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

Dear ,

Thank you for the opportunity for the industry to provide input into the formation of this Prudential Standard. The following submission sets out Swiss Re Life & Health Australia Limited's ("**Swiss Re**", "**we**", "**our**") response to Australia Prudential Regulation Authority's (“**APRA**”) package designed to address concerns regarding the increased use of offshore reinsurers by life insurers.

General comments

The proposed changes provide structure and clarity regarding an insurer's ability to use risk mitigation mechanisms for exposure to reinsurers. This is a welcome improvement. It gives insurers certainty over management actions that may be taken without the need to seek ad hoc approval from APRA each time. This provides stability and quicker implementation of market solutions to the industry.

Limits on Overseas reinsurers

Swiss Re considers that the changes to limits to overseas reinsurers do not sufficiently address APRA's concern that "risks also emerge from the possibility that offshore reinsurers may not take a long-term perspective when operating in the Australian market".

The proposed changes maintain the same level of asset concentration exposure for an insurer to a single overseas insurer as the current standards. In addition, the framework for risk mitigants potentially enables greater capacity for an insurer to reinsure with an overseas reinsurer. While it is possible that the insurer may adopt the same structure with a local reinsurer as with an overseas reinsurer, the local reinsurer may not be able to provide the same competitive terms. Collateral provided by local reinsurers must be in addition to assets in the statutory fund. It may be possible for

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an overseas reinsurer to avoid the requirement for additional capital if the collateral counts towards capital requirements in its home jurisdiction.

Limiting the total exposure to an overseas reinsurer, including the amounts that may be netted from funds withheld arrangements, may act to restore the balance between local and overseas reinsurers.

Other than the introduction of an addition test of 125% of the capital base, the proposals do not change the limit for an insurer reinsuring with an Australian reinsurer. The new capital base limit, while a welcome improvement for smaller insurers, will not 'bite' for larger insurers who will still have the same VAF limit under Attachment A 1(e). The increased demand for overseas reinsurance is in part caused by the limited capacity of Australian reinsurers to offer admissible reinsurance under the standards. Without increasing the VAF limit, there is no additional ability for an Australian reinsurer to increase its direct exposure to an individual insurer. The proposed changes require an insurer who wishes to increase its exposure to an Australian reinsurer to rely on the implementation of risk mitigation structures. These will incur additional cost, which is ultimately passed onto policyholders. They also add to operational risk and complexity. They may introduce other risks which incur capital charges e.g. asset market and credit risks.

The alternative for such insurers is to split their reinsurance across more than one Australian reinsurer. While promoting diversification, there is again an additional cost involved in such an approach for operationally managing the distinct tranches of risk. This cost is ultimately passed on to policyholders. With a 25% VAF limit, there are few insurers who would be able to reinsure their portfolios to their target reinsurance levels without utilising multiple reinsurers. A VAF limit for Australian reinsurers that would generally allow insurers to reinsure with a single Australian reinsurer under typical circumstances would seem a reasonable benchmark for a VAF limit.

We suggest that APRA consider raising the VAF limit for Australian reinsurers above the current and proposed 25% to restore the balance between local and overseas reinsurers. This may include limits that have regard to the size and strength of the reinsurer. We note that for general insurers GPS 117: Capital Adequacy Asset Concentration Risk Charge has no limit on reinsurance placed with Australian reinsurers rated A- or better. It may be possible to align the life insurance standard to the general insurance standard in this respect.

We have made comments on specific items below.

Paragraph 17

Swiss Re requests APRA to provide additional clarity regarding the intent and wording of the following paragraph.

Additional calculations will be required "If a reinsurance asset would increase in value when one or more of the equity, property, credit spreads, currency or default stresses specified in LPS 114 are applied to the fund’s other assets...".

Currency stresses are required to be applied in both directions in LPS114. Is the intent to perform the combination stress only in circumstances where the dominating stress direction in the final asset risk charge (ARC) calculation would cause an increase in reinsurance asset value? Or is it to apply

the asset risk diversification factor (ARDF) and the aggregation diversification factor (ADF) if the reinsurance asset is currency sensitive? As an example, if the dominating direction of the currency stress for LPS114 is AUD strengthening, but stronger AUD decreases the AUD value of the reinsurance asset, is the combination stress required?

Is the combination stress required whenever the reinsurance asset would increase in value as a result of the stresses being applied to it, or only when the reinsurance asset increases as a result of the stress being applied to other assets?

Paragraph 19

Swiss Re requests APRA to provide additional clarity regarding the intended calculation of the stressed reinsurance assets using the combination-stress method, particularly where an asset concentration risk charge (ACRC) is expected for reinsurance assets.

Under paragraph 18 (b) of LPS114: Capital Adequacy Asset Risk Charge, assets above the concentration limits in LPS117 are excluded from stresses. This means the value of the stressed reinsurance assets must be known, or there must be sufficient confidence that the value will not be in excess of the concentration limits, before the ARC can be determined.

The combination-stress method requires determined using the LPS114 results to be applied in order to determine the stressed reinsurance assets for LPS 117. This requires the ARC to be calculated before the combination-stress method and therefore the stressed reinsurance asset value can be determined.

The calculation appears intractable where an ACRC is expected.

Paragraph 20

For non-participating business the changes here provide clarity and generally reinforce the current methodology.

Swiss Re has no participating business and therefore may have limited understanding of the practical operations of this paragraph for participating business. However, it appears restrictive especially in the case of a statutory fund consisting of participating policies only. Some additional guidance on the intent of this paragraph and the limitations applicable to reinsurance of risks on participating business may be of value.

Paragraph 23

We consider the exclusion of reinsurance arrangements (specified in paragraph 3 of Attachment A) from the requirements when maintaining a cumulative asset exposure to each counterparty to be a practical solution to what may have otherwise been a potentially difficult and inconsistent allocation issue.

There are two potentially unintended consequences that we are seeking to confirm:

- Exposures to affiliated reinsurers will not be aggregated with exposures to appropriate retrocessionaires when testing concentration limits against a group of related party reinsurers. Are there circumstances under which APRA would approve one member of a related party group as an affiliated reinsurer and another member as an appropriate retrocessionaire for a specialist reinsurer statutory fund, thus allowing an increase in maximum exposure?

- Currently SRLHA assesses receivables balances from retrocessionaires under Attachment A (g) of LPS117. These balances do not form part of the stressed policy liability and therefore can't be included in the current paragraph 28 (50% of VAF) limit for specialist reinsurers. These balances therefore reduce the available exposure for the stressed retroceded policy liabilities. The proposal is that any amounts included under the clause which is currently Attachment A (g) will not reduce the available exposure to appropriate retrocessionaires.

  It is not clear whether there will be any balances of this nature under IFRS 17. Can APRA provide more detail on the proposed treatment of these receivables balances in light of the changes which will arise from IFRS 17?

Paragraph 29

This paragraph covers the requirements for deferred premiums, deposits back and funds withheld arrangements. Additional clarity is required about the requirements under this paragraph, either through the standard or through an accompanying guidance note.

Some examples of where clarity is needed:

a. (the life company) must set aside assets matching its liabilities to the reinsurer under each arrangement;

What degree of matching is required? Is it the fair values are the same, or is further matching required, e.g. cashflow matching?

b. the assets must either be held in a custody account established for this purpose or be otherwise identifiable in the books and records of the life company as comprising assets of the statutory fund in respect of which the arrangement applies;

In the case of a deposit back arrangement between cedant and reinsurer, where the reinsurer has a corresponding retrocession arrangement for the risk, the "natural" asset backing the reinsurer's liability to the retrocessionaire is its receivable from the cedant. This asset is not normally suitable to be placed in a custody account. Is it an appropriate asset for identification under 29(b) or would an alternative non-related asset need to be identified for this purpose?

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Collateral trusts

The revised standard gives clarity to the required structure and operations of a collateral trust or collateral posting and the required framework of the underlying reinsurance treaty. This is a complex area, and by its nature requires the involvement of parties external to the reinsurance treaty to have some custodial or fiduciary responsibility for assets. There are many candidates in the market which may be considered initially for these roles. It would be beneficial to expand on the nature of the allowed structures and responsibilities of the parties either as part of the standard, or in an accompanying guidance note. Examples of where we seek clarity as to whether a particular structure is permitted are:

Paragraph 33

Eligible Collateral Item is defined in paragraph 8 and relates to individual securities. It appears that paragraph 33 may be intended to apply to either an individual Eligible Collateral Item or a structure (e.g. a trust) containing more than one Eligible Collateral Item. Please clarify whether the requirement for the Eligible Collateral Item to be held for the term of the reinsurance asset refers to the structure or account and not the individual security being booked into the account.

Paragraph 35 (a)

Swiss Re requests APRA confirm that collateral operations of the types below are allowed under this paragraph in parts i, ii or iii:

(1) Retrocessionaire and Retrocedent (life company) open an account in the name of Retrocessionaire, pledged in favour of Retrocedent at a bank in Australia. Retrocedent delivers securities into the account. Retrocedent (life company) would be sole approver of any withdrawals from the account.
(2) Retrocedent (life company) opens an account at a bank in Australia. Retrocessionaire delivers securities into the account. Retrocedent (life company) would be only party instructing any movements on account.

These are favoured methods within the Swiss Re group for managing collateral arrangements in respect of transactions between related parties.

Paragraph 43

In its current format, paragraph 43 limits the maximum retrocession exposure to an appropriate retrocessionaire that a specialist reinsurer may substitute via specified risk mitigants to 50%. It does not limit the maximum exposure to an affiliated reinsurer. This limits the effectiveness of appropriate retrocessionaires. We request that paragraph 43 be expanded to exclude appropriate retrocessionaires from the 50% limit.

Funds withheld and deposit back arrangements are not subject to a maximum limit under the proposed changes. An insurer may therefore, through a combination of direct exposure, collateral trust or guarantee and funds withheld, reinsure 100% of its policy liabilities with a single overseas

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reinsurer. Including funds withheld and similar arrangements in the 50% limit for overseas reinsurers will prevent this, therefore maintaining more exposure under APRA supervision.

Letter of credit

Paragraph 42 (c) requires that the minimum letter of credit period is at least five years. There is limited availability and market depth for long dated letters of credit, increasing the price considerably. This additional cost will ultimately be passed to the cedant through the reinsurance contract pricing structure. We consider that a shorter minimum timeframe of three years is a good compromise between the cost considerations while still providing multi- year protection.

Paragraph 42(d) restricts the terms and conditions of the fee structure for the letter of credit. The direct costs of a letter of credit are typically borne by the reinsurer. This reinsurer may not be a company registered in Australia. It is restrictive for APRA to impose conditions over a commercial agreement between two parties over whom APRA may have no governance or control. We request that this provision be removed.

Please feel free to contact me if you would like to discuss any of the comments made in this submission.

Yours faithfully,

Appointed Actuary
Swiss Re Life & Health Australia Limited