Regulatory change is a constant in most financial services areas these days. Insurance in Australia is no different. APRA is in the middle of a major upgrade to the regulatory capital regime for life and general insurers, which is due to start from 1 January 2013.

So far, most of the focus has been on the likely changes to capital levels. The first and second round of QIS (quantitative impact statements) suggested that some companies would have substantial increases.

APRA's changes to capital governance, however, could have an equally large impact in many companies.

THE BOARD IS IN CHARGE

APRA's new proposals make it very explicit. Capital levels for insurance companies are the Board's responsibility. Not only that, but the Board has to send its own report to APRA every year (the ICAAP report) explaining its capital plans to APRA, and reviewing the last year. In a recent speech, Helen Rowell (Executive General Manager, Supervisory Support Division) made it quite clear:

APRA expects that the ICAAP will be developed by the insurer's senior management with input from relevant areas and experts. However, the ICAAP is fundamentally the responsibility of the Board: the Board should be actively engaged in the development of the insurer's ICAAP and its implementation, and must ultimately approve the ICAAP.

This change, and APRA's requirement for a report from the Board, is a step-up in Board responsibilities for insurance companies. While Boards have always had overall accountability, APRA is expecting the Board to have a deep understanding of the capital framework of their business. Expect an in depth conversation at the next APRA Board lunch.

CAPITAL IS THE PRICE FOR RISK

The capital management framework needs to be explicitly linked to the risk management framework. There needs to be a clear path from the Risk Appetite Statement to the level of capital held. The path needs to be quantitative, so that an explicit risk appetite statement can be linked to the capital held to support that risk.

Not only that, capital must be a key part of the decision making framework for an organisation. Every decision which changes the risk levels of an organisation (eg changes in price, sale of big new contracts, introduction of an outsourcing arrangement) must be considered through a capital lens.

The measurement of performance (monthly review of KPIs) must also show evidence of a capital lens – an improvement in profit at the price of increased risk should be explicitly measured that way, using capital as the price of risk.

For more about using capital as the price for risk, see my paper on this topic from 2009.

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RISK APPETITE AND CAPITAL MANAGEMENT MUST BE LINKED

APRA is expecting an explicit link between risk appetite and capital management. That means that you need to be able to show the path between your high level risk appetite ("we are targeting medium insurance claims volatility") and the way in which you manage your capital – both the level of target surplus, and the way in which you make decisions on insurance issues. Again, APRA sees this as a key part of the new framework. Helen Rowell again:

APRA expects there to be a clear link between an insurer's risk appetite and its risk and capital management framework, including the target capital levels determined as part of the insurer's ICAAP. APRA expects that target capital levels will be set in accordance with the insurer's risk appetite and not solely by reference to APRA's minimum capital requirements.

So you need to translate that statement (medium insurance claims volatility) into a quantified measure ($xm potential variance against budget) and a level of target surplus and decision making framework.

Most companies have some part of that series of steps, but very few can show the full end-to-end path.

CAPITAL IS AN INTEGRAL PART OF BUSINESS PLANNING

The capital implications of business plans (including the associated risks of the plan) must be important considerations in all business planning. That means capital projections, discussions of sources of capital (if the plan envisages capital being required) and scenario testing of the capital as well as profit position.

OPPORTUNITIES FOR COMPETITIVE ADVANTAGE

The companies that can make these requirements work for them, rather than treating them as another compliance burden will be the companies that win from the change. Companies need to:

- Use the opportunity to understand the capital intensity of their products and incentivise their team accordingly
- Use their superior understanding of risk and return to find the gaps in the market where they can achieve extra returns
- Source capital in advance of likely need by developing a good early warning stress and scenario testing framework

SO IS THIS MORE REGULATION GONE MAD?

Insurance companies in Australia do bear a large burden of regulation. On the other hand, they also weathered the GFC very successfully, at least partly due to that regulation (and supervision). My own view is that using a change in capital standards to pointedly change the level at which capital conversations take place inside an insurance company is a good development.

It's going to take time to bed down, but the companies who embrace the new requirements and take advantage of them will ultimately be the winners. ■

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