25 June 2021

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

Dear Sir/Madam,

We refer to APRA's letter dated 8th April, 2021 covering "Revisions to Prudential Standard LPS 117 Capital Adequacy Concentration Risk Charge". ClearView would like to thank you for giving us the opportunity to provide our thoughts on your proposals.

Key Principles

APRA's letter focuses on excessive use of overseas reinsurance. ClearView is supportive inasmuch that increased use of offshore reinsurers could reduce APRA's oversight in respect of risks that are directly transferred to jurisdictions where APRA does not have control. However, some of the changes proposed may lead to enhanced risks directly placed offshore (thereby potentially impacting policyholder protection) and put a domestic insurer such as ClearView at a competitive disadvantage compared to a foreign owned insurer. This, in our view, does not meet APRA's principles of financial stability and competition.

In particular,ClearView notes the following:

- The proposals mean that foreign owned insurers can transfer more of the risk overseas in jurisdictions whereby APRA does not have direct control (and potentially lower capital requirements), compared to if the same business was sold through a locally owned insurer.
- The higher net limits for foreign owned insurers and potentially unlimited level of gross exposure to overseas parents (via using risk mitigants) means that in a stressed situation, the provider of capital (i.e. the overseas parent) are themselves exposed to the stress (via the reinsurance overseas).
- There are currently close to as many domestic reinsurers as insurers (i.e. there is sufficient reinsurance capacity). There is a competition argument in that further increasing capacity via facilitating increased levels of risks placed overseas via overseas parents and overseas reinsurers can mean more support in times such as the Group Life issues in 2014 and to a lesser extent the retail disability income issues. However, the lack of local reinsurance support for poor market practices is an important risk signal, which can become lost the more the level of business that is placed overseas given the management is one step removed from the local environment. This can drag out cycles even longer. On the flipside, over the long run, overseas parents/reinsurers are likely to be less committed to the local market than domestic players.

ClearView, however, welcomes the changes made by APRA in terms of increased clarity on risk mitigants. As per ClearView's last submission, from a principles perspective, the ability to diversify risk via reinsurance is a fundamental part of risk management for an insurance company and the industry as a whole (particularly for Australian based and owned medium sized company such as ClearView). Any regulatory framework should facilitate this to occur and APRA's changes make clear what risk mitigants are available (notwithstanding their usage should be constrained for business placed overseas as noted above).

Observations on Proposals

Under current LPS 117 requirements, ClearView notes that the limit for a reinsurance arrangement with a counterparty grade of 1,2 and 3 (apart from with a locally registered reinsurer) is the greater of 5% of the value of assets (VAF) or 25% of the capital base. Even without risk mitigants, it is possible to have a relatively large exposure to overseas reinsurers or overseas parents via arrangements with multiple parties (i.e. having a series of 5% of VAF exposures).

Based on the proposed draft LPS 117, under Attachment A (g) and (3), there is effectively:

- An aggregate limit of the greater of 12.5% of VAF and 62.5% of capital base for reinsurance arrangements with an APRA approved affiliated entity (single entity) that is not a registered life company (including overseas parents) and with overseas reinsurers (in total)
- A limit of the greater of 5% of VAF and 25% of capital base for reinsurance with a single entity which is not an affiliated entity (i.e. non-affiliated overseas reinsurers). This is the same limit as currently, but there is now the 12.5% of VAF aggregate limit.

With respect to risk mitigants:

- There are no specified limits on allowable risk mitigants for an overseas affiliated entity;
- There is only a 50% haircut on collateral and guarantee type mitigants for overseas reinsurers under paragraph 43, but no limits on any netting arrangements.

The implications of these changes are as follows:

a) Excessive overseas reinsurance

- An insurer with an overseas affiliated entity could place its entire reinsurance with the overseas affiliated entity and lower its exposure to 12.5% of VAF using any of the allowable risk mitigants. Whilst APRA can restrict this under paragraph 44, this is not automatic and also does not apply to netting arrangements (deposit back arrangements, deferred premiums, etc).
- An insurer could use a couple of overseas reinsurers (albeit much harder than using a single overseas affiliated entity) and end up with an exposure substantially larger than 5% of VAF by using risk mitigants (particularly netting arrangements), noting though that this is harder than doing this via an overseas affiliated entity.

b) Locally owned insurers at a competitive disadvantage to foreign owned players

This can arise in the following ways, which does not create a level playing field between locally owned insurers and foreign owned insurers:

- An insurer with an overseas affiliated entity can use collateral trusts to manage its exposure. As APRA has acknowledged, under Section 38(3) of the Life Insurance Act, 1995 this will be impractical for a domestic reinsurer to provide given restrictions on life companies (including reinsurers) from mortgaging or providing a charge on assets of a statutory fund. Whilst a locally owned insurer can negotiate a similar arrangement with an overseas reinsurer, this will be harder to implement than doing this with a parent and also the exposure to a single unaffiliated counterparty is subject to lower limits (5% vs 12.5%).

- In addition, for a locally owned insurer reinsuring with an overseas reinsurer, both collateral and guarantee type arrangements (e.g. letters of credit) are subject to a 50% limit, putting locally owned insurers at a disadvantage.
- An insurer with an overseas affiliated entity can reinsure 12.5% of VAF with its parent or even higher with risk mitigants, who can then reinsure the entire risk with a single overseas reinsurer, thereby circumventing the 5% of VAF limit with a single offshore reinsurer. A domestic insurer would have much more difficultly doing this as would need to do this via multiple parties (reinsure to a domestic reinsurer, who then retrocedes to its parent and in turn to another reinsurer) and at a potentially much larger cost.

Consequences of the proposals

As a result of the above, it is likely that the proposals will result in increased levels of overseas reinsurance rather than less. This is either via entities reinsuring with their offshore parents or with offshore reinsurers and using risk mitigants to stay within the proposed LPS 117 limits. This will mean that APRA's objectives of financial safety and stability will be put at risk as APRA is not able to directly oversee or supervise the overseas affiliated entity or overseas reinsurer. COVID 19 is a good example where if the affiliated entity was in a jurisdiction materially impacted by COVID 19, there could be issues both meeting policyholder obligations on the portion reinsured overseas, as well as issues regarding potentially injecting capital into the domestic subsidiary if required due to issues overseas (i.e. both risks are correlated). Whilst the risk mitigants may help mitigate this, there are questions as to how effective certain risk mitigants help in these scenarios e.g. ability to renegotiate letters of credit, whether premium deferral arrangements work in an insolvency situation etc.

Further, excessive amounts of business placed overseas can drag out poor market behaviour for longer (as management is one step removed from the local environment).

In addition, as noted above, locally owned insurers are at a disadvantage compared to foreign owned insurers. This is against APRA's objective of competition and could result in further driving local insurers to be sold to overseas insurers and magnifying reinsurance to overseas parents. It is also likely that an overseas parent or overseas reinsurer is less committed to the local market than a locally based insurer or domestic reinsurer.

Suggested improvements

In light of the above, some of the changes suggested by ClearView to better meet APRA's financial stability and competition objectives include:

- Looking at the Life Insurance Act amendments to allow collateral trusts and deposit back type arrangements for domestic reinsurers or disallowing these for any reinsurance overseas to create a level playing field, noting that from a financial stability perspective a collateral trust arrangement using a local insurer is likely less risky than a similar arrangement with an overseas reinsurer or overseas affiliated entity;
- At minimum, extending paragraph 43 and the 50% limit on guarantee type mitigants to overseas affiliated entities (noting comments on collateral trusts above). This is to ensure that there are not effectively unconstrained levels of risks transferred overseas via usage of risk mitgants (noting APRA has asked for feedback on this issue in its response paper).
  In addition, ClearView suggests that limits should be imposed on netting arrangements with any reinsurance overseas. It is not clear to ClearView why netting arrangements do not lend themselves to similar types of limits, as suggested by APRA in its response paper. It is ClearView's opinion that these netting arrangements should not be used to

place excessive amounts of business overseas via parent companies or overseas reinsurers thereby circumventing the LPS 117 limits.
- Aligning the limits for a single overseas affiliated entity (12.5% of VAF) with that for a single overseas reinsurer (5% of VAF). Whilst APRA have said that it does not view that the 12.5% of VAF limit will materially increase vulnerability to global events, an entity can use this limit to then further reinsure to a single overseas reinsurer as covered above.

We would be happy to discuss any aspects of this submission further with you.

Yours sincerely,

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