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[redacted]
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
1 Martin Place (Level 12)
Sydney NSW 2000

Dear [redacted],

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

We refer to your letter of 4 March 2019 regarding the review by the Australian Prudential Regulation Authority (APRA) of *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117) and the use of offshore reinsurers.

We have adopted the terms and acronyms used in APRA's letter where appropriate.

Background

Your letter outlines APRA's concerns about the use of offshore reinsurance arrangements, especially in the Group Life market. These concerns can be summarised as follows:

- The increased use of offshore reinsurance creates the risk that APRA will not have adequate supervision of the life insurance market;
- The need to have robust supervision especially in relation to the superannuation market; and
- The risk that offshore reinsurers may not have a long-term perspective in the Australian market.

APRA's letter suggests that the asset concentration limits set out in Attachment A of LPS 117 be reduced. In addition, there would be restrictions placed on the use of related party reinsurers.

The life insurance market in Australia is increasingly being influenced by global trends. The majority of registered life insurers are not Australian owned (or will cease to be Australian owned in the near future). The five largest life insurers are controlled by offshore multinational institutions, or are soon to be controlled by offshore institutions (AIA/CBA, TAL Life/Suncorp, Zurich/Onepath, MLC and AMP). All registered reinsurers in Australian are foreign owned.

One of the reasons for this trend is that large multi-national insurers have a strong understanding of the long-term investment in life insurance that is required to ensure capital stability and sustainable profitability. We understand that this trend poses challenges for regulators, who must increasingly adopt a global outlook in order to regulate the local market. However, regulators must also be mindful that the imposition of regulatory and capital burdens may stifle investment appetite, with consequent impacts on competition and vitality in the local market. The reinsurance market, for all classes of insurance, is a global financial market which provides diversity and protection for the insurance market as a whole. This is recognised in international standards, such as the Insurance Core Principles adopted by the International Association of Insurance Supervisors (**IAIS**). These principles emphasise the importance of relationships between the domestic supervisor of the insurer and the international supervisor of the reinsurer (see paragraph 13.2 of the Insurance Core Principles).

In other key markets, for example in Europe and Japan, relevant standards focus more on the credit standing of the reinsurer rather than the jurisdiction in which it operates. In Japan where MetLife Inc. has a substantial local business, there are effectively no restrictions on offshore reinsurance.

Multi-national insurers, like MetLife's parent company, MetLife Inc., engage credit experts using sophisticated financial tools to analyse and monitor the counterparty risk associated with each reinsurance relationship.

Due to the significant retrocession by local reinsurers to offshore parent companies, we view local reinsurers as essentially branches of their global parent company. The appetite of local reinsurers is subject to the changing view of their parent company. As demonstrated in recent years, the existence of an APRA-regulated local office does not guarantee consistency of appetite nor service to local insurers. In 2013-14, some reinsurers withdrew their support for all or part of the Australian market, reducing reinsurance capacity and leading local insurers to rely more on the international market. The offshore reinsurance market was vital during this period to replace the capacity void created by the short-term approach of some local reinsurers.

Benefits of offshore reinsurance

MetLife considers that the benefits of offshore reinsurance include the below.

1. *Capacity*: Offshore reinsurers increase capacity in our market. We view this additional capacity as critical in our local market due to the unpredictability of local reinsurers. Local insurers continue to experience materially varying appetites from local reinsurers dating back to 2013. This has limited the options for local insurers in ceding certain pieces of business and added uncertainty regarding the availability of long-term reinsurance for certain benefit types.

2. *Greater access to competitive terms*: The existence of offshore reinsurance terms in our market has meant greater access to competitive terms for our clients. The offshore market has an increased ability to diversify (longevity/mortality) and offset exposures in other markets providing capital benefits for them.

3. *Improved member outcomes*: Offshore reinsurers are more open to providing a greater degree of delegation to the fronting insurance market. This has led to improved customer outcomes via better cycle times and responsiveness for claimants and underwriting applicants.

4. *Global thought leadership*: While local reinsurers are branches of global corporations, we gain more direct access and insights to the global marketplace via our interactions with offshore reinsurers. Having more direct exposure to the global marketplace continues to help shape our strategy on product, service and technological innovation.

APRA's proposed changes

APRA has asked for comments on the proposal to reduce the asset concentration limit for offshore reinsurers as summarised in the table below:

	Current	**Proposed**
Insurer - Offshore reinsurance	• *Counterparties graded 1-3*: The greater of 5% of VAF, and 25% of capital base per entity. • *Lower graded counterparties*: The greater of 2.5% of VAF, and 12.5% of capital base per entity.	• *Counterparties graded 1-3*: The greater of 5% of VAF in aggregate, and 25% of capital base in aggregate. • 2.5% of VAF limit per entity. • *Lower graded counterparties*: The greater of 2.5% of VAF, and 12.5% of capital base in aggregate.
Insurer - Related entity reinsurance	• No express limit, but if related entity is offshore - as per above.	• Up to 12.5% of VAF, subject to APRA agreement.
Reinsurer - Offshore retrocession	• *Related entity counterparties graded 1-3*: 50% of VAF, subject to APRA agreement. • *Counterparties rated lower:* Do not generally qualify for concessional treatment.	• Unchanged.

APRA's letter acknowledges that, historically, offshore reinsurance has been utilised to cede niche risks that cannot be placed locally (e.g. catastrophe and pandemic risks). By enforcing an aggregated 5% rule on all offshore reinsurance, offshore reinsurance will effectively be limited to those niche risks. Even to cover these risks, a 5% limit may, longer term, be insufficient to adequately reinsure these risks.

Specialist reinsurers have concessional treatment in relation to offshore retrocession under LPS 117. Under sub-paragraph 29(a) of LPS 117, reinsurers may retrocede up to 50% of VAF to offshore reinsurers. MetLife submits that insurers should be permitted to reinsure offshore to related parties to the same extent as reinsurers, subject to APRA agreement. The conditions for APRA agreement could reflect those used for use of non-APRA regulated reinsurers by general insurers (see *Prudential Practice Guide GPG 245 Reinsurance Management Strategy*).

MetLife submits that the use of group captive reinsurers be recognised in the life insurance prudential framework, as is the case in general insurance (see *Prudential Standard GPS 230 Reinsurance Management*) and that the proposed limit of 12.5% of VAF is too restrictive in the context of related captive reinsurers. Captive reinsurers can be used by large global insurers to reduce risk and gain efficiencies from economies of scale. As they are related parties, APRA can maintain regulatory oversight via the Australian entity and participate in supervisory colleges in the parent's home market.

APRA's letter canvasses the possibility that LPS 117 formalises arrangements for risk mitigating strategies such as collateral trusts by including them as an Eligible Collateral Item which would reduce the asset concentration risk charge. Collateral trust arrangements can be effective in reducing cross-jurisdictional and enforcement risk. MetLife supports formalising such arrangements as a risk mitigant when ceding business to non-APRA regulated reinsurers. MetLife gained approval from APRA to utilise a collateral trust arrangement in 2017, subject to a limit of VAF. If the conditions for such arrangements were formalised, it would create more certainty for insurers and efficiency for APRA.

We recommend that collateral trust arrangements which meet the conditions required by APRA should operate to increase the permitted exposure to offshore reinsurers.

APRA's letter asks for stakeholder comments on other forms of mitigation strategies. Withheld funds arrangements are arrangements under which the insurer can withhold premiums that would otherwise be payable as part of the regular settlement of reinsurance premiums and reinsurance claims. Funds withheld arrangements can be more protective of the interests of policyholders relative to secured collateral or other security interest, as they involve the insurer retaining sole and absolute possession of the assets in question. This is to be compared with other security interests in which the reinsurer also has a proprietary interest.

MetLife therefore recommends that APRA consider the use of withheld funds arrangements as a risk mitigant, which would operate to increase the permitted exposure to offshore reinsurers.

Conclusion

APRA comments that its concerns arise chiefly from offshore reinsurance in the group life market. The group life market faces unique challenges arising from the wholesale nature of the market. Gaining new business creates the need for capital commitments in a relatively short timeframe. As consolidation in the superannuation sector increases pace, the need for insurers to have flexible capital options will become even greater. In addition, the whole industry is facing operational and economic changes caused by the Government's Protecting Your Super Package. We encourage APRA to turn its mind to the risks faced by these market challenges when reviewing LPS 117.

We would be happy to meet with you to discuss the comments made in this letter or provide any further information.

Yours sincerely,

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Chief Executive Officer
MetLife Insurance Limited