Actuaries Institute

8 July 2021

Australian Prudential Regulation Authority (APRA)
Level 12
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Sydney
NSW 2000

Submission to APRA regarding LPS 117

This submission is a response from the Actuaries Institute ('the Institute') to the following documents released by APRA on 8 April 2021:

Response Paper – Revisions to Prudential Standard LPS 117 Capital Adequacy – Asset Concentration Risk Charge ('Response Paper'); and

Draft Prudential Standard LPS 117 Capital Adequacy Asset Concentration Risk Charge ('Draft LPS 117').

The response was coordinated by a working group ('the group') re-convened by the Institute to consider APRA's Response Paper and the Draft LPS 117. The group was originally convened in 2019 to formulate a response on behalf of the Institute to APRA's letter of 4 March 2019 ('Offshore reinsurers and the review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge')[1].

The Institute's intention is to represent as far as possible a cross-section of the views of its members. The Institute notes that there will not be a consensus view among its members on all aspects of the Response Paper and the Draft LPS 117.

The Institute considered the working group provided a broad cross-section of industry representation. One member represented APRA, but his involvement was limited to observation and representation of APRA's interest/areas of focus and did not guide the views of the group.

There was general agreement by the group not to revisit considerations raised in the previous Institute submission where APRA has now made its position/intent clear within the Response Paper and the Draft LPS 117.

The group determined to confine this response primarily to areas where there are perceived inconsistencies between the position/intent APRA has set out in the Response Paper and the content of the Draft LPS 117.

The group also included two areas where the group feels that APRA did not fully respond to and/or did not adopt suggestions/recommendations made by the Institute in the previous submission:

[1] References in this letter to 'offshore reinsurers' are to reinsurers which are not APRA registered or which have not been authorised by APRA as 'appropriate retrocessionaires'.

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- Proposed approach to limits on risk mitigants (set out in Section 4); and
- Clarification on 'carrying on a business' (set out in Section 5).

Consultation was undertaken with the Institute's Life Insurance Practice Committee (LIPC) however there was limited opportunity to consult more broadly with industry practitioners.

In summary, the Institute considers the greater clarity around the forms and use of risk mitigants to be welcome, however it notes that the Draft LPS 117 is unlikely to deal fully with APRA's prudential concerns relating to the increased use of offshore reinsurers, and may require APRA to make frequent interventions in order to apply limits on the recognition of risk mitigants in specific circumstances, consistent with APRA's stated objectives.

1. Summary

The Institute's response to the 4 March 2019 APRA letter made a number of comments, suggestions and recommendations. The Institute considers that some, but not all, of these were addressed in the Response Paper.

The Response Paper states that the draft standard takes a balanced approach that aims to ensure there are appropriate limits on the use of offshore reinsurers, while continuing to enable the benefits of their participation in the Australian market. The Institute recognises that the decision whether that balance has been achieved ultimately rests with ARPA, and accordingly this submission will focus on:

- Areas of apparent inconsistency between the Response Paper and the Draft LPS 117 (which may encompass areas previously raised by the Institute in response to the 4 March 2019 letter); and
- Other areas which the Institute considers warrant comment in relation to the Draft LPS 117.

The key areas where the Institute would like to provide feedback are introduced as follows:

Section 2	General commentary **on apparent inconsistences between APRA's stated intent in the Response Paper and the Draft LPS 117** and whether APRA will achieve what it intends. Some themes introduced here (and further explored in Section 3) include consideration of scenarios enabled by the Draft LPS 117 and what the implications might be for the industry, and different players within the industry;
Section 3	Specific **sample scenarios** enabled by the Draft LPS 117, and the likely or potential consequences of these scenarios;
Section 4	**Limits on risk mitigants**;
Section 5	**'Carrying on a business'** considerations in relation to **offshore reinsurers**;
Section 6	Application of **APRA discretions** to maintain use of offshore reinsurers within prudent levels; and

Section 7 **Other matters** which include:

- Drafting inconsistencies/clarity of wording in the Draft LPS 117;
- Use of collateral trusts by local insurers and reinsurers being considered by APRA to contravene the Life Act;
- Letters of credit ('LoCs') which the Draft LPS 117 proposes will be required to have a term of five years;
- Drafting considerations for participating business, and non-participating business with entitlement to discretionary additions; and
- Implications for insurers and reinsurers of the time lag between APRA's initial communication (December 2017) and the implementation of the revised LPS 117 (July 2023).

2. Comments on apparent inconsistencies between APRA's stated intent in the Response Paper and the Draft LPS 117

In the Response Paper APRA outlines the primary objectives on page 8 of financial safety and financial system stability, along with other considerations of efficiency, competition, contestability and competitive neutrality. It also includes other statements throughout the Response Paper indicating its intent.

The Institute observes there are some potential inconsistencies between some of APRA's stated intents in its Response Paper and what is enabled (or likely to be enabled) by the Draft LPS 117. These are summarised below and are developed further in the remainder of this submission.

Areas of intent expressed by APRA, with associated commentary on whether these have been addressed, or raise further questions, are set out in the following (with page numbers of the Response Paper referenced).

2.1 Prudent use of offshore reinsurers

"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" (page 8).

What is meant by "prudent levels" is not defined in the Response Paper and can be interpreted in the context of either the gross use of offshore reinsurance or the residual exposure following the use of risk mitigants. The Institute considers that materially greater use of offshore reinsurance would not be consistent with APRA's apparent intent and has therefore inferred that "prudent levels" should be interpreted in the context of maintaining gross use of offshore reinsurers within prudent levels (i.e. before application of netting arrangements and other risk/collateral mitigants).

As presently drafted, there are various circumstances in which the Draft LPS 117 may enable materially greater use (than now) of offshore reinsurers by all players, mainly via the use of balance sheet risk mitigants (such as those listed in paragraph 29 of the Draft LPS 117) and, in some cases, collateral risk mitigants.

APRA expressed its view on the difficulty in imposing limits on balance sheet risk mitigants in the Response Paper where it says *"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" (page 24). However, on the basis of the proposed Draft LPS 117, it seems likely that companies will seek to utilise balance sheet risk mitigants to a significant extent as part of prudent risk management. This can lead to significant gross exposures to overseas reinsurers, as shown in the scenarios presented further below.

If APRA considers that such outcomes constitute use of offshore reinsurers that is not "within prudent levels", this may require substantial under-the-counter (UTC) regulation by APRA of individual insurers/reinsurers in order to limit gross exposure and/or to constrain the use of risk mitigants to whatever level APRA considers is prudent. The Institute considers that extensive use of UTC regulation would be a retrograde step in regulating the use of offshore reinsurers and would produce a lack of regulatory clarity/certainty and a loss of market transparency.

The Institute considers that APRA's proposals improve the clarity of the treatment of risk mitigants, however do not fully address the considerations raised in the Institute's prior 2019 submission. In that earlier submission, the Institute noted that there should be limits on risk mitigants, that the limits should be proportional to the relevant net exposure limit and should have regard to the quality of risk mitigant. The Institute also foreshadowed that higher (or no) limits on risk mitigants created a greater risk of undermining what APRA is trying to achieve in its review of the use of offshore reinsurance.

In facilitating materially greater potential use of offshore reinsurance (than now), some industry stakeholders will likely support APRA's latest proposals (e.g. from a first-principles perspective of deploying risk mitigants as part of an effective risk management strategy), whereas other industry stakeholders will likely not support the proposals (e.g. from a systemic risk or level playing field perspective of offshore reinsurance being more advantaged rather than less advantaged by the Draft LPS 117, compared to the current standard).

2.2 Exposure limit for affiliated offshore related parties versus appropriate retrocessionaires

"It is not appropriate to increase this limit [12.5% for exposures arising from reinsurance arrangements between a life company and an offshore related party] so that it is in line with the limit for appropriate retrocessionares (50% of VAF)" (page 12).

It is apparent from the scenarios in Section 3 that use of risk mitigants can result in a life insurer having a materially higher gross exposure to an offshore authorised related party than the 12.5% proposed limit, via the use of risk mitigants allowed by the Draft LPS 117. The scenarios in Section 3 also show that a specialist reinsurer or a life insurer will be able to use risk mitigants to retrocede or reinsure (respectively) business substantially in excess of the 50% limit.

Thus, absent the application of UTC regulation by APRA, the proposed Draft LPS 117 may not deliver APRA's intent of maintaining different limits for the reinsurance of insurance business (12.5%) and the retrocession of specialist reinsurance business (50%).

2.3 Use of collateral trusts by local insurers/reinsurers prohibited by the Life Act

"… 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" (page 16).

The Institute considers that the Draft LPS 117 provides greater clarity regarding the permitted use and form of risk mitigants to reduce net counterparty exposure for the purposes of applying LPS 117 limits. This greater clarity is likely to be welcomed by industry stakeholders.

However, absent a change in the Life Insurance Act, onshore reinsurers may remain at a competitive disadvantage compared to offshore reinsurers by virtue of local reinsurers' inability to provide a collateral trust (from a statutory fund) to a cedant as a risk mitigant for a reinsurance arrangement. The Institute has concerns that APRA's reasoning regarding this current collateral trust prohibition may also extend to deposit-back and similar arrangements. This is discussed further in Section 7.2.

Although the current review of LPS 117 may not afford APRA an opportunity to overcome this current disadvantage, the Institute notes that the proposed Draft LPS 117 is likely to exacerbate this current disadvantage, to the extent that the current proposals will have the effect of promoting greater use of offshore reinsurance accompanied by the use of collateral trusts as risk mitigants (albeit subject to the 50% limit on collateral).

2.4 Limit on offshore reinsurer use of eligible collateral, guarantors or issuers of letters of credit

"It is proposed that a maximum of 50% 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" (page 23).

As noted above, the Institute's prior 2019 submission suggested that there should be limits on risk mitigants, that the limits should be proportional to the relevant net exposure limit and should have regard to the quality of risk mitigant. Thus, extending limits to all counterparties and all risk mitigants (including netting arrangements, where possible, and the various risk mitigants contemplated by paragraph 29 of the Draft LPS 117), where those limits (whether 50% or otherwise) might then vary according to the quality of risk mitigant, would be more in line with the Institute's original submission. If APRA decides to extend limits in this way, consideration may need to be given to whether the limits should be applied in aggregate across all risk mitigants and, if so, how.

2.5 Netting Arrangements

"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" (page 24).

The Institute is unclear how to interpret APRA's concerns or intentions here. Paragraph 29 of the Draft LPS 117 contemplates and requires that companies must quantify and recognise the relevant risk mitigant as a liability on the regulatory balance sheet. In which case, the Institute considers that risk mitigants falling within the scope of paragraph 29 ought to lend themselves to the application of limits. The Institute is therefore unclear how widely to interpret APRA's concerns about applying limits to netting arrangements, and the potential for circumventing those limits. This is discussed in Section 6.

3. Sample Scenarios Enabled by Draft LPS 117

3.1 Introduction

The sample scenarios were developed with the following categories of insurer and reinsurer in mind:

- Offshore reinsurers e.g. AXA (currently), Partner Re, Lloyds syndicates etc;
- Domestic specialist reinsurers (note this includes any "insurer" that also writes reinsurance inwards business via a dedicated reinsurance-only statutory fund) e.g. RGA, Pacific Life Re etc;
- Domestic insurer that is a subsidiary of an overseas multinational insurer (note this includes any "reinsurer" that also writes primary insurance business) e.g. Met Life, AIA etc; and
- Domestic insurer – other e.g. Clearview, Integrity etc.

The following terms are defined here and are referred to below and in the worked examples set out in Appendix A:

- Collateral Risk Mitigant ('CRM') - off-balance sheet tools such as third-party guarantees, LoCs and collateral trusts etc;
- Balance Sheet Risk Mitigant ('BSRM') - on-balance sheet tools such as netting arrangements and the more specific tools contemplated by paragraph 29 of the Draft LPS 117 (such as deferred premiums, deposit-back and funds-withheld arrangements);
- Stressed Value of Assets of the Statutory Fund ('SVAF');
- Asset Concentration Risk Charge limit (ACRC limit, or limit); and
- Offshore reinsurer assumed to have an APRA counterparty grade of level 3 or better.

The scenarios considered by the Institute are summarised below and set out in more detail in Appendix A.

The numeric examples are illustrative and approximate and represent simplified 'real-life' scenarios. The Institute considers that such approximations and simplifications do not detract from the validity of the conclusions drawn.

3.1.1 A domestic insurer (regardless of ownership), reinsuring directly to a non-related offshore reinsurer

A 5% limit applies to the insurer's exposure to the offshore reinsurer; there is a 50% limit on CRMs but no limit on BSRMs.

The example in Appendix A illustrates that by using just two offshore reinsurers (with risk mitigants), an insurer could likely accommodate all of its reinsurance needs and still be within the new aggregate 12.5% limit.

APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired.

3.1.2 A domestic insurer that is a subsidiary of an overseas multinational insurer and reinsures directly to an offshore APRA-approved affiliated entity

A 12.5% limit applies to the insurer's exposure to its affiliated reinsurer; there is no limit on CRMs and no limit on BSRMs.

The example in Appendix A illustrates that the insurer could reinsure 100% of insured risks to its affiliate and still come in under the 12.5% limit, since there are no limits on BSRMs and CRMs.

In addition, the offshore APRA-approved affiliated entity could provide CRM via a collateral trust which a domestic reinsurer would be prohibited from doing.

APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired.

3.1.3 A domestic insurer that is a subsidiary of an overseas multinational insurer and reinsures to its offshore APRA-approved affiliated entity which then onward-retrocedes to (offshore) non-related parties

This example is the same as 3.1.2 except that the additional leg of offshore retrocession to non-related parties can then be used to circumvent the 5% limit to an offshore reinsurer.

The indirect use of offshore reinsurance by the local insurer will only be constrained compared to example 3.1.1 to the extent that there are constraints on offshore reinsurance in the jurisdiction of the APRA-approved affiliated entity.

APRA would have minimal or no oversight of such "indirect" retrocession arrangements and no discretionary regulatory powers to directly constrain such arrangements if unintended/undesired by APRA. Although it is, in theory, possible for a specialist reinsurer to facilitate a similar risk transfer arrangement under the current LPS 117, by acting as a conduit between the domestic insurer and its overseas affiliate, the scenario described above will be more readily and directly accessible under the proposed Draft LPS 117.

3.1.4 A domestic specialist reinsurer that reinsures to an offshore APRA-authorised retrocessionaire

A 50% limit applies to the reinsurer's exposure to its retrocessionaire; there is no limit on CRMs and no limit on BSRMs

The Draft LPS 117 appears to enable a domestic specialist reinsurer to retrocede virtually all business.

APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired.

3.2 Implications and Consequences of the Scenarios Considered

Drawing from the scenarios set out in Appendix A, the Institute considers that there are various first order or more immediate implications/consequences that may flow from the proposed Draft LPS 117:

- Unlimited use of BSRMs to mitigate ACRC limits, requiring APRA to then apply UTC regulatory powers to curtail such use.
- Greater use of BSRMs and CSMs by all players to mitigate the applicable counterparty exposure limits.
- Greater flexibility for all players to have a materially higher gross exposure than the stated ACRC limits by mitigating the above-limit gross exposures.
- Greater use of internal reinsurance to APRA-approved affiliated entities by the multinational-owned local insurers, which is not available to other local insurers.
- Multinational-owned local insurers preferring to access offshore reinsurance via their APRA-approved affiliated entity (as there is only one 12.5% aggregate limit), thereby making the offshore leg of such arrangements less transparent to the regulator, rather than facing the offshore reinsurance market directly from onshore.
- More use of offshore reinsurance by domestic insurers, either directly or via the APRA-approved affiliated entities of multinational-owned local insurers (even though net exposures stay within the 5% limit), which may lead to the by-passing of domestic specialist reinsurers in favour of offshore reinsurers.
- More use of internal retrocession by domestic specialist reinsurers in excess of the current 50% limit, even though net exposures stay within the 50% limit via the use of risk mitigants.

The Institute also considers various additional second-order or longer-term implications/consequences that may flow from the proposed Draft LPS 117:

- The apparent scope for materially greater use of offshore reinsurance (absent UTC regulation by APRA) may align with one of APRA's stated intents that insurers should make their own prudent assessment of appropriate limits in accordance with their risk appetite when managing their reinsurance arrangements, rather than relying solely on LPS 117 prescribed limits.
- Will the primary insurance market become more concentrated in favour of the multinational-owned local insurers and how might other local insurers respond to such increased market concentration?
- In aggregate, will the proposals reduce the quantum of life insurance risks that are retained within the Australian market? Some industry stakeholders may consider that any such reduction is not, of itself, a concern to the extent that it occurs in the context of insurers' own prudent risk management of counterparty exposures and to the extent that offshore reinsurers are considered to bring broader benefits to the local insurance market.

- How will domestic specialist reinsurers respond if a much greater proportion of Australian risks are placed into the reinsurance market from offshore hubs rather than being reinsured directly by/from locally-licensed insurance entities within the Australian market? Will these competitive responses have the effect of hollowing out the local reinsurance market?
- Will offshore reinsurers be less incentivised to seek a licence to operate onshore?
- As noted earlier, there will need to be greater use by APRA of discretionary regulatory powers to constrain the use of netting arrangements and other risk mitigants if the scenario outcomes illustrated in Appendix A are considered by APRA to be unacceptable.
- If the illustrated scenarios eventuate, will APRA end up in a position where it has a less clear, rather than sharper, prudential line-of-sight regarding the use of reinsurance in relation to risk coverage provided to the Australian market?

4. Limits on Risk Mitigants

In the Institute's response to the March 2019 APRA letter, it made the following comment:

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

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

As set out below, the Institute considers that this comment was partially addressed in the Response Paper and by the Draft LPS 117.

Specifically, in the Draft LPS 117 paragraph 43, there is a limit of 50% of the reinsurance assets held in respect of a reinsurer (who is not an approved affiliated entity or a registered life company) which can be treated as an exposure to eligible collateral, guarantors or issuers of letters of credit.

This limit is therefore specific to the type of counterparty and type of risk mitigant.

However, there is no comparable explicit limit applied to other counterparties (including approved affiliated entities or approved appropriate retrocessionaires), nor are there any explicit limits applied to other forms of risk mitigants (including netting arrangements and the risk mitigants contemplated by paragraph 29).

The Institute notes that extending limits to all counterparties and to all risk mitigants (including netting arrangements, where possible, and the various risk mitigants contemplated by paragraph 29 of the Draft LPS 117), where those limits (whether 50% or otherwise) might then vary according to the quality of risk mitigant, would be more in line with the Institute's original submission. If APRA decides to extend limits in this way, consideration will need to be given to

whether the limits should be applied in aggregate across all risk mitigants, both BSRMs and CRMs, and, if so, how.

Paragraph 44 says that APRA may determine, if there are prudential reasons for doing so, a maximum limit of reinsurance assets held in respect of a reinsurer (who is an approved affiliated entity or an approved appropriate retrocessionaire) which may be treated as exposure to eligible collateral, guarantors or issuers of letters of credit. The Institute considers that such private determinations would not improve regulatory transparency/certainty of what limits are being applied to risk mitigants in practice and would increase the difficulties of determining in advance what limits would meet with APRA discretionary tacit/explicit approval.

Paragraph 43 also proposes that the 50% limit will be determined by reference to "the reinsurance asset held in respect of that reinsurer". The Institute notes that APRA has elected to reference "reinsurance asset" rather than "the relevant net exposure limit applicable to the particular reinsurance" which had alternatively been suggested by the Institute's 2019 submission.

Limits which are expressed as a percentage of reinsurance asset will not provide limits that are proportional to the relevant LPS117 net exposure limit applicable to a particular reinsurance counterparty.

The Institute also recommends that paragraph 43 be made clearer in the following two respects:

a) whether the reference to "reinsurance asset" is intended to be read as the stressed or unstressed value of that asset; and

b) whether the value of that reinsurance asset is required to deduct any reinsurance liabilities that have been netted per paragraphs 28 and 29.

5. Offshore Reinsurers and 'Carrying on a Business'

In its 2019 submission, the Institute proposed *"that APRA articulate the level at which the scale and frequency of an offshore reinsurer's operations in Australia reaches a point where they might reasonably be regarded as 'carrying on a business' in Australia, with the consequent obligation to obtain an APRA licence."*

The Institute notes that APRA has elected not to take up this suggestion in the Response Paper and Draft LPS 117.

While this is ultimately a matter for APRA, the Institute considers that the current proposals for LPS 117 provide a timely opportunity for APRA to publicly articulate its views on this matter in order to provide greater clarity to industry. As such, the Institute considers that this is somewhat of a missed opportunity.

6. APRA Discretion and Netting Arrangements

The Institute observes that APRA's view in the Response Paper and the Draft LPS 117 is that, while it has not put limits on all risk mitigants, it does not want misuse of risk mitigants to circumvent LPS 117 concentration limits.

The Institute also appreciates that discretionary assessments and approvals will continue to be required for some risk mitigation arrangements, for example, where the mitigants themselves are new/novel or where explicit limits are intrinsically hard to enunciate in advance.

However, the Institute was unclear how to interpret APRA concerns or intentions regarding netting arrangements. Paragraph 29 of the Draft LPS 117 contemplates and requires that companies must quantify and recognise the relevant risk mitigant as a liability on the regulatory balance sheet. In which case, the Institute considers that risk mitigants falling within the scope of paragraph 29 ought to lend themselves to the application of limits.

As presently drafted, the Institute considers it likely that the proposed Draft LPS 117 will still require significant numbers of discretionary considerations by APRA if it is APRA's expectation (per page 24 of the Response Paper) "that life insurers should not use netting arrangements to circumvent the limit" and if the reference to "netting arrangements" is intended by APRA to encompass the types of risk mitigants referred to in paragraph 29. A better approach might be to:

a) Define explicit limits for the risks mitigants referred to in paragraph 29, having regard to the quality of those risk mitigants compared to the quality of collateral-type mitigants (collateral trusts, LoCs and third-party guarantees); and

b) Thereby, potentially reduce the frequency of discretionary approvals needed for other forms of netting arrangements which might fall under paragraph 28 but which are not captured explicitly in paragraph 29.

7. Other Matters

7.1 Drafting inconsistencies/clarity of wording in Draft LPS 117

- Section 4.2.4 of the Response Paper which states "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" suggests the netting is on an unstressed basis. Paragraph 28 of the Draft LPS 117 allows the netting of assets and liabilities from reinsurance arrangements but does not specify whether reinsurance assets and liabilities are on a consistent basis (i.e. stressed versus unstressed) when netting is applied.
- Depending on whether/how APRA takes up the Institute's suggestions in Section 6 above, the Draft LPS 117 should provide greater clarity as to whether the risk mitigants referred to in paragraph 29 (deferred premiums, deposit-back and funds withheld arrangements) are to be read as netting arrangements or not.
- APRA may wish to consider whether the addition made at the end of paragraph 23, when read in conjunction with paragraph 21, has the unintended effect of giving an offshore reinsurance group a 7.5% limit in aggregate (by using 2.5% for a below grade 3 entity and 5% for a grade 3-or-better entity) rather than the 5% aggregate limit APRA intends.
- APRA may also wish to consider whether paragraphs 35(g)(iv) and 32 work together as intended. The Institute considers that the drafting of paragraph 32 might benefit from some revision to better capture the apparent intended operation/effect across the two paragraphs.

- The drafting short cut in paragraph 36(d) does not appear to operate as intended. For example, the "otherwise met" phrase suggests that a collateral arrangement held overseas in relation to overseas business in an overseas currency might still have to hold AUD assets and assets in Australia even though the relevant liability is overseas and in a foreign currency. Does APRA intend this outcome?
- Some aspects of Attachment A parts (e) and (g) may benefit from slight drafting amendments to improve clarity, in particular:
  - To clarify in (e) whether the statutory fund reference towards the end of the clause is intended to be a statutory fund of the registered life company or of the related entity; and
  - To clarify (g) to say "affiliated entity" instead of "related entity" and to say "of the registered life company where that affiliated entity is not a registered life company" rather than (as now) "of the life company that is not a registered life company".

7.2 Local insurers and reinsurers use of collateral trusts – contravention of Life Act

In the Response Paper (section 4.1 – Collateral trusts), APRA noted that 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 should ideally strive for 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; and
- 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.

In section 4.2.2 – Life Act Requirements APRA provided the following clarification:

> 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 Institute concurs with APRA's subsequent comment in this same section of the Response Paper that an APRA-authorised (re)insurer would likely consider it unattractive to source collateral assets from its general fund. The Institute considers that relevant stakeholders would likely find it helpful if APRA could provide substantive guidance to the life industry on the following related matters:

- Confirmation of APRA's Life Act interpretation regarding the provision of collateral trusts by a local insurer's or local reinsurer's statutory fund; and

- Confirmation of whether and to what extent APRA considers that other forms of risk mitigant are, and are not, considered to contravene these same provisions of the Life Act, most notably in relation to funds withheld, deposit-back and modco arrangements.

Absent a change in the Life Insurance Act, it appears that onshore reinsurers will remain at a somewhat competitive disadvantage compared to offshore reinsurers in relation to the provision of a collateral trust as a risk mitigant for a reinsurance arrangement.

7.3 Requirement for LoCs to have a 5-year term

The Institute notes that, in the experience of some market participants, sourcing a LoC with a 5-year term is difficult and expensive. To date, the maximum term that has been readily available is believed to be 3 years.

The Institute suggests that a LoC that has a shorter term than 5 years, with an "evergreen" provision, appropriate advance notice of non-renewal and an immediate drawing power for the beneficiary (upon notice of non-renewal) would seem to be a reasonable, prudent alternative to the 5-year term APRA has proposed.

The Institute also notes that a less restrictive requirement applies in GPS 117 paragraph 32:

> *"The collateral, guarantee or letter of credit referred to in paragraphs 27 and 30 must be effective for the expected period for payment of claims under the reinsurance contract under which the reinsurance recoverables arise. If this is impractical, the collateral, guarantee or letter of credit must be effective for a period of at least 24 months but be renegotiable each year to allow at least 12 months to identify alternative arrangements if the collateral, guarantee or letter of credit cannot be renegotiated."*

7.4 Participating business, and non-participating business with entitlement to discretionary additions

The Institute notes an apparent drafting issue in paragraph 20 dealing with participating and discretionary non-participating business.

The Draft LPS 117 appears to say that participating and discretionary non-participating business must be 'excluded' rather than being 'ringfenced'. In doing so, the current drafting may have the unintended interpretation that reinsurance of such business is not catered for under the Draft LPS 117. The drafting could be amended to clarify that the relevant categories of business are simply to be segregated for the purposes of then applying LPS 117 separately to each segregated category (determining the VAF, measuring counterparty exposures, determining/applying limits etc).

7.5 Time lag between initial APRA communication (December 2017) and implementation of new standard (July 2023)

The implementation date of 1 July 2023 was chosen to align with other professional standard changes (AASB 17 and LAGIC).

The Institute notes it will be a material period from the initial December 2017 letter raising concerns about use of offshore reinsurance, collateral arrangements and effectively

suspending approval of discretionary collateral arrangements to the date the new standard becomes effective. APRA has said in its Response Paper that it is not inclined to grant further discretionary approvals to allow entities to mitigate exposures to non-registered reinsurers for the purpose of calculating an asset concentration risk charge.

The Institute proposes that APRA consider approving new arrangements that are in line with the final standard, from the date the final standard is released (end of 2021) to 1 July 2023.

Conclusion

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

If you would like to do so, please contact the Actuaries Institute, on 9239 6100.

Yours sincerely

President

Appendix A

This appendix provides 4 offshore reinsurance (stylised) scenarios that may be enabled by the proposed Draft LPS 117 as currently drafted, ignoring any application by APRA of its discretionary powers.

The following terms are defined here and are referred to in the scenarios below:

- Collateral Risk Mitigant ('CRM') - off-balance sheet tools such as third-party guarantees, LoCs and collateral trusts etc
- Balance Sheet Risk Mitigant ('BSRM') - on-balance sheet tools such as netting arrangements and the more specific tools contemplated by paragraph 29 of the Draft LPS 117 (such as deferred premiums, deposit-back, funds-withheld and modco arrangements)
- Stressed Value of Assets of the Statutory Fund ('SVAF')
- Asset Concentration Risk Charge limit (ACRC limit, or limit)
- Offshore reinsurer, assumed to have an APRA counterparty grade of level 3 or better

A.1 A domestic insurer (regardless of ownership), reinsuring directly to a non-related offshore reinsurer

A 5% limit applies to the insurer's exposure to the offshore reinsurer; there is a 50% limit on CRMs (the example has assumed that paragraph 43 intends this to be measured on the total stressed reinsurance asset), and no limit on BSRMs.

Example:

- Reinsure stressed BEL of 30% of SVAF directly to a single offshore reinsurer
- Use BSRM of 15% of SVAF e.g. to cover a portion of the unstressed BEL
- Use CRM of 12% of SVAF e.g. this might be used for a portion of the stressed component of the BEL (i.e. < 50% of the total 30% SVAF gross exposure so complies with the 50% limit)
- Net exposure is 3.5% of SVAF vs a 5% limit [(30-15-12)/(100-15)]

A few issues are apparent that facilitate much greater use of offshore reinsurance than APRA may have intended:

- No limit on BSRMs
- The 50% limit on CRMs is based on the reinsurance asset exposure rather than either net stressed exposure or a limit defined as a percentage of the net limit
- The offshore reinsurer could provide CRM via a collateral trust which a domestic specialist reinsurer would be prohibited from doing – a collateral trust would generally be a more effective arrangement than a LoC or third-party guarantee, so this is an inherent advantage for offshore reinsurers
- Similarly, will a domestic specialist reinsurer be prohibited (by the Life Insurance Act) from providing a deposit-back BSRM?

- Using just 2 offshore reinsurers could likely accommodate all of an insurer's reinsurance needs (if it wished) and still be well within the new aggregate 12.5%
- APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired.

A.2 A domestic insurer that is a subsidiary of an overseas multinational insurer and reinsures directly to an offshore APRA-approved affiliated entity

A 12.5% limit applies to the insurer's exposure to its affiliated reinsurer; there is no limit on CRMs (paragraph 44(a) has no limit applied), and no limit on BSRMs.

Example:

- Reinsure a stressed BEL of 60% of SVAF directly to an offshore APRA-approved affiliated entity
- Use BSRM of 30% of SVAF e.g. to cover a portion of the unstressed BEL
- Use CRM of 23% of SVAF (the 50% limit does not apply)
- Net exposure is 10% of SVAF vs a 12.5% limit [(60-30-23)/(100-30)
- Dial up the BSRM or CRM as needed (since there is no limit) to maintain the net exposure below 12.5%

A few issues are apparent that facilitate much greater use of offshore reinsurance than APRA may have intended:

- No limit on BSRMs
- No limit on CRMs
- The insurer could reinsure 100% of insured risks to its affiliate and still come in under the 12.5% limit, since there are no limits on BSRMs and CRMs
- An offshore APRA-approved affiliated entity could provide CRM via a collateral trust which a domestic reinsurer would be prohibited from doing (and potentially likewise for a deposit-back BSRM?)
- The Draft LPS 117 appears to advantage multinational-owned local insurers compared to those that are not
- APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired.

A.3 A domestic insurer that is a subsidiary of an overseas multinational insurer and reinsures to its offshore APRA-approved affiliated entity which then onward-retrocedes to (offshore) non-related parties

Example is the same as A.2 except that the additional leg of offshore retrocession to non-related parties can then be used to circumvent the 5% limit to an offshore reinsurer.

The indirect use of offshore reinsurance by the local insurer will only be constrained compared to example A.1 to the extent that there are constraints on offshore reinsurance in the jurisdiction of the APRA-approved affiliated entity.

APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired.

A.4 A domestic specialist reinsurer that reinsures to an offshore APRA-authorised retrocessionaire

A 50% limit applies to the reinsurer's exposure to its retrocessionaire; there is no limit on CRMs (para 44(b) has no limit applied), and no limit on BSRMs.

Example:

- Reinsure a stressed BEL of 100% of SVAF directly an offshore APRA-authorised retrocessionaire
- Use BSRM of 30% of SVAF e.g. to cover a portion of the unstressed BEL
- Use CRM of 40% of SVAF (the 50% limit does not apply)
- Net exposure is 43% of SVAF vs a 50% limit [(100-30-40)/(100-30)]

A few issues are apparent that facilitate much greater use of internal retrocession than APRA may have intended:

- No limit on BSRMs
- No limit on CRMs
- The Draft LPS 117 appears to enable a domestic specialist reinsurer to retrocede virtually all business
- APRA would likely need to use UTC regulation (by exercising its discretionary regulatory powers) in order to prevent this outcome if it is unintended/undesired