AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
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05 September 2022

Richard Potts
Manager
State Insurance Regulatory Authority
Level 14-15, 231 Elizabeth Street, Sydney NSW 2000

Dear Mr Potts,

HOME BUILDING COMPENSATION REFORM CONSULTATION

The Australian Prudential Regulation Authority (APRA) welcomes the opportunity to provide background information to assist the State Insurance Regulatory Authority (SIRA) on its proposed reforms to redesign the regulation of the NSW home building compensation scheme.

Attachment A explains the legislative and prudential requirements underpinning APRA's prudential regulation of general insurers.

We would be happy to expand on this information. Please contact [redacted] if you would like to discuss this further.

Yours sincerely,

[redacted]
Executive Director
Policy and Advice Division

ATTACHMENT A: Overview of APRA's prudential and legislative framework for general insurers

The legislative framework

APRA is an independent statutory authority established under the *Australian Prudential Regulation Act 1998*. It is the prudential regulator of the Australian financial system responsible for regulating general, life and private health insurers, banks and other authorised deposit-taking institutions and specified superannuation entities.

APRA is responsible for the general administration of the *Insurance Act 1973* (the Act). The main objects of the Act are:

- to protect the interests of policyholders and prospective policyholders under insurance policies in ways that are consistent with the continued development of a viable, competitive and innovative general insurance industry; and

- to promote financial system stability in Australia.[1]

Only a body corporate authorised by APRA (i.e. a general insurer) or a Lloyd's underwriter can carry on 'insurance business' in Australia.[2]

Insurance business covers the business of undertaking liability, by way of insurance (including reinsurance), in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event, and includes any business incidental to insurance business, with some exclusions specified in the definition. While the Act broadly defines 'insurance business', it is important to note that other forms of insurance business, such as health insurance are not included in the definition. In addition, other types of prescribed insurance business, such as workers compensation insurance business carried on by a company licensed under Division 3 of Part 7 of the *Workers Compensation Act 1987* (NSW), are outside the application of the Act.

Prudential regulation of general insurers

Prudential regulation is aimed at promoting the financial safety of APRA-regulated institutions and financial system stability. It has a strong emphasis on preventative measures supported by close supervision against enforceable 'prudential standards'. Prudential regulation is intended to ensure that risks taken by financial institutions are within reasonable bounds and effectively managed so that institutions are well placed to meet their obligations. These obligations vary according to the type of institution but essentially involve some form of promise to meet financial commitments. For example, an insurance company accepts premiums on the promise to meet insurance claims when a specified event occurs.

APRA's prudential standards for general insurers, seek to achieve these objectives by, amongst other things:

- requiring directors and senior managers of general insurers to take primary responsibility for protecting the interests of policyholders;

[1] Subsection 2A(1) of the Act.

[2] General insurer's may also be regulated by other Commonwealth agencies such as the Australian Securities and Investments Commission (ASIC) and other State and Territory bodies.

- establishing requirements aimed at ensuring the prudent management of general insurers and supporting APRA's prudential supervision of general insurers; and

- facilitating APRA managing and responding to circumstances in which the ability of a general insurer to meet its obligations may be threatened.[3]

Prudential standards for general insurers fall within the following categories: capital; governance; and risk management, including general risk management and operational resilience.

APRA also collects financial and other data for our own supervisory purposes and on behalf of other agencies under reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

APRA's prudential and reporting standards for general insurers are available on the APRA website.

Capital

APRA's capital standards[4] require general insurers to maintain eligible capital of an amount which is in accordance with the scale, nature and inherent risks associated with its insurance business. This includes consideration of factors such as insurance risk, insurance concentration risk, asset risk, asset concentration risk and operational risk.

A general insurer must also have an Internal Capacity Adequacy Assessment Process, comply with any supervisory adjustment to capital imposed by APRA, make certain public disclosures about its capital adequacy position, comply with approved auditor and actuary requirements, seek APRA's consent for certain planned capital reductions and inform APRA of any significant adverse changes in its capital position.

Governance

APRA's governance standards include *CPS 510 Governance*, which sets out requirements for the sound and prudent management of an insurer by a competent Board, and *CPS 511 Remuneration* (effective 1 January 2023) which introduces heightened requirements on remuneration and accountability. *CPS 520 Fit and Proper* sets out minimum requirements for the fitness and propriety of individuals holding positions of responsibility.

GPS 310 Audit and Related Matters (GPS 310) requires a general insurer to appoint an auditor, specify the roles and responsibilities of the auditor and ensure the auditor is able to fulfil its responsibilities under the prudential standard. GPS 310 further requires an auditor to prepare and submit to APRA certificates and reports, audit the yearly statutory accounts, conduct a limited assurance review, and submit a Financial Information Declaration to APRA.

CPS 320 Actuarial and Related Matters requires an insurer to have access to appropriate actuarial advice to assist in the sound and prudent operation of its business.

[3] Section 2A(2) of the *Insurance Act*.

[4] GPS 110 Capital Adequacy, GPS 112 Capital Adequacy: Measurement of Capital, GPS 113 Capital Adequacy: Internal Model-based Method, GPS 114 Capital Adequacy: Asset Risk Charge, GPS 115 Capital Adequacy: Insurance Risk Charge, GPS 116 and GPG 116 Capital Adequacy Insurance Concentration Risk Charge, GPS 117 Capital Adequacy Asset Concentration Risk Charge, GPS 118 Capital Adequacy Operational Risk Charge, GPS 120 Assets in Australia, GPS 340 Insurance Liability Valuation.

Risk management

CPS 220 Risk Management (CPS 220) requires general insurers to have systems for identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating material risks that may affect its ability to meet its obligations to policyholders. A general insurer must maintain a risk management framework, risk appetite statement, risk management strategy, and business plan. CPS 220 also places notification requirements on the general insurer to notify APRA of breaches.

Further cross-industry prudential standards comprising *CPS 226 Margining and Risk Mitigation for Non-centrally Cleared Derivatives*, *CPS 231 Outsourcing, CPS 232 Business Continuity Management, CPS 234 Information Security, CPG 235 Managing Data Risk,* and prudential guidance *CPG 229 Climate Change Financial Risks* also apply to general insurers.