RESPONSE PAPER

Revisions to Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge

8 April 2021

Disclaimer Text

While APRA endeavours to ensure the quality of this publication, it does not accept any responsibility for the accuracy, completeness or currency of the material included in this publication and will not be liable for any loss or damage arising out of any use of, or reliance on, this publication.

© Australian Prudential Regulation Authority (APRA)

This work is licensed under the Creative Commons Attribution 3.0 Australia Licence

(CCBY 3.0). This licence allows you to copy, distribute and adapt this work, provided you attribute the work and do not suggest that APRA endorses you or your work. To view a full copy of the terms of this licence, visit https://creativecommons.org/licenses/by/3.0/au/

Contents

Executive summary 4

Glossary 5

Chapter 1 - Introduction 6

Chapter 2 - Concentration limits for reinsurance assets 10

Chapter 3 - Measurement of limits and definition of stressed reinsurance assets 13

Chapter 4 - Treatment of risk mitigants 16

Chapter 5 - Next steps and consultation 25

Executive summary

APRA is proposing revisions to *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117). These revisions seek to strengthen the standard to respond to prudential concerns from the increased use of offshore reinsurers, and improve clarity on key definitions.

To support the safety and resilience of the financial system and individual entities, it is important that APRA has adequate oversight of the markets it regulates. In December 2017 and March 2019, APRA communicated its concern that the increased use of offshore reinsurers could reduce APRA's oversight, putting at risk APRA's ability to effectively supervise the prudent operation of the life insurance industry and hence the protection of policyholders.

Of particular concern is the increasing amount of group life insurance which is being placed with offshore (rather than domestic) reinsurers, given the importance of group life reinsurance to the provision of insurance through Australia's superannuation system.

Proposed revisions

To address these concerns, APRA is proposing revisions to existing restrictions on exposures to offshore reinsurers in LPS 117 to further mitigate the risk presented by this growth in use of offshore reinsurers. These revisions include the introduction of an aggregate limit on exposures to offshore reinsurers and restrictions on the recognition of risk mitigants in certain circumstances.

These proposals have been informed by an initial round of consultation conducted in 2019. APRA received diverse feedback during this consultation, with submissions highlighting a wide range of risks and benefits associated with the use of offshore reinsurers. APRA's proposed revisions consider stakeholder feedback and take a balanced approach that aims to ensure there are appropriate limits on the use of offshore reinsurers, while continuing to enable their participation in the Australian market.

APRA is also using this review as an opportunity to introduce a number of enhancements and updates to the standard. These aim to make the standard more practical for use by insurers by providing clarity on key definitions and better facilitate the use of risk mitigation techniques where appropriate.

This review is running concurrently with APRA's AASB 17 Insurance Contracts (AASB 17) implementation and Life and General Insurance Capital Standards (LAGIC) updates. Given the nature of the proposed changes to LPS 117, APRA has chosen to address these matters independently and is carefully managing the interlinkages between these reviews.

Consultation

APRA seeks feedback on the draft prudential standard LPS 117 which accompanies this Response to Submissions paper by 25 June 2021.

Glossary

AASB 17	AASB 17 Insurance Contracts
ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
ARC	Asset Risk Charge
ACRC	Asset Concentration Risk Charge
ICAAP	Internal Capital Adequacy Assessment Process
LAGIC	Life and General Insurance Capital Standards
Life Act	Life Insurance Act 1995
PCA	Prescribed Capital Amount

Chapter 1 - Introduction

1.1 Background

In recent years, APRA has observed increased use of offshore reinsurers by life companies, which creates risks that need to be carefully managed. APRA is responding to this emerging risk by reviewing the existing limits on exposures to offshore reinsurers in LPS 117.

Reinsurance is a fundamental part of the life insurance industry. Given the important role reinsurers play within the life insurance market, and because reinsurance can be considered an alternative to capital, it is important that APRA has an appropriate level of oversight over the reinsurance arrangements used in order to promote financial safety and stability and hence protect policyholders.

Offshore reinsurance

Under the *Life Insurance Act 1995* (Life Act), foreign life insurance companies that want to operate in Australia are required to establish an Australian subsidiary or, where eligible, an Australian branch that complies with the Life Act and APRA prudential standards. This includes foreign life insurance companies that predominantly write inwards reinsurance business.

In some circumstances, Australian life companies are able to obtain reinsurance from offshore reinsurers that do not operate in Australia. LPS 117 exposure limits for such offshore reinsurance arrangements are considerably lower than the limits for other reinsurance arrangements.

APRA defines offshore reinsurers as reinsurers that are not registered under the Life Act and therefore are outside of APRA's regulatory remit. APRA-approved offshore related parties, including appropriate retrocessionaires of specialist reinsurers, have been carved out of the scope of this review because APRA has a greater level of oversight of these entities.[1]

APRA actively supervises all life insurers (including reinsurers) which are registered under the Life Act. APRA's objective is to ensure that under all reasonable circumstances, financial promises made by life insurers to policyholders are met: oversight of both primary writers and reinsurers is vital to fulfilling this mandate. When primary writers place risk with offshore reinsurers, APRA is not able to directly oversee or supervise the reinsurer receiving this risk. If the use of offshore reinsurers continues to increase, the portion of the market over which APRA has direct oversight will be reduced.

Offshore reinsurers provide important benefits to the local industry; they can be a source of extra reinsurance capacity in the domestic market and are an avenue for direct insurers to

[1] *Prudential Standard LPS 001 Definitions* (LPS 001) defines a specialist reinsurer as a statutory fund of a registered life company where all policies referable to the fund are reinsurance policies and none of the policies are owned by a related entity of the life company. Appropriate retrocessionaire is defined in paragraph 29 of LPS 117.

access competitively priced reinsurance support for innovative product designs. APRA has been mindful of both the risks and benefits of offshore reinsurers throughout this review.

1.2 Consultation process

APRA communicated it would be reviewing LPS 117 in a letter to industry on 15 December 2017.[2] APRA undertook an information gathering exercise in 2018 that captured reinsurance arrangements and arrangements that have the effect of reducing an insurer's Asset Concentration Risk Charge (ACRC) as it pertains to reinsurance. This information helped establish the scope of this review and development of preliminary policy proposals.

APRA initiated its first round of consultation with the release of an industry letter in March 2019.[3] This letter outlined prudential concerns relating to increased use of offshore reinsurers and the options being considered to respond to these concerns. This letter also detailed proposed revisions to improve the effective operation of the standard.

APRA received 15 submissions in response to the consultation letter. Non-confidential submissions are available on APRA's website.

Some of the issues covered in this review, particularly the participation of offshore reinsurers in the Australian life insurance market, have commercial impacts that differ according to the nature of the industry participant's business. Accordingly, APRA has received diverse feedback on its proposals.

1.3 Balancing APRA's mandate

When developing policy proposals, APRA seeks to balance the objectives of financial safety, financial stability and efficiency, competition, contestability and competitive neutrality.

The March 2019 letter asked stakeholders to comment on issues APRA should consider to achieve this balance. The wide range of views informed the revised proposals set out in this consultation package, that aim to effectively manage prudential risks associated with offshore reinsurers, while still enabling the benefits of their participation in the Australian market.

Competition

Some stakeholders submitted that APRA's proposal would reduce competition and therefore result in worse outcomes for policyholders. Submissions highlighted that offshore reinsurers

---

[2] APRA, Review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge (Industry Letter, December 2017) available at: https://www.apra.gov.au/sites/default/files/review-of-lps-117-15-dec-2017_0.pdf

[3] APRA, Offshore reinsurers and the review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge (Industry Letter, March 2019) available at: https://www.apra.gov.au/sites/default/files/letter_offshore_reinsurers_and_the_review_of_prudential_standard_lps_117_capital_adequacy_asset_concentration_risk_charge_v1.pdf

bring competition and innovation to the local market and that restricting them could result in increased costs and reduced availability of reinsurance support for certain product designs.

The revisions are designed to ensure the use of offshore reinsurers remains within prudent levels, and do not stop offshore reinsurers from entering the market as an APRA registered entity. No changes are being proposed to the existing requirements for establishing an Australian subsidiary.

Some respondents suggested APRA's interpretation of competitive neutrality should focus on 'creating a level playing field'. APRA's interpretation of the concept of competitive neutrality is that government business activity should not have a competitive advantage over private sector competitors due to public ownership.[4] A level playing field forms part of APRA's considerations in the context of competition impacts.

PRIMARY OBJECTIVES	
Financial safety ⬆	Financial system stability ⬆
Improved: The proposals responding to offshore reinsurers will allow APRA to maintain an appropriate level of supervisory oversight of the life insurance industry, supporting APRA's ability to promote financial safety.	**Improved**: The proposals responding to offshore reinsurers improve financial system stability as they maintain this capacity within prudent levels, capping the risk of excessive reliance which could otherwise lead to instability in a stress scenario.

[4] For a fuller explanation of how APRA considers the various components of its mandate, see APRA's objectives (Information Paper, November 2019).

OTHER CONSIDERATIONS	
Efficiency ⬆	**Slightly improved**: Making the regulatory requirements clearer will reduce the need for industry and APRA to clarify, and sometimes amend, requirements on a case by case basis (which can be a process that takes time and imposes regulatory burden).
Competition ⬇	**Slightly reduced**: The revisions concerning offshore reinsurers may slightly reduce competition within the reinsurance market. The proposals aim to ensure the use of offshore reinsurers is capped within reasonable prudent limits. This will help to ensure that prudential risks are mitigated while benefits brought by offshore reinsurers are still realised.
Contestability ⬌	**No change**: The proposed revisions do not alter contestability in the market, as they do not affect the ability of new entrants to enter the market by establishing an Australian life insurance subsidiary.
Competitive Neutrality ⬌	**No change**: The revised standard does not create an advantage for public sector entities relative to other market participants.

Chapter 2 - Concentration limits for reinsurance assets

The Asset Risk Charge (defined in *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge*) is calibrated for statutory funds whose investment assets and credit exposures are well diversified. Additional capital is required if a fund has concentrated exposures. The ACRC is the amount by which investment assets and credit exposures exceed specified limits. Changes in the life insurance market have prompted APRA to review the limits relevant to reinsurance assets. This chapter sets out APRA's response to submissions on these proposed revisions.

2.1 Exposures to offshore reinsurers

The March 2019 letter outlined APRA's proposal to include a requirement for exposures to offshore reinsurers with a counterparty grade of 1, 2 or 3 to be measured in aggregate. This aggregate exposure was proposed to be subject to a limit set as the greater of 5 per cent of the value of the assets of the statutory fund (VAF) and 25 per cent of capital base, with a 2.5 per cent of VAF limit on individual offshore reinsurers. Aggregate exposures to offshore reinsurers with a lower counterparty grade would be subject to a limit half this size. The collective exposure to offshore reinsurers would also be subject to a 5 per cent of VAF limit.

Comments received

A number of submissions viewed the aggregate and individual offshore reinsurer limits as too restrictive. Respondents highlighted possible negative impacts to policyholders, particularly in circumstances where there is a contraction in local reinsurance capacity.

One respondent stated that the proposals discourage risk sharing across borders which could in turn intensify the impacts from a shock to the Australian market. Some respondents indicated that the proposals may not always be sufficient to allow full capital relief for reinsurance of catastrophe and pandemic risk.

However, a number of respondents supported the introduction of the aggregate limit. Some submissions took a more conservative stance than APRA's proposed option, questioning whether non-APRA regulated entities should provide any capital relief for insurers that reinsure with them. One submission recommended that the proposal be structured to not allow insurers to have an exposure to an offshore reinsurer above the new limit by managing the exposure with collateral.

APRA's response

Having considered stakeholder feedback, APRA has increased its proposed limits to provide additional flexibility while still ensuring the majority of reinsurance arrangements remain with APRA-authorised reinsurers.

APRA is proposing to refine the approach to:

- introduce a 12.5 per cent of VAF aggregate limit for offshore reinsurers (rather than 5 per cent, as initially proposed); and

- maintain the existing individual offshore reinsurer limits of 5 per cent of VAF for counterparties with counterparty grade 1, 2 or 3, and 2.5 per cent of VAF for lower grade counterparties (rather than reducing the individual limit for all offshore reinsurers to 2.5 per cent, as initially proposed).

The adjusted proposal allows APRA to maintain adequate oversight of the operation of the Australian life insurance market for the protection of policyholders, while providing added flexibility for insurers to access offshore reinsurance within prudent limits.

2.2 Related party exposures

In the March 2019 letter, a 12.5 per cent of VAF limit for exposures arising from reinsurance arrangements between a life company and an offshore related party was proposed. Access to this higher limit, compared to the lower limit for other (unrelated) individual offshore exposures outlined above, would be subject to an APRA approval process.

This proposal was important in the context of a changing life insurance market. Multiple acquisitions and mergers in the life insurance industry which have shifted the market to being largely foreign owned, with a consequent increase in exposures to offshore related parties.

Comments received

A number of respondents expressed general support, seeing it as a tool to allow insurance groups to better manage overall risk exposures. Some submissions suggested a higher limit. One submission recommended this new limit be increased to align with limits available to specialist reinsurers (50 per cent of VAF).

In contrast, a number of respondents did not support this proposal. Some submissions argued it could lead to further exposure to and reliance on multinational entities, making the Australian financial system more vulnerable to global events. Some submissions suggested this proposal contradicted APRA's offshore reinsurer proposals and highlighted the potential for it to reduce the local reinsurance market and destabilise the market in the long term.

APRA's response

APRA is proposing to retain the planned 12.5 per cent of VAF individual limit for offshore related parties (where approved by APRA). In response to feedback, APRA proposes that any such related exposures should also be counted against the aggregate limit for offshore reinsurers.

APRA's view is that this proposal will not materially increase the Australian financial system's vulnerability to global events. Any marginal increase of this risk is outweighed by the benefits of the proposal.

Respondents requested further information on APRA's decision to calibrate this limit at 12.5 per cent of VAF. The calibration of the limit was determined using informed judgement about

potential risks that could arise from exposures to different counterparties. The limit was also set to be proportionate to other existing limits within the standard.

It is not appropriate to increase this limit so that it is in line with the limit for appropriate retrocessionaires (50 per cent of VAF). This higher limit is specific to business that is retroceded (not reinsured) by specialist reinsurers to an appropriate retrocessionaire. The different nature of the arrangement means that different limits are appropriate.

Submitters requested further guidance on APRA's process for approving a related counterparty for access to this higher limit. The process will be similar to that used to assess the suitability of an appropriate retrocessionaire. The assessment will consider a number of factors such as financial strength and prudential soundness, the level of prudential supervision, group arrangements and also the nature of the relationship between the APRA regulated entity and the related counterparty.

To improve risk sensitivity, APRA proposes that under this new limit downgrades would be treated in the same way as for appropriate retrocessionaires, with the limit scaled down over 2 years.

The draft standard uses 'affiliated entity' when referring to this limit.

2.3 Other amendments

APRA is proposing to improve risk sensitivity for the 25 per cent of VAF limit for reinsurance with APRA-authorised insurers and reinsurers, by reducing this limit for lower rated counterparties. The existing limit would only apply for counterparty credit grades of 1-3. If the registered life company had a counterparty grade of 4-7 the limit of 2.5 per cent of VAF for 'other assets' would apply.

Downgrades would be treated in the same way as for appropriate retrocessionaires, with the limit scaled down over 2 years.

Chapter 3 - Measurement of limits and definition of stressed reinsurance assets

This chapter sets out APRA's response to submissions on the proposal to amend how limits are measured and the definition of stressed reinsurance assets.

3.1 Measurement of limits

The March 2019 letter stated that APRA was considering changing the reinsurance asset limits to be expressed solely as a percentage of the capital base. How the limits are currently expressed creates issues such as limits differing depending on the type of business held in the fund.

Comments received

Submissions were generally against the proposal to set concentration limits using solely the capital base. The strongest argument against was that in adverse circumstances the concentration limit would become more punitive; if claims experience is poor, reinsurance assets increase while the capital base reduces. Insurers would therefore have to keep reinsurance exposures well within the limits in normal conditions, to ensure sufficient headroom in case of very adverse claims experience.

Some submissions indicated support for the ring-fencing of participating assets for the purpose of calculating the limits.

APRA's response

Following consideration of feedback received, APRA is not proposing to express reinsurance exposure limits solely as a percentage of capital base. However, APRA is proposing other revisions to address concerns with the structure of the current limits.

Statutory funds with significant amounts of participating and/or discretionary investment business can have a much larger VAF-based limit relative to their capital base than funds containing only risk business and/or non-discretionary investment business. This is because many of the asset risks for such funds (other than reinsurer default risk) can be mitigated by reducing future policyholder bonus and crediting rates. For funds with participating and/or discretionary investment business as well as risk business, the current VAF based limits can allow excessively large reinsurance exposures relative to the size of the capital base.

APRA is now proposing a modified form of VAF as the basis for setting the limits for reinsurance exposures. It is proposed that for reinsurance assets, VAF be revised to be defined as:

- the assets of the fund as reported in the statutory accounts (with the exception of reinsurance assets which are measured on a stressed basis);

- less assets backing participating traditional business and participating unbundled investment business (gross policy liabilities, policy owners' retained profits, and shareholders' retained profits);
- less assets backing gross policy liabilities for non-participating benefits with entitlement to discretionary additions.

APRA proposes to also introduce a capital base component to the limits so that insurers with a relatively large capital base are able to exceed the relevant VAF limit. The capital base limits proposed are proportional to those that currently exist in the standards for other types of assets.

While exposure limits to registered life companies can exceed 100 per cent of the capital base under the existing and proposed standard, APRA does not necessarily view this as imprudent because, in the event of reinsurer default, a substantial portion of the exposure should be recoverable. APRA expects insurers to make their own assessments of appropriate limits in accordance with their risk appetite when managing their reinsurance arrangements and not rely only on the LPS 117 limits.

3.2 Stressed reinsurance assets

3.2.1 Investment risk sharing

APRA's March 2019 letter outlined a deficiency in how LPS 117 accounts for reinsurance arrangements that share investment risk due to the ACRC calculations only including insurance stresses and no asset stresses. If there is investment experience sharing in an arrangement, future counterparty exposure could increase under adverse investment conditions.

Comments received

Some respondents considered it reasonable that APRA seek to address this potential deficiency in the standard. Other respondents thought this proposal had limited benefits. One respondent expressed the view that this proposal could make the calculation unnecessarily complicated and that its practical application was unclear.

APRA's response

While reinsurance arrangements which transfer asset risks are fairly uncommon, redefining stressed reinsurance assets to include asset stresses as well as insurance stresses is a logical change to ensure that the ACRC accurately accounts for exposures arising from reinsurance arrangements.

APRA is proposing that the measurement of stressed reinsurance assets remain unchanged (insurance stresses only), except in the case where the value of the reinsurance asset increases in response to a fall in the value of the fund's assets under equity, property, credit spreads, currency or default stresses. In this situation, the value of the stressed reinsurance asset would be calculated as the greater of the current value and an alternative value. The alternative value would be determined under a combination asset and insurance stress, as

the amount by which combination-stressed policy liabilities increase when they are determined gross of reinsurance.

Real interest rate and expected inflation stresses have been excluded from asset stresses as these affect most reinsurance assets without necessarily transferring asset risk. In a typical reinsurance arrangement, the movement in the value of the reinsurance asset in response to these stresses is not dependent on the investment assets held by the life company. If the company matches its investment assets to its net policy liabilities, the value of reinsurance assets will remain roughly constant as a proportion of total assets in the post stress environment.

3.2.2 Drafting clarification

Revisions are proposed to clarify that when determining stressed policy liabilities gross of reinsurance, stress margins and the diversification factor used to derive the adjusted stress margins must be determined on a gross of reinsurance basis. They cannot be assumed to be the same as in the net of reinsurance scenario. This clarification is proposed to ensure the original intent of the standard is clear.

Chapter 4 - Treatment of risk mitigants

This chapter summarises input received on options to revise the treatment of risk mitigants under LPS 117 and details APRA's proposed revisions.

4.1 Summary of submissions on treatment of risk mitigants

The March 2019 letter advised that APRA was considering options to tighten and refine the definitions of risk mitigants in LPS 117, including whether collateral trusts should be permitted under the standard. The letter indicated that limiting recognition of mitigation for capital purposes was being considered. The possible introduction of governance and oversight requirements for risk mitigants was also outlined. Feedback received in submissions is summarised below.

Definition and use of risk mitigants

Some respondents submitted that the current definitions of risk mitigants is clear and adequate. Other respondents recommended APRA expand the current definitions to include letters of credit, funds withheld arrangements and collateral trust structures. Some recommended that APRA should make the definitions consistent with the definitions in *Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge* (GPS 117) and *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge* (GPS 114). One respondent submitted that certain credit enhancement structures are currently being explored by market participants due to the restrictive definition of eligible collateral and this should therefore encourage APRA to accelerate expansion of the definition of risk mitigants.

Collateral trusts

Submissions contained recommendations on how collateral trust structures should be considered under the standard. There was recognition of the complexities of interactions between collateral trusts and the Life Act, and that any outcome needs to ensure there is a level playing field. The Life Act prevents the mortgage or charge of an asset of a statutory fund, such as would be required in setting up a collateral trust, other than in very limited circumstances. Since offshore reinsurers are not subject to these restrictions they are likely to find it easier than APRA-authorised reinsurers to provide collateral via a collateral trust.

Governance of mitigants

Respondents recognised the importance of an appropriate level of governance and oversight of risk mitigants. It was recommended that the level of governance and oversight be commensurate with complexity and any new governance requirements be included within existing requirements (for example, within the Internal Capital Adequacy Assessment Process (ICAAP)).

Two submissions recommended APRA publish 'template forms' of collateral instruments that it has approved. A number of respondents expressed a view that governance and oversight proposals should not require independent legal advice.

4.2 Proposed revisions to the treatment of risk mitigants

4.2.1 Overview

Risk mitigants are an important element of an insurer's approach to managing credit risk arising from reinsurance arrangements. The current standard outlines how the impact of applying the asset concentration limits can be reduced by the use of collateral and guarantees. Market developments have led to this section of the standard no longer being fit for purpose.

APRA's main objective is to enhance clarity of requirements and expectations. By clarifying and refining the treatment of risk mitigants under LPS 117, it is expected that insurers will be able to utilise mitigation features in a more efficient manner.

While focus has been on risk mitigation techniques used in the context of reinsurance exposures, some proposed changes affect assets other than reinsurance assets.

APRA has established three categories of risk mitigants to help communicate the proposed revisions. These categories are not explicit in the draft standard.

- Collateral-type mitigants - mitigants that take the form of assets being a substitute for the exposure to a reinsurance asset.
- Guarantee-type mitigants - mitigants that allow security for a reinsurance asset to be provided by a third-party guarantor.
- Netting arrangements - arrangements where the net exposure to the reinsurance asset is reduced through contractual terms in the reinsurance treaty altering the underlying premium and claims cash flows, or other payments made or received so as to reduce the reinsured's exposure to the reinsurance asset.

A list of the main types of mitigants within each of these categories can be found in the following table, providing common terminology to facilitate the consultation process.

Table 1. Commonly used risk mitigants

Category	Title	Description
Collateral-type mitigants	Collateral arrangement	A registered charge or mortgage or other legally enforceable security interest in or over an eligible collateral item (including custodial deposit arrangements where the custodian acts exclusively on the instruction of the reinsured).
	Collateral trusts	An arrangement where assets are housed in a trust on behalf of the reinsured as security for the reinsurer's obligations under the reinsurance contract.
Guarantee-type mitigants	Guarantee	A guarantor agrees to meet the obligations of the reinsurer to the cedant in the event that the reinsurer defaults.
	Letter of credit	An arrangement under which a reinsured can call upon the third party issuer to make payments required from a reinsurer where

Category	Title	Description
		the reinsurer fails to pay an amount required under the reinsurance contract, typically provided by an ADI.
Netting arrangements	Premium deferral	Arrangements that allow the insurer to defer the payment of premiums, either in the normal course of business or as a means of avoiding an ACRC. It has the effect of reducing the net counterparty exposure to the reinsurer.
	Funds withheld	A portion of reinsurance premiums is withheld, typically equal to the reinsurer's expected share of expected incurred claims. A separate funds withheld liability is recorded and has the effect of reducing the net reinsurance asset.
	Deposit back	The reinsurer invests the assets backing the reinsured policy liabilities with the cedant. It differs from funds withheld in that the deposit back is funded by the reinsurer, again having the effect of reducing the net reinsurance asset.
	Modified coinsurance	Reinsurance premiums are paid the normal way, but reinsurance recoveries are based on changes to policy liabilities or incurred claims reserves, rather than paid claims.
	Other netting arrangements	While most of the preceding arrangements include a form of netting, other forms of netting reinsurance assets and liabilities are possible, resulting in a reduction to the net exposure to a reinsurer.

The following sections provide further details of the proposed revisions to the standard.

4.2.2 Collateral-type mitigants

Key features

Collateral-type mitigants are arrangements that exhibit the following features.

- As a substitute for a reinsurance asset, the reinsured under a reinsurance contract is given security over a defined pool of assets, increasing the level of security in respect of the reinsurance asset (fully, or in part).
- Security that can take different forms, such as eligible collateral items being held in a trust, a mortgage or some other security interest over eligible assets.
- Assets that normally comprise cash and high-grade bonds or other debt obligations.
- Assets held under the collateral arrangement must specify to which statutory fund of the reinsured the assets are referable.
- Governance arrangements that would typically include a review of the adequacy of the secured assets from time to time and require a top-up or release to maintain a given level of security.

- Comprise a security interest over eligible collateral items or a trust holding such items for the benefit of the reinsured.

Security of arrangements

The current standard requires collateral to take the form of a registered charge, registered mortgage or other legally enforceable security interest in, or over, an eligible collateral item.

The draft standard also recognises collateral against a reinsurance asset if it is held in a collateral trust that satisfies certain conditions.

Life Act requirements

Under section 32 and 48 of the Life Act, assets of a statutory fund must be administered, invested and otherwise dealt with in the interest of policyholders of that statutory fund (viewed as a whole). Using assets of a statutory fund to preference the claims of particular policyholders ahead of the interests of policyholders as a whole is not consistent with a life company's obligations. Additionally, subsection 38(3) of the Life Act restricts life companies from mortgaging or putting a charge on assets of a statutory fund. Siloing assets in a trust for the benefit of a third party is not a permitted use of statutory fund assets under subsection 38(2) of the Life Act.

The aforementioned requirements of the Life Act have implications for how and when collateral trust structures can be used, particularly for APRA-authorised reinsurers. To post collateral in the form of a trust and comply with the Life Act, an APRA-authorised reinsurer would likely need to source the collateral assets from its general fund. This option is likely to be unattractive to the reinsurer.

Term-matching requirements

Presently LPS 117 requires an eligible collateral item to be held for the period that the underlying reinsurance asset is held. A life company needs to have a security interest over an eligible asset whose term is not less than the term of the reinsurance asset.

Given the long-term nature of life reinsurance, it may be impractical to source eligible assets that satisfy this term-matching requirement. The draft standard recognises eligible collateral items held within a collateral trust provided the reinsurer maintains the trust in place until the reinsurance arrangement is terminated and all of the reinsurer's obligations have been discharged.

Since collateral trust agreements typically allow for reinvestment of assets when they mature, assets held in the trust do not themselves need to satisfy the term-matching requirement. The draft standard specifies that life companies must address the risks associated with this change in their ICAAPs.

Legal jurisdiction requirements

To lessen legal and operational risks, the draft standard includes a requirement for collateral arrangement contracts to be governed by the law of an Australian state or territory, except where they apply exclusively to overseas statutory funds. Additionally, where an agreement provides for arbitration, the seat of arbitration must be a capital city of a state or territory of Australia.

Top-up arrangements

Depending on changes in the value of the underlying reinsurance asset and the collateral assets, the adequacy of a collateral arrangement as a substitute for the underlying reinsurance asset could change over time. Where the value of the collateral arrangement diverges from the value of the underlying reinsurance asset, there is a risk that the collateral arrangement will no longer be adequate, resulting in an ACRC arising.

Amendments are proposed to the standard to ensure this risk is addressed in the ICAAP. The amendments include a requirement to specify the method for determining the value of assets to be held under the collateral arrangement and how to deal with any shortfall or excess. Adjustments to the required collateral amount must be determined by the Appointed Actuary of the reinsured life company.

4.2.3 Guarantee-type mitigants

Key features

Guarantee-type mitigants exhibit the following features.

- Security that is provided by a third party in the form of a letter of credit or demand guarantee. APRA is proposing that guarantees in respect of reinsurance assets must be provided by an APRA-regulated ADI with a counterparty grade of 1, 2 or 3.
- An asset must be explicitly, unconditionally and irrevocably guaranteed for the remaining term of the underlying asset. For guarantees relating to reinsurance assets where this would be impractical APRA proposes that:
  - The guarantee must be effective for a period of at least five years.
  - If the reinsurer is put into administration during the guarantee period, the reinsured must be able to draw-down to meet the reinsurer's share of incurred claims, not solely the reinsurer's share of claim payments due in the guarantee period.
  - The guarantee may include a condition assigning claims to the guarantor provided that claims by the reinsurer's policyholders rank ahead of the guarantor's assigned claims.
- Guarantees cannot be provided by the life company's parent or related entities.

Guarantee and guarantor requirements

To provide greater clarity on APRA's expectations regarding guarantee-type mitigants, the draft standard includes a number of specific requirements.

Additionally, it is proposed that LPS 117 be amended to require guarantees in respect of reinsurance assets to be provided by an APRA-regulated ADI with a counterparty grade of 1, 2 or 3. This aligns to GPS 117 requirements for guarantees relating to reinsurance recoveries due from non-APRA-authorised reinsurers.

Nature of guarantees

Revisions included in the draft standard specify that when a life company notifies a guarantor that an amount due and payable under a reinsurance contract has not been paid, the guarantor must pay the amount[5] within five business days.

The draft standard also specifies that if the reinsurer is put into administration during the guarantee period, the guarantor must cover not only outstanding reinsurance claim payments, but the reinsurer's share of claims that have been incurred but not paid and any unearned reinsurance premiums.

Term-matching requirements

Presently a guarantee is required to be explicit, unconditional, irrevocable and enforceable for the remaining term to maturity. The remaining term to maturity refers to the term of the asset being guaranteed. For reinsurance assets with an indefinite term, this is impractical.

GPS 117 specifies that where it is impractical for a guarantee that relates to reinsurance recoveries due from non-APRA-authorised reinsurers to be effective for the expected claim payment period, it must be effective for a period of at least 24 months and be renegotiable each year. This allows at least 12 months to identify alternative arrangements if the guarantee cannot be renegotiated.

Given the long-term nature of most life reinsurance arrangements, APRA is proposing that where it is impractical for the guarantee term to match the term of the reinsurance asset, the guarantee must be effective for a period of at least five years. At each anniversary the guarantee must automatically extend for a further term of 12 months until either the life company or guarantor gives notice that automatic extension will cease. This allows at least four years for a life company to identify alternative arrangements.

Substitution of counterparty

The existing standard provides for credit risk to be assessed using the counterparty grade of a third-party guarantor. Where higher ACRC exposure limits apply to counterparties with a higher credit rating[6], exposure to a lower-grade counterparty can be assessed against the higher limit by obtaining a suitable guarantee.

The draft standard includes revisions in respect of guarantees that meet the relevant requirements. These revisions allow life companies to treat an underlying asset that has been guaranteed as an exposure to the guarantor.

Treatment of the guarantee in the ACRC

To provide greater clarity on how a guarantee should be treated in the calculation of the ACRC, the draft standard includes revisions specifying that, where the guarantor is an APRA-regulated ADI, the guarantee exposure is assessed against the item (c) limit of Attachment A. This limit also applies to bank bills.

---

[5] Subject to a limit of the face value of the guarantee or letter of credit, less any prior draw-downs.

[6] For example, the individual offshore reinsurer limits of 5 per cent of VAF for counterparties with counterparty grade 1, 2 or 3 and 2.5 per cent of VAF for lower grade counterparties

Assignment of reinsurance claim to guarantor

APRA has recently observed guarantees which provide for the assignment of a claim under a reinsurance contract to the guarantor where a draw down occurs under the guarantee in relation to the claim.

As noted above, guarantees are generally required to be unconditional. However, revisions have been included in the draft standard to allow for a guarantee to provide for such an assignment as long as the guarantor's assigned claim is subordinate to the claims of all of the reinsurer's policyholders in any statutory fund in the winding up of the reinsurer.

4.2.4 Netting arrangements

Key features

Netting arrangements exhibit the following features.

- Typically, under a reinsurance agreement, there are timing differences between when premiums are paid and claims received. The magnitude of the exposure to a reinsurer, or the reinsurance asset, is affected by these timing differences. APRA is aware that various measures and practices are adopted and incorporated into reinsurance treaties to reduce the effect of these timing differences.
- Given that premiums typically exceed expected claims, one approach is to delay or defer the payment of premiums.
- The majority of mitigants in this category deal with mechanisms that effectively accelerate the recognition of claims, thereby reducing the effect of timing differences.
- Several mitigants in this category rely on the principle of being able to net off assets and liabilities in respect of the same reinsurer.
- In respect of funds withheld and deposit back arrangements, funds must be held by the reinsured who must have an enforceable contractual right to draw on the deposit to meet the reinsurer's liabilities.

Roll-off risk

Several mitigants in this category create a liability to the counterparty that can be netted against amounts owing from the counterparty. This results in a smaller net exposure to the reinsurer and thus a smaller counterparty risk. Considering different elements of the exposure to the reinsurer, it is possible that they will not always change in a consistent manner, resulting in a change in the net exposure to the reinsurer.

Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112) considers a similar concept which is defined as 'roll-off risk'. APS 112 defines this as the risk of a sudden material increase in an exposure(s) when short term obligations that have been netted against longer-term claims either mature, are rescinded or are generally no longer available to offset the obligation. APS 112 requires that an ADI's netting policy must include systems and controls for monitoring netting arrangements that should include monitoring and managing roll-off risk.

A similar concept to what is defined as roll-off risk in APS 112 occurs in life insurance. It occurs when liabilities to a reinsurer have a shorter term than amounts owing from a reinsurer, resulting in an increased net exposure. It is proposed that requirements for management of roll-off risk are included in LPS 117, similar to those in APS 112 for roll-off risk.

Inflating VAF

Some of the mitigants in this category have the effect of inflating both insurer assets and insurer liabilities by the same amount. This may occur with funds withheld or deposit back arrangements where reinsurance assets continue to be valued as if these amounts are owed to the cedant by the reinsurer with a corresponding funds withheld liability being shown on the liability side of the cedant's balance sheet. This has the unintended consequence of increasing VAF and subsequently the exposure limits in LPS 117. This is an undesirable outcome because there has not been any change in the net assets or capital base.

For the purpose of determining asset concentration limits for non-reinsurance assets, APRA is proposing to amend the definition of VAF to make it net of any reinsurance liabilities reported in the statutory accounts that are able to be netted against reinsurance assets. Similarly, asset concentration limits for reinsurance assets will be based on the stressed value of the assets less any liabilities to the reinsurer which satisfy netting requirements.

4.2.5 Limiting recognition of mitigation for capital purposes

The current standard does not place restrictions on how much the impact of applying the asset concentration limits can be reduced by using risk mitigants. The March 2019 consultation letter stated that APRA was 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.

Submissions contained a variety of views on this proposal. Common themes in the submissions were that any limit on recognition should be proportional to the applicable net exposure limit and that the limits should be set at different levels depending on risk mitigants.

Following further consideration, APRA proposes to only limit the recognition of risk mitigants for capital purposes when the counterparty is an offshore reinsurer. APRA is proposing an aggregate limit for the use of offshore reinsurers. This aggregate limit will only be effective at responding to APRA's concerns if limits are also applied to risk mitigants. While risk mitigants may limit exposure to counterparty risk, unlimited use of risk mitigants undermines the effectiveness of the limits in addressing the prudential concerns APRA has with offshore reinsurers.

It is proposed that a maximum of 50 per cent of a reinsurance asset held in respect of a reinsurance arrangement with an offshore reinsurer can be treated as an exposure to eligible collateral, guarantors or issuers of letters of credit.

The merit of extending this restriction to arrangements with offshore related parties is also being considered. APRA will use stakeholder feedback from this consultation to inform its view.

APRA's adopted approach is to propose limits for certain types of mitigants. Netting arrangements do not readily lend themselves to this approach due to calculation complexities. Nonetheless, APRA's expectation is that life insurers should not use netting arrangements to circumvent the limit.

It is also proposed that APRA be able to determine limits on recognition of risk mitigants in specific circumstances if deemed necessary.

Chapter 5 - Next steps and consultation

5.1 Timetable and transitional arrangements

Submissions on the proposals in this consultation package should be provided by 25 June 2021. Following consideration of feedback received, APRA expects to release a final standard by the end of 2021. Revisions made to LPS 117 will give rise to consequential amendments, particularly to LPS 114. Draft consequential amendments will be consulted on once the revised LPS 117 has been finalised.

Concurrent with this review, APRA is also reviewing how to integrate AASB 17 into the LAGIC framework. LPS 117 may be subject to minor revisions as part of the AASB 17 integration process. APRA is proposing revisions from this review and AASB 17 revisions to come into effect at the same time on 1 July 2023.

APRA will put in place appropriate arrangements to allow for an orderly transition to the revised standard, including insurer specific transition arrangements on a case by case basis. APRA is not intending to grandfather existing requirements in LPS 117.

Current adjustments and exclusions will cease to apply once the current standard is revoked. Insurers with adjustments or exclusions to the current standard are encouraged to discuss these arrangements with their responsible supervisor. APRA will only exercise its adjust or exclude powers where there are compelling reasons to do so.

Up until the time that the new standard is effective, APRA maintains the position it communicated in December 2017 and is not inclined to grant further discretionary approvals to allow entities to mitigate exposures to non-registered reinsurers for the purpose of calculating the ACRC. This does not apply when the non-registered reinsurer is a related party or appropriate retrocessionaire.

5.2 Request for submissions and cost-benefit analysis

APRA invites written submissions on the proposals set out in this paper and the draft standard. Written submissions should be sent to insurance.policy@apra.gov.au by 25 June 2021 and addressed to:

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

APRA requests that all interested stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any increases or decreases to the compliance costs incurred by businesses as a result of APRA's proposal.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: https://rbm.obpr.gov.au/.

Respondents are requested to use this methodology to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that entities would undertake regardless of regulatory requirements in their ordinary course of business.

5.3 Important disclosure requirements – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Requests for submissions to remain in confidence are to be clearly marked on the first page of the submission.

Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

APRA