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Offshore reinsurers and the review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge

This letter is a response from the Actuaries Institute ('the Institute') to APRA's letter to all life insurers, dated 4 March 2019.

The response was co-ordinated by a working group ('the group') convened by the Institute to consider APRA's questions in turn. The Institute's intention is to represent as far as possible a cross-section of the views of its members. The Institute notes that there will not be a consensus view among its members on all aspects of APRA's questions.

Acknowledging the limited timeframe to prepare the submission and inevitable differing commercial views of members of the Institute, it was decided the focus should principally be on points of commonality within the general confines of the scope of APRA's proposals and the preparation of the submission accordingly, while noting that the views of individual companies could be expressed via individual company submissions. Due to the limited timeframe there was limited opportunity to consult more broadly with industry practitioners.

The Institute considered the working group provided a broad cross-section of industry representation, including offshore reinsurers. The APRA representative involvement was limited to observation and representation of APRA's interest/areas of focus and did not guide the views of the group.

References in this letter to 'offshore reinsurers' are to reinsurers which are not APRA authorised and which have not been approved by APRA as 'appropriate retrocessionaires'.

The discussion in the Institute working group meetings was wide-ranging. This is perhaps best illustrated by the points raised in relation to Question 4 of the APRA letter (refer to the response to Question 4 for further detail).

1. *APRA question: APRA's position on offshore reinsurers is outlined in this letter. Are the concerns identified realistic and relevant?*

APRA's concerns regarding offshore reinsurers are summarised as:

- Reduced visibility and prudential control over the activities of offshore reinsurers;
- Insufficient oversight and access, by APRA, to offshore reinsurers via their use by registered life companies, especially in relation to the group risk market;
- Possibility that offshore reinsurers may not take a long-term perspective when operating in the Australian market; and,

- Existing LPS 117 limits are not sufficient to address the emerging prudential concerns as they allow for a potentially significant increase in exposures beyond the current position.

The Institute agrees that these concerns are realistic and relevant.

2. ***APRA question: In the context of the options discussed in this paper, what issues should APRA consider to ensure it strikes an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, whilst promoting financial stability?***

The Institute considers the following points relevant to APRA's objectives, noting that the response to Question 4 incorporates further detail around some of the issues considered and related discussion.

Financial safety

- APRA's ability to undertake its supervisory role for offshore reinsurers is limited compared to APRA-licensed reinsurers and as such the Institute agrees with the need for appropriate limits on the use of offshore reinsurers to protect the financial safety of Australian life insurers and, by extension, Australian policy owners.
- The use of risk mitigants, within prescribed limits, by offshore reinsurers may improve the level of financial safety of Australian life insurers using such reinsurers, subject to consideration of the quality of those risk mitigants.

The consideration of limits and use of risk mitigants is considered further in the response to Question 3.

Financial efficiency

- As APRA notes, in some instances offshore reinsurers provide reinsurance solutions at appropriate prices to meet niche needs that may not be met by APRA-licensed reinsurers (e.g. catastrophe excess of loss reinsurance) and the Institute considers that life insurers should be able to continue to access such specialist or niche forms of reinsurance.

Competition and Contestability

- After the current round of industry consolidation has been completed, there will be eight 'large' APRA-licensed life insurers, seven 'small' APRA-licensed life insurers, and seven APRA-licensed reinsurers.
- The Institute proposes that APRA form a view on whether this constitutes an adequate level of competition in the life insurance and reinsurance market. In this context:
    - The Institute notes that APRA-licensed life insurers are able to conduct reinsurance business, and some do, which increases the level of competition and contestability in the reinsurance market;
    - The Institute also notes that offshore reinsurers are free to "domesticate" by seeking an APRA licence, and some have done so, which further facilitates competition and contestability in the domestic reinsurance market;

- APRA has provided alternative ways for reinsurers to participate in the market, specifically the amendment to the Life Act in 2004 allowing offshore life companies to operate branches in Australia.

- The Institute considers that the proposed 12.5% related party limit and the formal accommodation of risk mitigants may increase competition. The Institute further considers that the proposed reduction in the individual exposure limit for offshore reinsurers and the proposed new aggregate exposure limit for offshore reinsurers may reduce competition. The net effect of APRA's proposals on competition will depend on the interaction of these proposals and will also depend on the limits ultimately prescribed by APRA regarding the use of risk mitigants.
- The Institute proposes that APRA articulate the level at which the scale and frequency of an offshore reinsurer's operations in Australia reaches a point where they might reasonably be regarded as 'carrying on a business' in Australia, with the consequent obligation to obtain an APRA licence.

Competitive neutrality

- The Institute notes APRA's relatively narrow definition of competitive neutrality ('ensuring state-owned and private businesses compete on a level playing field') and that APRA does not anticipate that competitive neutrality considerations would bear upon the life insurance market.
- However, the Institute considers that APRA should adopt a wider definition of competitive neutrality which encompasses the notion of a level playing field in the life insurance market and which would be more in line with the broader interpretation of competitive neutrality that APRA has expressed in other publications.
- For example, from the APRA submission to the Productivity Commission - Competition in the Australian Financial System (Sept 2017) :
    - *APRA also endeavours to maintain competitive neutrality in its prudential framework and supervisory activities by minimising unnecessary or artificial regulatory distinctions between different entities undertaking activities which exhibit similar risk profiles. Competitive neutrality is aligned with an approach to prudential supervision whereby similar risks are subjected to similar prudential treatment. Such an approach contributes to efficiency, contestability and competition.*
    - *In developing its policy framework, APRA seeks to balance the need for competitive and efficient outcomes against financial safety. The prudential framework can affect the relative position of competitors by imposing differential costs and, for that reason, APRA acts to ensure that its prudential requirements are applied in a competitively neutral manner where possible.*
    - *With a view to, amongst other things, better accommodating applicants with non-traditional business models, APRA is making changes to its licensing framework to increase transparency and assist new entrants in obtaining authorisation. This includes the creation of a centralised licensing team to increase efficiency and consistency within the licensing process and improve communication with applicants. APRA is also currently consulting on a phased*

approach to licensing. Initially, the phased approach is intended to support increased competition in the banking sector by reducing barriers to new entrants, particularly those with innovative business models, including greater use of technology. The overall objective of this set of changes is not to lower entry standards overall, but rather to make them easier to navigate.

Financial stability

- The Institute recommends that APRA considers the impact of any changes to LPS117 on the stability of product terms and pricing offered by Australian insurers which are supported by offshore reinsurance capacity and whether transitional arrangements would be required.
- The Institute notes that local reinsurance support / capacity for some risks may vary (and have varied) over time. Additional reinsurance support provided by offshore reinsurers may assist with filling such capacity constraints in such instances. However, if the product and pricing terms ultimately prove to be less sustainable than desired, then offshore reinsurance support may serve to impede progress towards improved product sustainability.

3. ***APRA question: This letter outlines a number of options APRA is currently considering as part of the review of LPS 117, including but not limited to, those relating to asset concentration limits and risk mitigants. APRA requests feedback on the appropriateness, feasibility and effectiveness of these options.***

By way of introduction, the Institute understands that there are no proposed changes to the following existing limits:

- 50% limit on a locally registered specialist reinsurer retroceding to an appropriate retrocessionaire (noting this is a second-tier limit that applies after the 25% limit on a local insurer reinsuring to an individual local insurer or reinsurer);
- 25% limit on a local insurer reinsuring to an individual local insurer or reinsurer;
- 2.5% default limit for assets for which no other limit is specified in LPS 117.

The Institute also notes the existing ability of APRA to impose a supervisory adjustment to a local insurer's or reinsurer's Prescribed Capital Amount where concerns (including concentration risk) exist about the assets backing capital requirements.

The Institute has considered the proposed changes in this context.

The Institute does not have a view on the specific quantum of the percentage limits proposed by APRA, and considers these should be determined by APRA to be consistent with APRA's risk appetite, and specifically in response to APRA's concerns about the increased use of offshore reinsurers by APRA-licensed insurers.

The Institute responds to APRA's proposals and options under consideration in turn.

Section 3.1 Exposure to offshore reinsurers

(a) Should exposure of ceding insurers to individual offshore reinsurers with a counterparty grade of 1, 2 or 3 be capped at 2.5% of the insurer's VAF?

The Institute supports having a limit for individual offshore reinsurers. The Institute notes that the proposed limit of 2.5% is lower than the current limit of 5%, and at that level there would be no differentiation between an offshore reinsurance exposure with counterparty grade of 1, 2 or 3, and any other asset (for example an offshore reinsurance exposure with a lower counterparty grade).

(b) Should aggregate exposure of ceding insurers to offshore reinsurers with a counterparty grade of 1, 2 or 3 be capped at the higher of 5% of VAF or 25% of the insurer's capital base?

The Institute supports having an aggregate limit for offshore reinsurers and supports using the higher of a VAF limit and a Capital Base limit.

Section 3.2 Related party exposures - should an insurer be permitted to reinsure business with an offshore group company, up to an exposure limit of 12.5% of VAF, subject to APRA approval?

The Institute formed the following views:

- support for a higher limit than currently applies (i.e. 5%) for a related offshore party subject to an appropriate approval process;
- the approval process should be similar in approach to the approval process required to be undertaken by a local specialist reinsurer retroceding to an appropriate retrocessionaire;
- there should be visibility of what the approval process entails;
- a hierarchy of limits is appropriate;
- there should be clarity that the proposed 12.5% limit applies to a related party with counterparty grade 1, 2 or 3 and the proposal should be clear what happens if the counterparty grade is below grade 3 (e.g. paragraph 29 (b) of the current LPS 117's phased step-down of the limit applicable to an appropriate retrocessionaire receiving cessions from a local specialist reinsurer);
- the proposal should be clear whether the permitted limit for an APRA-authorised related party is reduced by the amount of any admissible exposures to non-authorised related parties. This is how the current standard works, but the APRA letter is silent on this point.

The Institute acknowledges that APRA has proposed a limit of 12.5% and additional considerations related to this proposal are set out in the response to Question 4.

Section 3.3 Measurement of limits - should exposure limits be expressed solely as a percentage of the capital base (rather than as a percentage of VAF)?

The Institute's preference is to retain the current general approach of limits being expressed by reference to the higher of VAF and Capital Base. It was felt that, in most cases, VAF would apply currently.

The Institute had considerable reservations over the greater complexity of using solely Capital Base, and also noted that the use of Capital Base would likely lead to some bizarrely-expressed limits given how small the Capital Base can be relative to the VAF (e.g. where insurers write a lot of re-rateable risk business and have large DAC balances).

The Institute took the view, in the interests of the integrity of APRA's prudential framework for the benefit of policy owners, that participating assets should be ring-fenced such that only those assets count towards the VAF for a reinsurance of participating business and do not count towards the VAF for a reinsurance of non-participating business.

The Institute doesn't support extending the concept of ring-fencing to sub-categories of non-participating business.

Section 4.1 Definitions and use of risk mitigants

Comments on the APRA intention to:

(a) **tighten and refine definitions of risk mitigants which can be taken into account when calculating the Asset Concentration Risk Charge (ACRC);**

(b) **analyse whether collateral trust structures should be explicitly permitted under the Standard**

The Institute is comfortable with APRA's proposal to permit collateral trusts as eligible collateral. Properly designed collateral trusts are an effective risk mitigant against the underlying exposure. However, the following points should be noted:

- The definition of eligible collateral should be expanded to include other arrangements including letters of credit and funds withheld arrangements as appropriate risk mitigants;
- APRA needs to consider how collateral trust arrangements can be accommodated under the Life Act for an APRA-licensed (re)insurer with the aim of providing a more level playing field compared to offshore reinsurers.

Section 4.2 Limiting recognition of mitigation for capital purposes

Comments on APRA consideration of the option of capping the extent to which life companies can use risk mitigants to lessen the impact of applying the limits in LPS 117

The Institute believes there should be caps on the extent to which life companies can use risk mitigants to lessen the impact of applying the limits in LPS 117 subject to the following observations:

- The limit should be proportional to the relevant net exposure limit applicable to the particular reinsurance counterparty and should have regard to the quality of risk mitigant;
- The higher the limit, the greater the risk of undermining what APRA is trying to achieve in this review (visibility, safety and stability); the lower the limit the more constrained the market will be (competitiveness and efficiency).

Section 4.3 Governance

The Institute believes it would be useful if APRA could publish pre-approved templates of risk mitigants such as collateral trusts, letter of credit arrangements and funds withheld arrangements. In this context, 'template' could mean, for example, a specific collateral trust deed, the precise form of which is pre-approved such that no additional approval process is required.

In addition, where APRA approves new collateral arrangements for use in normal business situations, it would be desirable to have market transparency of the general nature and form of collateral being approved.

These both would help streamline APRA governance and provide market transparency, efficiency and contestability and would lessen the need to seek external legal advice for every case.

Section 5.1 Investment risk sharing

APRA has suggested that there is a potential deficiency in LPS117 in relation to how investment risk sharing is treated when applying stresses to reinsurance assets. The Institute considers it reasonable that APRA seek to address any such deficiency.

4. APRA is considering responding to increasing use of offshore reinsurers by changing LPS 117. Are there other policy responses which APRA should consider?

The Institute has not proposed any other specific policy responses beyond those outlined in APRA's 4 March letter and those outlined in the Institute's response to question 3 above. However, the Institute's working group considered and discussed several related matters which are outlined here for APRA's interest and further consideration.

As noted earlier, the Institute has framed its responses to question 3 of APRA's 4 March letter in the context of the existing regulatory/supervisory framework and the other (unchanged) LPS117 exposure limits for licensed insurers/reinsurers (25%), appropriate retrocessionaires (50%) and the default (2.5%) for other unspecified exposures. These existing exposure limits, in respect of which the Institute notes no changes have been proposed by APRA, have set the tone for the responses in question 3.

The working group convened by the Institute noted that this framing had the potential to constrain the breadth of thinking and considerations that might be applied to the operation of the reinsurance framework for life insurance risks originated within the Australian market, and the broader operation of the life insurance market.

The working group considered and discussed a number of these broader aspects but, in the time available for preparing this submission, the Institute has not sought to provide any firm conclusions or recommendations on these points. Nevertheless, these broader aspects have been summarised below in order to record some key matters that were considered/discussed and to aid APRA's overall deliberations as it seeks to balance the objectives of the APRA Act in relation to the Australian life insurance industry.

Principles-based regulation and supervision

The working group considered the following key points:

- Given the time that has elapsed since the current regulatory and capital framework was formulated, the imminent introduction of IFRS17 and the continued evolution of the Australian life insurance market, a consideration is, whether a more fundamental review of the regulatory, supervisory and capital framework is warranted. If so, whether it might provide an alternative means of APRA overcoming its concerns regarding the extent to which offshore reinsurers (and insurers) can operate within the Australian life insurance market without a local licence.
- For example, whether IFRS17 might provide a fresh opportunity to revisit the principles-based approach to regulatory capital frameworks and entity-supervision, with the aim of providing greater transparency of offshore reinsurers' (and offshore insurers') operations such that APRA would be able to assure a level playing field (of regulatory requirements, regulatory supervision and equivalence of capital requirements for similar risks borne) between APRA-licensed players and offshore players.
- Additionally, whether there are other approaches to local supervision and enforcement that might provide a similar outcome, without the need for differential exposure limits for APRA-licensed players versus offshore players.
- The alignment of life insurance and general insurance, concluding this would be more appropriate to include in the context of a broader principles-based review.
- Under this principles-based approach, offshore insurers (as opposed to just offshore reinsurers) might additionally expect to be able to ply their trade in the Australian market without obtaining an APRA licence. It was recognised that such an outcome may give rise to a broader range of public policy considerations.

Carrying on a business in Australia

The working group considered the following key points:

- Whether there comes a point that the scale and frequency of an offshore reinsurer's operations in Australia are such that the offshore reinsurer might reasonably be regarded as "carrying on a business" in Australia, whereupon an obligation to obtain an APRA licence would presumably be triggered.
- Whether it is appropriate that an offshore reinsurer which contends that it is not carrying on a business in Australia should reasonably expect to have wide access to a regulated market.
- Whether more clarity could be provided to stakeholders regarding when APRA considers that the "carrying on a business in Australia" threshold has been crossed, in the interests of a) the day-to-day effectiveness and integrity of APRA's current regulatory/supervisory framework, b) APRA's objectives under the APRA Act, and c) greater market transparency for all stakeholders.

Capacity and Competitiveness

The working group considered the following key points:

- The need for the Australian life insurance market to be able to access sufficient supply of specialist covers, including catastrophe and pandemic protections, which are more typically provided by offshore reinsurers.
- There was considerable discussion of whether APRA-licensed reinsurers and insurers, when considered in conjunction with APRA's proposed new 12.5% limit for related party exposures, are able to provide sufficient reinsurance capacity (beyond the types of specialist covers referenced above) to meet the needs of the Australian life insurance market.
    - One perspective is that APRA-licensed reinsurers have had less appetite for certain risks in recent years, most notably certain Group TPD and disability income benefit designs, leading to reduced reinsurance capacity from existing APRA-licensed reinsurers. This has prompted new APRA-licensed entrants into the Australian reinsurance market, and greater participation by offshore reinsurers.
    - An alternative perspective is that this reduction in appetite among APRA-licensed reinsurers stemmed from concerns about the longer-term sustainability of these product/benefit structures, and that offshore reinsurers entering the market may provide reinsurance on terms that serve to prolong certain of those structures.
- There was discussion of the extent to which offshore reinsurers can provide a valuable independent check and balance on in-market reinsurance pricing, in the interests of the Australian consumer. However, there was also considerable discussion as to whether offshore reinsurers' pricing reflected solely an innately keener pricing philosophy or whether there were other inherent advantages enjoyed by offshore reinsurers which influence their pricing outcomes.

Principle of a level playing field

There was considerable discussion by the working group of the principle of, and what constituted, a level playing field between APRA-licensed reinsurers and offshore reinsurers and, by extension, between APRA-licensed insurers and offshore insurers. Within a broad-ranging discussion, the working group considered the following key points:

- Whether the playing field is currently tilted in favour of offshore reinsurers (compared to APRA-licensed reinsurers) by virtue of the combination of current exposure limits and APRA's prior approvals of collateral to mitigate counterparty exposures to offshore reinsurers.
- While APRA's proposals may lessen this current tilt, it was noted that this will depend greatly on the risk-mitigant limits that APRA ultimately adopts. For example, if risk-mitigant limits are not proportional to the relevant exposure limit, it was noted that offshore reinsurers (and offshore insurers) could continue to be advantaged compared to APRA-licensed insurers and reinsurers. (Accordingly, the Institute has proposed that risk-mitigant limits should be proportional to the relevant exposure limit in order to provide a more level playing field.)

- It was also noted that, even after APRA's proposed changes to limits, an insurer could still obtain offshore reinsurance up to 15% (of VAF) with a single offshore third-party reinsurer by using its APRA-authorised related party as a conduit. This would be in addition to the current settings whereby an insurer can use a specialist reinsurer as a similar conduit. Thus, allowing for some as-yet-unspecified additional limit for risk-mitigating collateral, APRA's proposals will still enable offshore reinsurers to participate at meaningful scale in the Australian market.
- Lastly, as APRA itself notes, the proposals do not affect the ability of an offshore reinsurer to seek an APRA licence. To the extent that the proposals may encourage some offshore reinsurers to do so, this would be a welcome outcome in the interests of competition and contestability on a level playing field, and thereby in the ultimate interests of the Australian consumer.

New Related Party Limit

Extending the level playing field point above, the working group also discussed (without resolution) whether the pursuit of a level playing field should mean that the proposed 12.5% limit should be increased still further (for example, to align with the 50% appropriate retrocessionaire limit for specialist reinsurers).

- One "top down, balance sheet" perspective is that an APRA-licensed specialist reinsurer is able to retrocede 50% of its "stressed" balance sheet and that an APRA-licensed insurer ought to be permitted to do likewise to an APRA-authorised related party (overseas), in order to provide a comparable treatment of the two balance sheets.
- An alternative "bottom up, end consumer" perspective is that a 12.5% limit is the maximum limit that is consistent with providing "look through" equivalence, where "look through" refers to considering the indirect exposure borne by an end consumer. Under current settings, APRA's limits mean (in effect) that for each $100 of life insurance risk that is originated from an Australian consumer, the maximum indirect exposure that consumer has to an appropriate retrocessionaire is $12.50 (assuming domestic reinsurance to the limit of 25% and then onwards retrocession to the limit of 50%). Thus, a 12.5% new related party limit would provide an equivalent degree of overseas counterparty exposure for that consumer on this "look through" basis.
- A further perspective is that the current settings already provide a level playing field between APRA-licensed reinsurers and insurers by virtue of the separation of specialist reinsurance and other insurance business which APRA introduced several years ago. Each APRA-licensed life (re)insurer is permitted to write insurance business and "specialist" reinsurance business. Thus, although the limits applicable to specialist reinsurance business currently differ from those applicable to insurance business, the limits for each respective type of business are the same for all regulated entities and all such entities are permitted to engage in both types of business.
- It was noted that providing a 50% limit for overseas related party reinsurance by an APRA-licensed entity that writes life insurance business as an "insurer" (as opposed to writing business as a "specialist reinsurer") would have two key effects:

- It would unwind the aforementioned separation and would create a framework whereby an Australian consumer could bear a materially higher indirect exposure to a single overseas counterparty than is possible under APRA's current and proposed limits; and
- It would provide a potential means for offshore (third party) reinsurers to participate in materially greater scale than under APRA's current and proposed limits, by using an insurer's new 50% related party limit as a larger conduit.

- Lastly, an alternative "top down, macro-prudential" perspective was discussed, whereby an exposure limit of an overseas related party (of an APRA-licensed (re)insurer) would be set by reference to the Australian life insurance market's aggregate (indirect) exposure to that related party, rather than by specifying an exposure limit for each statutory fund of APRA-licensed entities. Taking this alternative top-down perspective might provide a clearer view of the overall systemic exposure of the Australian market to an overseas related party and might thereby align with APRA's objective of maintaining system integrity. It was recognised that this approach could give rise to materially higher counterparty exposures for an individual statutory fund and would cause different APRA-licensed insurers to be treated differently depending on both their respective market shares and whether they had overseas related parties.

Conclusion

The Institute would be pleased to discuss this submission with APRA.

If you would like to do so, please contact [redacted] Chief Executive Officer of the Actuaries Institute on [redacted]

Yours sincerely

[redacted]

President