A Comparison of Methods for APRA's General Insurance Capital Requirements

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Abstract

The Australian Prudential Regulation Authority (APRA) recently put in place new general insurance prudential standards that allow insurers to choose between two methodologies for determining their minimum capital requirement (MCR) – the Prescribed Method and the Internal Model Based (IMB) Method. This paper explores the implications of these new capital requirements from the perspectives of two key stakeholders: the insurer and APRA. From the insurer's perspective, there is an incentive to minimise capital required in order to minimise the cost of capital. From APRA's perspective, it is important that the Prescribed Method adequately charges risks to meet their benchmark solvency objective for all general insurers.

This paper performs a comparison of the MCRs as calculated under the two methods and analyses the merits of the Prescribed Method's capital charges. Three key results are found. First, based on the insurance volatility assumptions of leading industry consultants, the IMB Method produces a higher MCR than the Prescribed Method implying that insurers have an incentive to use the Prescribed Method to calculate their MCR. Second, the capital charges under the Prescribed Method are shown to be inadequate to meet APRA's benchmark solvency objective across the entire general insurance industry. Third, it is found that there is a need for further work to be performed to reach an industry consensus on appropriate insurance liability volatility levels.