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**To: General insurers and Level 2 insurance groups**

**Recognising potential reinsurance recoverables from aggregate reinsurance cover**

The purpose of this letter is to clarify the types of reinsurance contracts that may be considered to provide aggregate reinsurance cover for the purposes of determining the Insurance Concentration Risk Charge (ICRC) under *Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge* (GPS 116).

This letter also reminds general insurers and Level 2 insurance groups (insurers) of their obligation to contact APRA in order to recognise aggregate reinsurance cover in the ICRC. The specific obligations of insurers before recognising aggregate reinsurance cover are set out in Attachment A.

**Reinsurance contracts that may be recognised**

GPS 116 provides that 'aggregate reinsurance cover' provides protection from an 'accumulation of retained losses from multiple events'. Therefore any reinsurance contract that responds in this manner is considered to be aggregate reinsurance cover for the purpose of determining the ICRC. In contrast, reinsurance contracts that are triggered following a single event only[1] are not recognised by APRA as aggregate reinsurance cover.

Some reinsurance contracts contain clauses that allow for the retention of the insurer to be reduced for the second or subsequent loss occurrence. These clauses are often referred to as 'drop-down' or 'subsequent-event retention' clauses and are most commonly found in property catastrophe excess of loss reinsurance contracts.

A simple example is a property catastrophe excess of loss cover of $90m excess of $10m, for an insurer with a Natural Perils Probable Maximum Loss (NP PML[2]) of $100m, for the calculation of the Natural Perils Vertical Requirement (NP VR[2]). A drop-down clause within that reinsurance arrangement might provide a reduction (drop-down) in the insurer's primary retention on the second or subsequent event loss occurrence to $2m. In this scenario, the insurer may apply to APRA for recognition of the drop-down of $8m in the insurer's retention, if the drop-down would be triggered upon the next NP PML or net whole of portfolio loss.

'Drop-down' covers as described above may not be viewed by the reinsurance industry as a typical aggregate reinsurance arrangement. However drop-down covers respond to an

[1] For clarity, 'single event only' means there has not already been at least one event that has resulted in an accumulation of retained losses above the primary retention on the aforementioned reinsurance contract.
[2] GPS 116 defines the terms NP PML (at paragraph 21), and NP VR (at paragraph 18)

accumulation of retained losses from multiple events, and therefore meet the definition of aggregate reinsurance cover for the purpose of paragraph 6 of GPS 116.

Therefore, if an insurer wishes to recognise its reduction in retention as a result of the 'drop-down' clause as an aggregate reinsurance recoverable for calculation of the various components of the ICRC, this needs to be referred to APRA. For the NP HR[3], APRA will need to agree on the methodology proposed by the insurer, whereas for the NP VR, APRA will determine whether or not to recognise the aggregate reinsurance cover and, if recognised, will agree on the methodology proposed by the insurer. If it is clear that the reinsurance arrangement provides aggregate reinsurance cover in a similar way to the simple example above, APRA envisages that the process of approval and/or agreement would be relatively straightforward.

The name of the clause or contract type is not relevant to whether APRA will consider recognition of a specific reinsurance arrangement. Rather, what is relevant is the nature of the contract and the way in which it responds to an accumulation of retained losses from multiple events.

There may be other forms of aggregate reinsurance cover available in the marketplace, which meet the intent of paragraph 6 of GPS 116. In determining whether to contact APRA in order to seek recognition for these covers, an insurer may find it useful to assess whether these covers meet the definition of 'aggregate reinsurance cover' under paragraph 6 of GPS 116.

**Completing the relevant reporting forms**

An insurer that recognises potential aggregate reinsurance recoveries is required to record these amounts in the correct field. Specifically, aggregate reinsurance recoveries should be captured in:

a) *Reporting Form GRF 116.0 Insurance Concentration Risk Charge* (GRF 116.0) in:

- Item '1.7. Less: Other adjustments' for the NP VR;
- Items '2.3.4. H3 aggregate offset' and '2.4.4. H4 aggregate offset' for the NP HR; and
- Item '3.3. Less: OA reinsurance recoverables' for the OA VR[3]; and

b) *Reporting Form GRF 116.4 LMI Concentration Risk Charge* (GRF 116.4) in Item '2.4. Available reinsurance' for the LMICRC[3].

**Further guidance for insurers**

*Prudential Practice Guide GPG 116 Insurance Concentration Risk* outlines APRA's expectations regarding the process to be followed and the types of information to be provided by the insurer if recognition of potential aggregate reinsurance cover recoverables is sought.

[3] GPS 116 defines the terms NP HR (at paragraph 27), OA VR (at paragraph 44) and LMICRC (at paragraph 53)

**Next steps**

APRA is not seeking a formal response to this letter. An insurer that is taking credit for potential aggregate reinsurance cover, or planning to do so, should:

a) satisfy themselves that the arrangements meet the requirements set out in paragraphs 13 and 14 of GPS 116;

b) ensure they have obtained the relevant APRA approval and/or agreement before doing so, and if not, contact APRA as soon as possible; and

c) ensure that any amounts which are recognised are recorded in the correct field in GRF 116.0 and/or GRF 116.4.

If you have any questions regarding this letter, please contact your responsible supervisor.

Yours sincerely

Charles Littrell
Executive General Manager
Policy, Statistics and International

## Attachment A – Key GPS 116 provisions for the purpose of recognising aggregate reinsurance cover

Sub-paragraph 6(a) of GPS 116 states that 'aggregate reinsurance cover' includes:

(i) aggregate reinsurance cover that protects the regulated institution from an accumulation of retained losses from multiple events of a certain size; and

(ii) aggregate stop-loss reinsurance cover that protects the regulated institution from an accumulation of retained losses from multiple events on a part or totality of its portfolio.

Paragraph 26 of GPS 116 provides that an insurer wishing to recognise potential reinsurance recoverables from aggregate reinsurance cover, for the calculation of the Natural Perils Vertical Requirement (NP VR), must apply to APRA. If the insurer does not apply to APRA, they are not permitted to recognise potential reinsurance recoverables from aggregate reinsurance cover in the ICRC. If the insurer does apply, APRA may, or may not grant credit for the aggregate reinsurance cover in the calculation of the NP VR. If credit is granted, APRA will then agree a methodology with the insurer.

Paragraphs 33 and 40 of GPS 116 provide that an insurer may adjust the Natural Perils Horizontal Requirement (NP HR) for potential reinsurance recoverables from aggregate reinsurance cover where the methodology proposed by the insurer for determining the adjustment is agreed to by APRA. This differs from the approach in the NP VR, as APRA will recognise aggregate reinsurance cover in the calculation of the NP HR, so long as the methodology used to determine this credit is agreed with APRA.

Recognition of potential reinsurance recoverables may be allowed once the aggregate reinsurance cover has reached its attachment point, or will reach the attachment point as a result of the occurrence of:

- the next Natural Perils Probable Maximum Loss (NP PML) or net whole of portfolio loss for the NP VR; or

- the accumulation of up to the three H3 losses[4] or the accumulation of up to the four H4 losses[4] for the NP HR.

An insurer may adjust their NP VR calculation between reporting quarters through recognition of aggregate reinsurance cover recoverables, if, as a result of a natural perils event occurring, the next NP PML or net whole of portfolio loss will breach the attachment point on the aggregate reinsurance cover. An insurer seeking to adjust their NP VR calculation between reporting quarters, must apply to APRA as soon as is practicable before recognising these amounts in the next quarterly return.

An insurer must agree a methodology with APRA for adjusting the NP HR for potential reinsurance recoverables from aggregate reinsurance cover prior to the inception date of the insurer's catastrophe reinsurance program. This is because, under paragraph 28 of GPS 116, the NP HR must be calculated at the reporting date on or prior to the inception date of the insurer's catastrophe reinsurance program and then held constant for the remaining duration of the catastrophe reinsurance program.

[4] GPS 116 defines the terms H3 loss (at paragraph 30), and H4 loss (at paragraph 37)

Additionally, paragraph 33 and 40 of GPS 116, require that there is no double-counting of the H3 and H4 aggregate offsets and the premium liabilities offset (PL offset[5]) for the NP HR.

An insurer may recognise potential reinsurance recoverables from aggregate reinsurance cover for the Other Accumulations Vertical Requirement (OA VR) and Lenders Mortgage Insurance Concentration Risk Charge (LMICRC) without needing to apply to, or agree a methodology with, APRA.

For the avoidance of doubt, the reinsurance arrangements must meet the requirements of paragraphs 13 and 14 of GPS 116.

[5] GPS 116 defines the term PL offset (at paragraph 43)