

10th May 2019

General Manager, Policy Development
Policy and Advice Division
Australia Prudential Regulation Authority
Level 12, 1 Martin Place
Sydney, NSW, 2001

Dear Sir / Madam,

RE: Aon submission regarding OFFSHORE REINSURERS AND THE REVIEW OF PRUDENTIAL STANDARD LPS 117 CAPITAL ADEQUACY: ASSET CONCENTRATION RISK CHARGE

This submission sets out Aon's response to Australia Prudential Regulation Authority's ("APRA") letter to all insurers dated 4th March 2019 ("the Letter"), particularly the main areas under consideration as per Attachment A of the Letter.

Please note that our submission can be made public.

Aon is in a unique position as we are neither an insurer nor reinsurer, however, we are a key stakeholder in the reinsurance industry. The views we present here are based on our experience and interactions with the many stakeholders in the industry – in particular, insurers, reinsurers (both local and offshore), and superannuation trustees. Our primary business is to provide risk and capital management consulting, reinsurance strategy and reinsurance placement services to both the life and general insurance industry in Australia. We have specifically been involved in many of the offshore reinsurance placements referred to in the Letter.

Aon's overall position is summarised as follows:

- Aon welcomes the review of LPS 117 and its focus on financial safety and financial system stability.
- Use of Offshore reinsurers in the Australian general insurance segment is a key element of each Insurer's risk management framework. GPS 117 provides an effective framework for managing the counter-party exposure risk of both onshore and offshore reinsurers.
- Aon would like to see improved consistency between LPS 117 and GPS 117 in line with the stated objectives in the Letter.
- Reinsurance by its very nature requires the pooling of risk and it cannot support the Australian life and superannuation market without access, whether directly or indirectly, to global markets and capital.
- Local Life Reinsurers directly regulated by APRA ("the Onshores") are some of the largest and most significant reinsurers globally, however they do not always provide the necessary support to the local market, as was evidenced in 2013 for Group Insurance renewals, and this led to a systemic need to seek alternate (offshore) markets
- Local Life Reinsurers more generally have limited appetite for tail risk such as Catastrophe, Pandemic and Stop Loss covers, which is becoming an increasingly important risk management tool as Insurers look to hold higher retentions on their proportional reinsurance covers.
- Many of the large Group Insurance schemes inside the Superannuation segment are now so large, that the local insurance (and reinsurance) market is not able to manage the size of the tail risk, and the reinsurance market would actually benefit from further deepening (not restricting), at least from an Insurer and Member perspective.
- Aon supports deepening the reinsurance market available to local insurers by providing access to over 180 specialist reinsurers, that will better support the Life

Insurance industry and improving access to global markets in a prudent way. Without the support of these offshore markets (which will occur by introducing prescriptive rules), the options being considered by APRA in the Letter may actually have the opposite effect on financial safety and financial system stability.

- Aon recognise that some offshore reinsurers may not be as prudently regulated as local reinsurers. We would propose that this risk be mitigated, rather than avoided, by:
 - a. additional reporting requirements by the Insurer
 - b. the Insurer's Appointed Actuary explicitly consider any potential additional risk on a case by case basis in their LPS 320 advice to the Board, and ultimately make adjustment to risk capital as appropriate. Guidance for these considerations / adjustments could be provided by APRA.
 - c. the Eligible Collateral regime within GPS 117 (and GPS 114) be extended to life insurance within LPS 117

Aon believe that APRA can meet its primary objectives of Financial Safety and Financial System Stability without the need to adjust the current reinsurer concentration restrictions of 25% of VAF for Onshore and 5% of VAF for Offshore reinsurers. This can be achieved by:

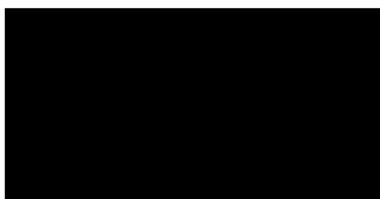
1. Mostly keeping the current framework "as is"
2. Introducing "Eligible Collateral" to the standard in a consistent way to GPS 117
3. Implementing appropriate governance and framework.

Aon's vast experience in general insurance reinsurance placements, especially in relation to offshore reinsurers, makes us well placed to consult with APRA so to create an environment which deepens the reinsurance market (through both local and offshore reinsurers) in a way which maintains, if not strengthens, the financial safety and financial system stability for all stakeholders. We would welcome further involvement in your review with this experience and knowledge in mind.

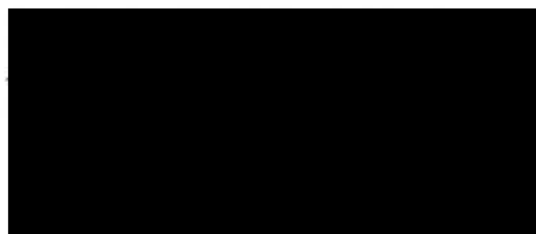
Our response to questions specifically raised in the Letter are addressed in the Attachment.

We look forward to engaging with you over 2019 on this important policy review.

Kind regards



President APAC, CEO Australia & NZ
Reinsurance Solutions
Aon



Head of Life Reinsurance
Reinsurance Solutions
Aon

Attachment - Responses to questions specifically raised in the Letter

Section 2	Scope of Review APRA welcomes input from stakeholders on the proposed scope for this review
Aon Response	<ul style="list-style-type: none"> Aon agrees with the scope outlined in the Letter. In addition, Aon would like to see the use of Eligible Collateral within GPS 117 be extended to LPS 117
Section 2.1	Offshore Reinsurers APRA welcomes comments and feedback from stakeholders on the concerns and risks outlined in this section.
Aon Response	<ul style="list-style-type: none"> <i>"Historically offshore reinsurers have predominantly assumed niche risks not supported by the local reinsurance market. Through its supervision activities APRA has, however, observed increased offshore reinsurance within the group risk market in the past three to four years. These observations are supported by the data collected in the LPS 117 information request."</i> <p>Aon is of the view that the increased use of offshore reinsurance in the Group risk market is a demonstration that this portfolio of risk has, perhaps unintentionally, become more akin to a "niche" market segment which is not sufficiently supported by the local reinsurance market and, as such, could now be considered special risk. This has occurred for several reasons:</p> <ol style="list-style-type: none"> 1. Increased pricing (basis) risk due to the increased awareness of fund members and legislative changes which have shifted the underlying basis; 2. Historically large losses experienced by local reinsurers has reduced their risk appetite for such segments, yet the underlying products are still strongly demanded by the market; 3. A general shallowing of the local insurance market driven by the amalgamation of many insurers in the industry has reduced the competition and choice of insurance provider, particularly for the large fund segment; 4. The large insurers may now be highly dependent (operationally) on a few large funds, making them "too big to fail", and potentially creating some non-rational market pricing signals; 5. The local insurance market looking to hold higher retentions and / or place non-proportional covers which the local reinsurance market has less appetite for. <ul style="list-style-type: none"> <i>"APRA's concern lies with its ability to maintain effective oversight and supervision of the risk profile of the Australian life insurance industry".</i> <p>Aon agrees that APRA has more effective oversight of local insurers, however Aon would propose this concern can be addressed in three ways, whilst maintaining support to deepen the reinsurance market:</p> <ol style="list-style-type: none"> 1. Increase reporting requirements from the local insurer as to their use of offshore reinsurers, such as the general insurance reinsurance data collection

	<ol style="list-style-type: none"> 2. Require the Appointed Actuary to consider the additional risks inherent in using offshore reinsurers and hold appropriate additional risk capital to reflect any additional risk identified. 3. Introduce an Eligible Collateral regime as already in place in the general insurance industry. <ul style="list-style-type: none"> • As is common practice in the General Insurance industry, spreading large insurance risks across multiple reinsurers (whether via individual classes / schemes or in a layered aggregate approach) actually increases the risk appetite of the market as a whole, and deepens the market to sustain future shocks. • The current framework provides an appropriate limitation on how much risk can be placed with each counter party. Having a differential of 25% for onshore vs 5% for offshore reinsurers provides a clear message to insurers about how to prudently manage asset concentration risk. • In Australia, Aon has observed that it is not always possible for the local reinsurance market to provide full capacity due to risk appetite and a reluctance to share risk with their local competitors. Ensuring that offshore markets can still be accessed will assist the life and superannuation industry in full placement whilst local reinsurance markets retain their lead shares on the placement (as local markets are more willing to co-participate with offshore reinsurers).
Section 2.2	<p>Balancing financial safety with other considerations</p> <p>APRA is seeking feedback from stakeholders regarding how the options considered in this attachment impact the various aspects of APRA's mandate.</p>
Aon Response	<p>Financial Safety – whilst direct local regulation is critical to the financial safety of our market, we would suggest a principles-based, rather than a prescriptive-based solution, is the best method for ensuring ongoing financial safety of the life insurance industry.</p> <p>There are several globally recognised financial rating models used locally and recognised as an appropriate measure of financial safety in both LPS 117 and GPS 117. In addition, Aon notes that APRA participates in global regulatory colleges and has memorandum of understandings with many international regulators, providing detailed access to the financial safety of individual reinsurers and markets in general.</p> <p>Whether a financial institution is registered locally or internationally is unlikely to directly impact the financial safety of the company, and whilst the use of rating agency models may not be perfect, these, along with APRA's insight into global markets, would likely provide early indication of any financial stress being observed by an individual company.</p> <p>Further, the provision of Eligible Collateral by an offshore reinsurer, provides a higher degree of financial security than a local insurer (or reinsurer) relying upon its global parent to repatriate funds.</p> <p>As an example, a large global reinsurer (with locally licensed subsidiary) experienced significant financial stress in both 2001 and 2008. The general insurance side of the business, being a branch, would have had restricted access to additional capital from its parent company. It is not clear how being a locally regulated reinsurer provided stronger financial</p>

safety in these instances than would an offshore reinsurer who has lodged Eligible Collateral with an APRA regulated ADI.

Aon would suggest that the Appointed Actuary (AA) is in a well-placed position to manage any increased financial safety concerns, rather than relying on a prescriptive regulatory limit. As part of their annual FCR, the AA could make consideration of not only the financial rating of an Insurer's counterparties, but also note any concerns that may have recently presented in the financial safety of these companies. The AA could then provide bespoke recommendation on how best to mitigate any additional risk, whether this be through holding additional risk capital or reducing exposure to such entities. A principles-based standard is likely to provide greater financial safety than a prescriptive one.

Financial System Stability - the most effective way to promote financial system stability is by fostering a deep and flowing market. We support your view that *"a long-term perspective is essential for a stable life insurance market"*, and this also instils consumer confidence in the system. However, it is not clear that the participation of offshore reinsurers takes a different durational lens on the market or risk than an onshore reinsurer would. They recognise the long-term nature of these risks and are equally committed to fulfilling their obligations.

Restricting an insurers' ability to use offshore reinsurers in an effective way, delivers the adverse outcome of shallowing the reinsurance market. Allowing an insurer to use each offshore reinsurer for a modest share of exposure (up to 5%) as per the current standard, provides appropriate mitigants to the Insurer when the local reinsurance market is systemically stressed (as was evidenced in 2012-13). Without this option, it is more likely that the scenario APRA is trying to avoid will indeed eventuate.

Efficiency – from a non-proportional (tail risk) perspective, as noted in your Letter, the majority of these reinsurance coverages are placed with offshore reinsurers, and hence we would anticipate the market to be materially impacted from an efficiency perspective under the proposed changes. From a proportional risk transfer perspective, there is arguably sufficient capacity in the market for most segments. However, the large industry group fund segment (where annual risk premiums are above say \$100m) has a much more restrictive market (in both insurer and reinsurer participation and capacity). We would consider the current market to be inefficient in this segment. Aon has been well positioned to create market efficiency in the General Insurance market, particularly where multiple reinsurers (both local and offshore) are participating on a risk exposure, and we see a systemic need to improve the efficiency of the large industry group fund segment, particularly as more funds grow and / or consolidate into this category.

Competition – Aon see an aggregate cap of 5% for offshore reinsurers as too restrictive. With the increased focus in capital management on tail risk and special risks, there is a need for non-proportional covers to support an insurers risk management framework which could potentially extend beyond the 5% exposure level. Adding to this, the increased pricing basis uncertainty risk of large group schemes, and it quickly becomes possible to have materially more than 5% of the portfolio categorised as special risk being outside the risk appetite of the local reinsurance market.

	<p>Aon would recommend that the current 5% limit per off shore reinsurer remain in place and allow Insurers to spread and diversify their large risk exposures across multiple onshore and offshore reinsurers. In our opinion, the current framework allows for the correct balance of competition between onshore and offshore reinsurers, whilst maintaining prudence over financial safety.</p> <p>Contestability – as the significant period of M&A activity observed of the past 10 years is now slowing, it is evident that new Insurers are indeed entering into the market in an effort to differentiate and disrupt the large consolidated insurers. There is evidence that these efforts (of new entrants) have been quite restricted in the sense that offshore reinsurers (who are willing to support their entry) have not been able to support them through traditional reinsurance arrangements, but rather using debt and equity instruments. The barriers to entry (both cost and time delay) of a reinsurer are such that many of the smaller niche markets are not able to justify the investment to support a start-up. Perhaps there is an option that APRA could consider in creating a class of “registered offshore reinsurer”. These entities would not be locally licenced, but they could write up to \$Xm of exposure in the market (in aggregate), and should they wish to go above this level, then they would need to become licensed. This would address:</p> <ul style="list-style-type: none"> • The oversight concern raised by APRA • The agility required for new entrants • The opportunity for new entrants to come into the market and confirm their business model with the intent to become a fully licensed reinsurer once they grow to sufficient size.
Section 3	<p>Asset Concentration Limits</p> <p>Stakeholders are invited to provide general feedback to APRA on the merits or otherwise of these options.</p>
Aon Response	<p>3.1 Exposure to Offshore Reinsurers</p> <p>Our experience and observations indicate that</p> <ul style="list-style-type: none"> • the market’s exposure to the Offshores has recently stabilised, in part, due to the revived local reinsurer risk appetite for group insurance business; • exposure to Offshores of some of the Insurers has likely already reached a level close to, or exceeding, the new proposed limits. Implementing the proposed lower limits could have unintended consequences, and specifically, be a catalyst to a new market dislocation with a much more profound impact since the Offshore buffer would have been already exhausted; • it is unclear whether these new limits would be grandfathered when implemented, and how this would work for new business versus renewals; • the new limits would mean that some niche risk protection purchases such as catastrophe and pandemic covers could have exceeded the limits in their own right. These covers have historically been provided by the Offshores, with little, if any, local appetite being available; • the implementation of aggregated limits may lead to unintended consequences as exposures may be linked to reserve exposures which are subject to fluctuations;

	<ul style="list-style-type: none"> the Offshores have often brought innovative ideas to the local insurance market, and may be less willing to do so with reduced opportunity. <p>We would recommend:</p> <ul style="list-style-type: none"> Maintain the current uncollateralised limit of 5% per Offshore counterparty (or equivalent level considering any impact under section 3.3); Maintain the uncapped aggregate exposure to all offshore reinsurers (this is key to financial system stability); Introduce Eligible Collateral (consistent with the general insurance regime) such that the individual offshore limit is increased to that of an Onshore reinsurer (and still maintain equivalent financial safety); Insurer reporting requirements be strengthened with respect to their use of Offshores such as Appointed Actuary requirements noted earlier or an APRA reinsurance data collection (like the general insurance equivalent); and Niche risk protection purchases such as catastrophe and pandemic covers be excluded from the exposure measure. <p>These recommendations would:</p> <ul style="list-style-type: none"> Maintain financial safety equivalent to fully utilising Onshore reinsurers; Promote competition and a deep healthy market of reinsurance solutions (and therefore financial system stability); Provide sufficient competitive tension in the local reinsurance market to respond to the needs of the insurer and end customer; Recognise the potential increased risk of Offshores and allow Insurers to mitigate appropriately without restricting competition and innovation.
<p>Aon Response</p>	<p>3.2 Related Party Exposures</p> <p>We consider this new metric not entirely relevant given the reasoning noted for review of LPS 117.</p> <p>There are examples (such as Gerling) where parent companies have defaulted on their local subsidiaries. There are also examples where parent companies have become stressed (such as a large Global Reinsurer in 2001 and 2008) and would not be in a strong position to fund any capital strains, as there is typically strong correlation of performance between the related entities.</p> <p>Further, it may actually be contrary to the proposed changes for the Offshores and make the implementation of the new limits unrealistic. We have witnessed a change in the ownership of local life insurers (to foreign companies) of late. Both MetLife Inc. and Allianz SE were identified as Global Systemically Important Insurers by the Financial Stability Board in 2016. These organisations are believed to have widespread financial impacts around the globe and warrant heightened supervision by the FSB.</p> <p>The proposed related party limit could lead to further exposure and reliance on multi-national entities with global operations. This could result</p>

	<p>in increased vulnerability of the Australian financial system to global events (e.g. 2008 GFC).</p> <p>There is also potentially a loop hole (and advantage) for local offices of global insurers to cede risks to the Offshores by first ceding to their related parties, and then passing on, contradicting the intent of 3.1.</p> <p>Aon would recommend that related parties be subject to the same aggregate limits, and only local Reinsurers continue to receive the competitive advantage of higher limits for related parties.</p>
Aon Response	<p>3.3 Measurement of Limits</p> <p>We are supportive of the proposed change provided the ring-fencing nature of assets backing participating products. The inclusion of these investment assets for the purpose of reinsurance exposure limits measurement may undermine the effectiveness of the standards and lead to unintended high dollar exposure to reinsurance counterparties.</p> <p>This change should be applied consistently to both onshore and offshore reinsurance exposures.</p>
Section 4	<p>Risk Mitigants</p> <p>Stakeholders are invited to provide general feedback to APRA on the merits or otherwise of these options.</p>
Aon Response	<p>We note the proposal to cap the use of risk mitigants and would question the necessity of this measure, given that risk mitigants do not necessarily create concentrations. It appears unclear why APRA's oversight is lessened by use of risk mitigants, as the collateral would be held to the benefit of the life insurer, who would have full access to information and can share it with APRA as appropriate.</p> <p>Aon recommends applying a consistent approach to defining and utilising Eligible Collateral as detailed in GPS 117.</p>
Section 4.1	<p>Definitions and use of risk mitigants</p> <p>APRA requests that stakeholders explain any concerns they have with the current definitions of risk mitigants in LPS 117 and also any suggestions they may have regarding appropriate ways to introduce clarity. Stakeholder perspectives on permitting collateral trusts as Eligible Collateral are also welcome.</p>
Aon Response	<p>Aon welcome the recognition and standardisation of risk mitigants for the purpose of LPS 117.</p> <p>We are of the view that the current definition of Eligible Collateral should be expanded to cover not only individual asset classes but also vehicles containing these recognisable assets. Collateral Trusts are examples of these vehicles and we welcome their explicit allowance in the standards in addition to the options noted in GPS 117.</p> <p>We support the standardisation of collateral trusts for the purpose of LPS 117. We have extensive knowledge of structures used locally for both life and general insurance business and would welcome the opportunity to work with APRA on this matter.</p>

Section 4.2	Limiting recognition of mitigation for capital purposes As part of this review APRA is considering the option of capping the extent that life companies can use risk mitigants to lessen the impact of applying the limits in LPS 117 and comments are welcome on this option.
Aon Response	<p>Aon would propose that, with the use of Eligible Collateral, Offshore reinsurers could extend their exposure to the equivalent of a local reinsurer ie up to 25% of VAF. The rationale being that these assets now provide the same financial safety as a local reinsurer regulated by APRA.</p> <p>The value proposition of a local reinsurer at such point, should become focused on their service proposition. The asset collateral is equivalent.</p>
Section 4.3	Governance To ensure the quality of the risk mitigants which life companies are taking credit for when calculating the ACRC, APRA is considering the possibility of introducing governance and oversight requirements. The specifics of the governance and oversight requirements have not been determined and suggestions are welcome, however it could include a requirement for independent legal advice and other expert review, as well as more detailed reporting to APRA.
Aon Response	Regarding the governance aspects, Aon supports the consideration of requirements and would encourage APRA to first consider whether what is undertaken in the general insurance industry is an appropriate first step. As noted earlier, Aon is heavily involved in collateralisation aspects on the general insurance side and have also been involved with some of the recent Trust structures on the life side. We would be happy to participate in some working groups and reviews on this topic.
Section 6.1	Consultation Questions
Question 1	APRA's position on offshore reinsurers is outlined in this letter. Are the concerns identified realistic and relevant?
Aon response	<p>The concerns identified in the Letter are relevant from our perspective, but not necessarily realistic. I.e. Offshore reinsurers are becoming more prominent in the local reinsurance "system" and a review is appropriate to ensure the system remains safe and appropriate. However, we are not of the general view that the use of Offshore reinsurance is reducing the financial safety or financial system stability.</p> <p>Reinsurance is an integral part of the sustainability of the insurance industry, and specifically, the Superannuation Industry Group Insurance schemes. With continued fund consolidation indicated by APRA, and the systemic growth of the sector, concentration risk issues will continue to emerge at the fund level, ultimately impacting member outcomes. The long-term trend here is clear – the system will need more (not less) options to diversify the insurance concentration risk. Improving accessing to global markets in a prudent way is key to managing this risk.</p> <p>Aon is not of the view that limiting the use of Offshores in aggregate is an appropriate way to address these concerns. We have seen from the recent past that the local reinsurance capacity be shocked and dry up in a very short period of time. The Offshores played a key role in supporting the group insurance market through its 2012 / 2013 crisis, and they have an evolving and at times material role to play in the Australian insurance market.</p>

	<p>Local insurers have invested significant actuarial and legal resources in establishing internal process (e.g. actuarial sign-offs and collateral trust) to ensure that any increased risk associated with Offshore reinsurers is considered, identified and mitigated to ensure the financial safety of their own businesses. The option to use Offshores has been weighed up by each Insurer as an alternate to the local reinsurer proposition (where available), and it is appropriate to continue to provide such autonomy to the market, where a prudent framework is</p> <p>Further limiting exposure as proposed would remove the Offshore buffer to the local reinsurance capacity and bring uncertainty to the existing offshore arrangements.</p> <p>We are of the view that these concerns remain valid, but can be effectively addressed using a framework of identification, assessment, mitigation and monitoring on a case by case basis.</p>
Question 2	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?
Aon response	<p>The key issues that we suggest APRA to consider would include the following:</p> <ul style="list-style-type: none"> • A principles-based approach to the financial safety and stability framework will be more effective than a prescriptive one. This would allow a better balance of the objectives stated and allow the market to work more efficiently and competitively; • Oversight of the use of both local and offshore reinsurance by Insurers can be maintained through enhanced reporting requirements of APRA, and providing guidance to the Appointed Actuary in preparation of their LPS 320 advice and Financial Condition Report; and • Markets are becoming more global, and the Australian insurance industry needs to remain competitive and dynamic. A consistent approach should be taken between Life and General insurance frameworks, and a consistent approach should be taken between Onshore and Offshore reinsurers, in terms of risk assessment and mitigation.
Question 3	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.
Aon Response	<ul style="list-style-type: none"> • Aon do not support the proposed restrictions to the use of Offshore reinsurers. • Appropriate use of Offshore Reinsurers does not reduce the financial safety or stability of the market • Restricting the use of Offshore reinsurers is likely to increase the effect of future shocks in the local market, reduce competition, reduce market efficiency and innovation. • Insurers should demonstrate increased governance and risk assessment processes on the use of Offshore and related parties to ensure risks are appropriately identified and managed.

Question 4	APRA is considering responding to increasing use of offshore reinsurers by changing LPS 117. Are there other policy responses which APRA should consider?
Aon Response	<ul style="list-style-type: none"> • The general insurance industry has long embraced the offshore markets and had developed skillsets / professionals who specialise in working with offshore markets. It has led to a vibrant market as well as the opportunities to bring world class practices to Australia. • APRA could consider creating a new class of registered off-shore reinsurance which shows indication of a longer-term commitment to the Australian market and prudential supervisory, but with less onerous registration, capital and compliance requirements whilst they remain a "specialist" or smaller size participant. • The life insurers and the industry practitioners have embraced the Offshores. Now, for us to collectively restrict them through hard limits (rather than through proper regulation) may risk making our proudly principle-based supervisory system less relevant. • Whilst Aon supports the use of offshore reinsurers in a prudent way, we also see a distinction in offshore reinsurers actively conducting business in Australia compared to local insurers looking for alternate solutions offshore to meet their needs not being met by the local reinsurance market. Our view is that Insurers should be requesting offshore support (when the local reinsurance market is not sufficient), and not being solicited by the offshore markets directly. These decisions should be under the management and control of the local Insurer, and an offshore reinsurer actively engaging in this market should be demonstrating a commitment to this market, either via the registration approach we have suggested, or via local license application.

