



RESPONSE PAPER

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

March 2022

Disclaimer Text

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Executive summary

APRA has finalised updates to *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117) to strengthen requirements for the management of offshore reinsurance.

The finalised revisions to LPS 117 address prudential concerns arising from the increased prevalence of offshore reinsurance. The revisions aim to ensure APRA continues to have adequate oversight of the life reinsurance market, for the protection of policyholders. The key change is an adjustment to exposure limits in LPS 117 to ensure that the amount of risk placed outside of APRA's regulatory remit is within prudent levels. If these limits are exceeded, insurers are required to hold additional capital to reflect the increased risks associated with higher levels of offshore reinsurance.¹

Recognising both the risks and benefits brought by offshore reinsurers to the Australian market, APRA has focused on ensuring there are appropriate limits on the use of offshore reinsurers to manage risks, while not prohibiting their participation in the market altogether. The finalised revisions aim to balance the prudential risks associated with the use of offshore reinsurers with the benefits that they can provide.

Next steps

This paper outlines feedback received on the April 2021 draft of LPS 117 and APRA's response to this feedback.² While the offshore reinsurer revisions to LPS 117 are now finalised, feedback is being sought on minor draft updates to LPS 117 to reflect broader reforms to the insurance capital standards from the integration of AASB 17 Insurance Contracts (AASB 17) and LAGIC updates.

APRA is also making consequential amendments to *Prudential Standard LPS 114 Capital Adequacy Asset Risk Charge* (LPS 114) and to *Reporting Standard LRS 117 Capital Adequacy Asset Concentration Risk Charge* (LRS 117).

APRA invites written submissions on the AASB 17 and LAGIC updates to LPS 117 and consequential amendments to LPS 114 and LRS 117, which are set out in chapter 3. All other amendments to LPS 117 have previously been consulted on and are now considered final.

¹ The updated LPS 117 also includes a number of technical revisions to further clarify requirements on the eligibility and recognition of effective credit risk mitigation for capital purposes.

² APRA, *Revisions to Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (Response Paper, 8 April 2021)

Glossary

| | |
|--|---|
| AASB | Australian Accounting Standards Board |
| AASB 17 | AASB 17 Insurance Contracts |
| ADF | Aggregation Diversification Factor |
| APRA-approved affiliated offshore reinsurer | An offshore reinsurer who is related to or affiliated with the ceding registered life company (excluding specialist reinsurer statutory funds), and approved by APRA. |
| APRA Connect | APRA Connect is the new data collection solution for reporting entities to lodge entity information and data with APRA. APRA Connect will progressively replace Direct to APRA (D2A). Data collected by APRA under the Financial Sector (Collection of Data) Act 2001 is used for prudential supervision, statistical publications and shared with partner agencies |
| ARDF | Asset Risk Diversification Factor |
| LAGIC | Life and General Insurance Capital Standards |
| Offshore reinsurer | A life insurance company that is not registered under the Life Insurance Act 1995 (Life Act), that reinsures risk for life companies registered under the Life Act. APRA does not classify an appropriate retrocessionaire of a specialist reinsurer as an offshore reinsurer. |
| Unaffiliated offshore reinsurer | An offshore reinsurer that is not related to or affiliated with the ceding registered life company. |
| VAF | The value of assets of the fund |

Chapter 1 - Introduction

1.1 Overview

To support the safety and resilience of the financial system and individual entities, it is important that APRA has adequate oversight over the sectors of the market that it regulates. As previously communicated, APRA is concerned that the increased use of offshore reinsurers could put at risk our ability to effectively supervise the Australian life insurance industry and protect policyholders.

APRA actively supervises all life insurers (including reinsurers) which are registered under the *Life Insurance Act 1995*. 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 important to fulfilling this mandate.

Reinsurance reduces capital requirements and is therefore to some extent a substitute for capital. Given this, it is important that reinsurance can be called on when needed. Unlike locally regulated reinsurers, offshore reinsurers are not subject to APRA's regulation or prudential requirements. APRA does not have prudential oversight of the reinsurer when it is offshore and is therefore unable to take regulatory actions such as issuing directions or imposing supervisory adjustments to capital where concerns arise.

There is consequently an increased risk that reinsurance from an offshore reinsurer is not available when needed, putting at risk the protection of policyholders if not managed appropriately and within prudent limits.

APRA is therefore revising LPS 117 to ensure that the requirements in the standard are commensurate with the risks associated with offshore reinsurance. APRA is adding additional limits and controls into the standard, including the introduction of an aggregate limit on exposures to offshore reinsurers and restrictions on the recognition of risk mitigants in certain circumstances. If a life company exceeds these limits it will be required to hold additional regulatory capital.

Balanced approach

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

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. For example, direct writers (life insurers) may not support APRA's objective to restrict their use of offshore reinsurers, while domestic reinsurers may be concerned about the proposal not being restrictive enough on offshore reinsurers. APRA has aimed to carefully balance these views.

APRA's revisions have been made after considering stakeholder feedback, and take a balanced approach: the updates aim to ensure there are appropriate limits on the use of offshore reinsurers, while continuing to enable their participation in the Australian market.

1.2 Consultation process

The review of LPS 117 to address concerns on offshore reinsurance has been subject to a comprehensive consultation process. The process has involved an information request in 2018, engagement with industry through a consultation letter in 2019, and a consultation paper on proposed revisions to the standard in 2021.

The key proposed revisions to the standard communicated in 2021 were:

- the introduction of an aggregate limit on exposures to offshore reinsurers. If a life company exceeds this limit it will be required to hold additional regulatory capital. This proposal aims to mitigate the risks posed by growth in such reinsurance arrangements;
- more favourable treatment of reinsurance exposures to APRA-approved affiliated offshore reinsurers, through the application of a higher individual asset concentration limit;³
- clearer requirements on the types of risk mitigants and the conditions under which they would be considered eligible for mitigating asset concentration risk; and
- requirements preventing the circumvention of asset concentration limits (where the counterparty is an offshore reinsurer that is not related to the life company and not approved by APRA) by imposing a cap on the recognition of collateral-type and guarantee-type risk mitigants.

Feedback

APRA received 12 submissions responding to the 2021 proposals. Non-confidential submissions are available on APRA's website. This Response Paper summarises the input received, APRA's response to this feedback and subsequent revisions to LPS 117.

Submissions generally acknowledged the rationale for APRA's review of LPS 117. Most submissions welcomed the additional clarity on the risk mitigation mechanisms available for life insurers to manage credit risk exposures. While many submissions were supportive of the proposed preferential treatment of APRA-approved affiliated offshore reinsurers, a number of submissions expressed concern about the proposal, questioning whether the proposals collectively would enable more risk to be placed offshore, contrary to the objectives of APRA's review. As a result, submissions highlighted potential adverse impacts

³ This approach is conceptually consistent with the concessional treatment of specialist reinsurers retroceding to an overseas parent or affiliated entity that is approved by APRA as an appropriate retrocessionaire.

on the local reinsurance market. A number of submissions also questioned why limits on the recognition of risk mitigants did not extend to netting arrangements, noting that this may enable some insurers to exceed asset concentration limits.

APRA's response

In finalising revisions to LPS 117, APRA now intends to amend LPS 117 to include limits on the recognition of eligible collateral, guarantees and letters of credit as risk mitigants in respect of APRA-approved affiliated offshore reinsurers.

In response to some stakeholder concerns about the potential use of netting arrangements to deliberately circumvent asset concentration limits, through amendments to LPS 117 APRA is reinforcing its expectations that netting arrangements are not to be used to circumvent asset concentration limits. APRA is also introducing reporting requirements for netting arrangements to prevent deliberate circumvention of asset concentration limits. Insurers are encouraged to approach APRA before entering into, or modifying, offshore reinsurance treaties with netting arrangements that may result in more than 25 per cent of either the individual risk portfolio or group risk portfolio being placed offshore.

The revised LPS 117 includes a reduction in the minimum term for letters of credit to three years from five years. This minimum term must be met in order to be recognised as a risk mitigant for capital purposes. This responds to concerns that letters of credit with five-year terms were not widely available at a reasonable cost, without raising material prudential concerns. The revised LPS 117 also includes a number of other minor changes and clarifications in response to submissions.

1.3 Further revisions to LPS 117 arising from AASB 17 and LAGIC updates

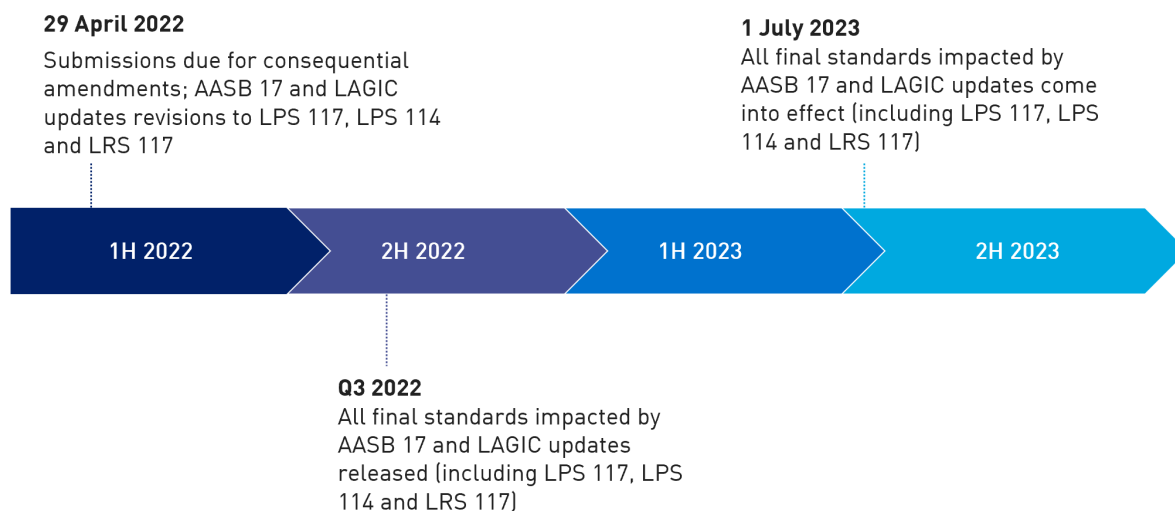
APRA released a Response Paper, *Integrating AASB 17 into the capital and reporting framework for insurers and updates to the Life and General Insurance Capital (LAGIC) framework* in December 2021.⁴ This included proposals to revise LPS 117 to integrate changes arising from *AASB 17 Insurance Contracts* and for updates to the LAGIC framework. In that paper, APRA highlighted that the draft standard would be released as part of this review.

With this Response Paper, APRA is also consulting on consequential amendments to LPS 114 and to LRS 117.

⁴ APRA, *Integrating AASB 17 into the capital and reporting framework for insurers and updates to the LAGIC framework* (Response Paper, 13 December 2021)

1.4 Next steps

Written submissions on the draft AASB 17 and LAGIC update proposals for LPS 117, and draft consequential amendments to LPS 114 and LRS 117, are due by 29 April 2022. Following consideration of stakeholder feedback, the final version of these standards will be released, alongside other standards affected by the AASB 17 and LAGIC updates, in Q3 of 2022. All revised standards, including LPS 117, LPS 114 and LRS 117, will commence from 1 July 2023.



Chapter 2 - Response to submissions

This chapter outlines APRA's response to feedback received as part of the 2021 consultation. Key revisions are outlined in 2.1 and minor revisions are outlined in section 2.2.

2.1 Key revisions

Preferential treatment of approved affiliated parties⁵

The April 2021 draft of LPS 117 proposed a limit of 12.5 per cent of the value of the assets of the fund (VAF) for exposures arising from reinsurance arrangements between a life company and an APRA-approved affiliated offshore reinsurer. If a life company exceeds this limit, additional capital would need to be held. This limit was higher than the limit for unaffiliated offshore reinsurers. The April 2021 draft LPS 117 also proposed that there would be no limit on the extent to which risk mitigants could be recognised to reduce exposures arising from these reinsurance arrangements.

Comments received

Several submissions noted that, contrary to APRA's objective of capping the amount of reinsurance placed offshore (with reinsurers outside of APRA's oversight), the proposals may result in greater levels of offshore reinsurance. The absence of proposed limits on the recognition of risk mitigants would permit gross exposures to be materially higher than the 12.5 per cent of VAF limit.

Other submissions supported the proposed measure, noting that it would allow more reinsurance to be directed to parent/affiliated entities. This would bring a range of benefits, including greater incentives for long term foreign investment in the life insurance industry. It may also provide APRA with visibility of pricing and valuation metrics underpinning affiliated party offshore reinsurance arrangements, which, in turn, would strengthen APRA's prudential oversight.

APRA's response

APRA continues to see a strong rationale for the preferential treatment of offshore reinsurance arrangements with APRA-approved affiliated parties. This view reflects a number of factors:

- managing insurance risk and reinsurance exposure within a group can be prudent and should not be unduly discouraged (even if located in a foreign jurisdiction);

⁵ Comments relate to the proposals for counterparty grades 1, 2 and 3.

Deferred premiums, deposit backs and funds withheld arrangements – matching

The April 2021 draft of LPS 117 included requirements for deferred premiums, deposit backs and funds withheld arrangements that must be met if reinsurance netting is to be recognised. One part of the requirement is that the life company must set aside assets matching its liabilities to the reinsurer under each arrangement.

Comments received

Some stakeholders suggested that the meaning of 'matching' be clarified, noting that some may interpret this to mean cash flow matching.

APRA's response

LPS 117 has been updated to clarify that in this circumstance 'matching' means 'equal in value to'. That is, a life company must set aside assets 'equal in value to' its liabilities to the reinsurer under each arrangement.

Limit on recognition of risk mitigants – stressed or unstressed

The April 2021 draft of LPS 117 specified that in specific circumstances a maximum of 50 per cent of the reinsurance asset held in respect of that reinsurer can be treated as an exposure to eligible collateral, guarantors or issuers of letters of credit.

Comments received

Submissions sought clarification regarding whether this refers to stressed or unstressed reinsurance assets and whether it applies before or after netting.

APRA's response

LPS 117 has been updated to clarify that the stressed value of the reinsurance assets after netting (if netting is permitted) should be used.

Netting of assets and liabilities – stressed or unstressed

The April 2021 draft of LPS 117 permitted netting of assets and liabilities in certain circumstances.

Comments received

Respondents sought clarification regarding whether assets and liabilities must be calculated on a consistent basis (stressed or unstressed) when netting is applied.

APRA's response

Assets and liabilities must be calculated on a consistent basis when they are netted. The net amount must be valued after applying stresses to both assets and liabilities. APRA's view is that paragraph 28 of revised LPS 117 is clear on this matter. No additional changes have been made.

Reinsurance of participating business and discretionary non-participating business

The April 2021 draft of LPS 117 proposed a modified form of VAF as a basis for setting the limits for reinsurance exposure, informed by the assumption that participating business and discretionary non-participating business will not be materially reinsured. This assumption is informed by current industry practice.

Comments received

Some submissions suggested these products be ringfenced with separate measures of VAF and asset concentration limits.

APRA's response

No additional changes are proposed to this section of the standard. If participating business is reinsured, the policy owners bear most of the reinsurer default risk. This may be inappropriate and not something policy owners would expect unless it was specifically drawn to their attention.

If a life company decides to reinsure participating business and this causes issues with concentration limits, APRA will consider this on a case by case basis and may use its adjust and exclude power if it is in the policy owners' interests to do so.

Application of aggregate limit

In finalising the offshore reinsurer proposals in LPS 117, APRA included a requirement to apportion any Asset Concentration Risk Charge that arises from applying the aggregate limit on offshore reinsurance exposures in proportion to exposure amounts being assessed against the aggregate limit. This was introduced to clarify the operation of paragraph 18 of LPS 114, which specifies that Asset Risk Charge stresses must not be applied to any part of assets in excess of LPS 117 asset concentration limits.

Chapter 3 - Further revisions

This chapter outlines:

- proposed further changes to LPS 117 driven by the integration of AASB 17 into APRA's insurance capital framework and LAGIC updates (in addition to the revisions to LPS 117 that APRA has finalised via this Response Paper);
- consequential proposed changes to LPS 114, driven by revised LPS 117; and
- proposed changes to LRS 117, driven by the revised LPS 117, the integration of AASB 17 and the introduction of APRA Connect.

APRA invites written submissions on the proposals set out in this chapter only. All other amendments to LPS 117 have previously been consulted on and are now considered final.

3.1 Proposed changes to LPS 117 from AASB 17 and LAGIC updates

A number of further changes to LPS 117 were proposed in APRA's 2021 Response Paper on AASB 17 and LAGIC updates (2021 AASB 17 Response Paper). APRA is now consulting on these proposed changes.

APRA's proposals for AASB 17 driven changes to LPS 117 were outlined in Section 2.4.2 '*Capital risk charges and other requirements*' of the 2021 AASB 17 Response Paper. The introduction of AASB 17 means that the total assets of a fund could change significantly due to the new accounting measurement models and because life companies will be disclosing insurance and reinsurance assets as separate asset items on the balance sheet. This could result in systemic changes in the levels of VAF in the industry.

When determining VAF for asset concentration limits that apply to non-reinsurance assets, it is proposed that LPS 117 be updated to specify that AASB 17 insurance and reinsurance asset items must be deducted from the total assets reported on the AASB 17 balance sheet, while premiums and other receivables (referred to as insurance policy receivables) must be added to the VAF. These receivable items are the same items that would be recognised as the additional regulatory adjustments for the capital base calculation (proposed under draft *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*) but gross of any tax effects. Under AASB 17, insurance policy receivables are recognised within insurance and reinsurance contract liabilities and assets instead of being reported as separate items on the balance sheet. APRA's view is that this proposed approach would continue to recognise such receivables within VAF for non-reinsurance assets.

When determining VAF for asset concentration limits that apply to reinsurance assets, the stressed value of reinsurance assets (determined under *Prudential Standard LPS 115 Insurance Risk Charge* (LPS 115)) must be added to the VAF for non-reinsurance assets. This proposal should result in minimal impact on VAF from AASB 17 for reinsurance assets (before excluding assets allocated to support participating business and discretionary non-

participating business), given that APRA has not proposed to change the risk-free best estimate liability and LPS 115 requirements under AASB 17.

As communicated in Section 4.2 'All insurance industries – Dollar value exposure limits' of the 2021 AASB 17 Response Paper, dollar value exposure limits within LAGIC standards have remained unchanged for some time. APRA intends to review these dollar value limits. It is proposed that the adjusted dollar value exposure limits are determined as the existing dollar value limit indexed by inflation, rounded as appropriate.

3.2 Proposed consequential changes to LPS 114

LPS 114 requirements relating to the impact of holding eligible collateral and guarantees against an asset also require amendment due to the changes to LPS 117. These amendments ensure that the impact of applying asset risk stresses may be reduced where eligible collateral is held or the asset has been guaranteed, and the arrangement is of a kind that complies with the requirements of LPS 117.

3.3 Proposed consequential changes to LRS 117

To ensure the reporting of accurate and relevant data by life companies to APRA, *Reporting Standard LRS 117.0 Asset Concentration Risk Charge* (LRS 117) must be updated to reflect revised LPS 117

LRS 117 is also one of a number of life insurance reporting standards affected by the new AASB 17 accounting requirements. The 2021 AASB 17 Response Paper foreshadowed that APRA would consult on changes to LRS 117 driven by AASB 17, revised LPS 117 and the introduction of APRA Connect in a single process. In summary, draft LRS 117 has been amended as follows:

- The data has been significantly restructured to reflect the tabular format that APRA will adopt to collect capital data under APRA Connect (instead of the current form view).
- Additional data items and dimensions to reflect the updated LPS 117 and to obtain better visibility over non-reinsurance and reinsurance exposures are proposed. Relating to this, separate sections for non-reinsurance and reinsurance exposure data items are also proposed, given that these exposures are subject to different capital requirements under LPS 117.
- A new section to collect data on gross and reinsurance premiums (after removing any offsetting mechanisms) has been added to better understand the extent of insurance risks being transferred overseas.
- Data items that are collected under other reporting standards have been removed and enhanced data definitions included.

Chapter 4 - Next steps and consultation

This chapter outlines the implementation timeline for revised LPS 117. The consultation process for AASB 17 and LAGIC updates driven changes to LPS 117 and consequential changes to LPS 114, and LRS 117 are also explained.

4.1 Implementation

Final LPS 117 – reflecting the revisions finalised in this Response Paper and those arising from AASB 17 - will commence on 1 July 2023. Consequential amendments to LPS 114 and LRS 117 are also proposed to commence on this date.

As outlined in the 2021 AASB 17 Response Paper, current adjustments and exclusions will cease to apply once the current LPS 117 is revoked. Life insurers with current adjustments or exclusions 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.

APRA will not grandfather existing requirements in LPS 117, but will consider insurer specific transition arrangements on a case by case basis. Affected insurers are encouraged to contact their responsible supervisor.

4.2 Request for submissions

APRA invites written submissions on the proposals set out in Chapter 3 of this paper only. All other amendments to LPS 117 have previously been consulted on and are now considered final.

Written submissions should be sent to insurance.policy@apra.gov.au by 29 April 2022 and addressed to:

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

4.3 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