

20 February 2008

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Dear Mr Chapman

Re: MIIAA Response to the APRA paper 'Refinements to the General Insurance Prudential Framework'

1. Introduction

The purpose of this paper is to provide a written submission to the second consultation paper on the Refinements to the General Insurance Prudential Framework issued on 19 December 2007. MIIAA acknowledges the response by APRA on page 15 of the consultation paper which states, "After full consideration of all of the submissions received and associated discussions, and in the light of the amended Insurance Act, APRA continues to believe that the underlying rationale for the proposal is consistent with and appropriate to APRA's prudential framework for general insurers". Therefore we will not duplicate the issues raised in the MIIAA's previous submission dated 24 September 2007, except to state that we regard many of the issues detailed in our previous submission as not being adequately dealt with by APRA in their second consultation paper and that they remain valid. In addition our members may make separate submissions to APRA highlighting issues that are of particular concern to them.

2. Transitional arrangements

The consultation paper acknowledges on page 16 that by 2012 reinsurance recoverables from pre 30 June 2008 contracts will not be significant except perhaps long tail classes such as medical indemnity.

To allow for the reality that reinsurance recoverables from pre-June 2008 contracts for our sector will be significant, it would be equitable that the transitional arrangements be extended by a

further 4 years to 2016 for reinsurance policies arranged solely for the purpose of medical indemnity prior to 30 June 2008.

3. Non-APRA authorised reinsurance recoveries capital charge

Both the initial and the modified proposals effectively require that insurers fully capitalise reinsurance recoverables from non-APRA-authorized reinsurers as follows:

- Under the original proposal, removing the recoverables from the capital base; and
- Under the modified proposal, a 100% investment capital factor means that the entire value of the recoverables will be added to the Minimum Capital Requirement.

This change moves the impact from the numerator to the denominator in the MCR times cover equation thus significantly increasing the effect on the MCR ratio resulting in a more onerous treatment of these reinsurance recoverables than is the case for the treatment of intangibles. This approach appears contrary to the principles of APRA's Prudential Standards relating to both counterparty quality and concentration risk.

We recommend that APRA select a capital factor of less than 100%, say 50%, that while providing a deterrent for placing business with non-APRA authorised reinsurers, does acknowledge that there is clearly significant value in these recoveries compared to their non-existence.

4. Recoverables to be payable to the insurer in Australia

Page 18 states "the recoverables under the reinsurance contract be payable to the insurer in Australia, with no other payment mechanism to be subjected for convenience".

We suggest that before implementing this requirement APRA consider the practical difficulties and administration burden this will place on individual Lloyds syndicates. Lloyds syndicates currently group claims settlements to authorised Lloyds brokers periodically. Funds are then allocated and passed on to the insurer. This requirement would require each Lloyds syndicate to forward recoveries direct to the insurer. Lloyds syndicates are not all equipped for this whereas Lloyds brokers have set up processes to ensure the smooth transition of funds.

Reinsurance brokers are agents of the insurer. It is unreasonable not to allow funds to be directed to an agent of the insurer in the first instance. Whether the agent is located in or outside Australia should not be an issue.

5. Investment Charges

While in principle the MIIAA agrees with the intent of the proposed increase in charges for investment in equities and property we do not support the proposed approach to implementation.

The MIIAA submits that transitional arrangements should be included in the proposed changes to allow insurers to adjust their equities / property portfolios gradually over a period of time. This is particularly important in the context of the current turmoil in investment markets.

6. Capital Buffer

APRA's paper of 19 December states on page 9 "The buffer for all other insurers generally expected to be 1.2 times their minimum capital requirements".

APRA have previously indicated an expectation of medical indemnity insurers of a minimum capital base of 1.5 times the MCR.

The MIIAA seeks clarification of whether the level of capital buffer expected by APRA of medical indemnity insurers will be 1.2 times the MCR.

7. Illusory Time to put Security Arrangements in Place

APRA have a desirable aim of encouraging non-APRA-authorized reinsurers to put in place security arrangements that will enhance the protection of Australian policy holders. APRA states that "the transitional arrangements would allow insurers four years to plan for some combination of security arrangements and additional capital". However for medical indemnity insurers there is no leverage to negotiate with non-APRA-authorized reinsurers participating in prior reinsurance programs to place these security measures. Even if the transitional measures are extended, the long tail nature of our portfolio means that inevitably our members' previous reinsurance panel composition will affect the MCR ratio adversely, without any methods of mitigating this effect apart from raising capital.

8. Future Selection of Reinsurers

In relation to future selection of reinsurers, APRA's aim remains desirable but as previously submitted it is inevitable that that this will come at an incremental cost to the insurers and inevitably to MIIAA members' policyholders, who include the majority of Australia's doctors.

The incremental cost would result from increased premiums due to firstly a less competitive reinsurance market due to reinsurers being effectively shut out of the Australian market, and secondly the financial cost to non-APRA-authorized reinsurers for the security arrangements necessary for Australian long tail insurers to benefit from these reinsurance arrangements. In addition, if the proposals are introduced, we believe that the current retrocession arrangements of several APRA-authorized reinsurers will cause capital pressure on these reinsurers and this will flow on to increased reinsurance premiums, or even reconsideration of the reinsurers commitment to the Australian market.

9. Conclusion

The benefit of APRA's proposals regarding reinsurance recoveries and increased asset capital charges in the way that these are proposed to be implemented will in our view be outweighed by the detrimental effect of the increased financial burden on our members and their policyholders.

If you have any questions regarding this submission please contact Ellen Edmonds-Wilson, CEO of the MIAA on 08 8113 5312 or ellen@miiaa.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ellen', is placed over a light grey rectangular background.

Ellen Edmonds-Wilson
Chief Executive Officer