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Association of Building Societies and Credit Unions

Abacus
Australian Mutuals

9 March 2012

Mr Neil Grummitt
General Manager, Policy Development
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Dear Mr Grummitt

REVIEW OF DRAFT CAPITAL STANDARDS FOR LIFE INSURERS – COMMENTS ON APRA DECEMBER 2012 DRAFT STANDARDS

Thank you for the opportunity to comment on APRA's draft capital proposals and response to submissions released on 9 December 2011.

Abacus – Australian Mutuals is the industry body for credit unions, mutual building societies and friendly societies. Collectively, Abacus member institutions have more than $80 billion in assets and serve more than 6 million members.

Overview

As noted in our previous submissions to APRA, Abacus broadly supports the objectives of the review which include:

- aligning the standards across life insurers, general insurers and Authorised Deposit taking Institutions;
- improving the risk sensitivity of the standards;
- framing the minimum regulatory prudential capital calculation on a 99.5% probability of sufficiency over a one-year time horizon; and
- updating the standards in response to the recent financial crisis and other market developments.

We welcome changes made by APRA in the updated proposals which partly address a number of concerns raised in industry submissions, such as the simplification of some aspects of the standards and the increase in the admissibility of mortgage backed securities.

Nonetheless, there remain a number of aspects of the draft standards and APRA's response to submissions that are of significant concern to the friendly society industry. These include:

1. Transitional arrangements and engagement model.
2. APRA-determined minimum Prescribed Capital Amount.
3. Aggregation benefit for friendly society funds.
4. Credit spread factors.
5. Asset value for term deposits.

A number of these concerns reflect the view expressed in our previous submissions that the current proposal has a number of anti-competitive features which risk creating an unlevel playing field between different participants in the life insurance industry.

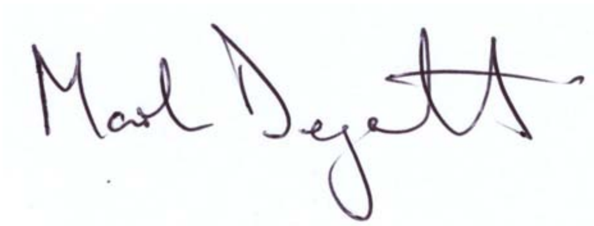
Friendly societies typically adopt simple business structures and offer simple products supported by conservative investments yet are subject to additional regulation compared to life insurers. For example, issuing a new product involves establishing a separate benefit fund with APRA and requires approval of the benefit fund rules.

We are concerned that the proposed new standards do not give sufficient recognition to friendly societies' specific issues compared to the current standards.

Abacus and its member friendly societies look forward to working closely with APRA as the proposals are finalised. We will contact you shortly to arrange a meeting to discuss the issues raised in this submission.

In the meantime, if you have any questions in relation to this submission, please contact Daniel Newlan on [redacted] or [redacted].

Yours sincerely



MARK DEGOTARDI
Head of Public Affairs

SUBMISSION TO APRA ON DECEMBER 2011 DRAFT STANDARDS

1. TRANSITIONAL ARRANGEMENTS AND ENGAGEMENT MODEL

Issue 1 – Transitional arrangements

APRA will consider allowing transitional arrangements where insurers are unable to implement changes to their current operations or arrangements to mitigate the impact of increased capital requirements before 1 January 2013. Transition will be granted on a case-by-case basis.

The draft standards indicate the granting of transitional relief may apply until 31 December 2014, a maximum two year transition period. In our initial submission we proposed a three year transition.

We set out below further background explaining the need for a longer transition than has been proposed.

We are also concerned with the level of analysis and evidence that societies will need to provide to APRA in order to qualify for transition. One requirement is the projection of a society's capital position for at least four years to 1 January 2016, regardless of the length of transition applied for.

This requirement is extremely onerous. Instead, societies should simply be required to apply for a set transition period and justify their request by tabling capital projections in line with the requested transition, up to three years in our view.

Capital impacts from changes

In our initial submission, we highlighted a number of areas where friendly societies are impacted by the proposed changes.

While the intention is that the draft standards result in lower capital requirements compared with those underlying QIS2, this is not the case for some friendly societies, which continue to see significant increases in required capital.

One cause of these increases are the changes to credit spread factors (both default and bond spread) for highly rated securities.

As an illustration, Table 1 below sets out asset stresses for securities with a credit duration of 2.5 years of various investment grade credit ratings, under LPS 3.04 and the proposed APRA standards.

Table 1:

Asset Shock from Credit Spread Factors

(expressed as a % of assets)

Counterparty Grade	S&P Rating	Asset Shock Increase due Default Sprd change (1)	Bond Spread Factor Excess (LAGIC-LPS3.04) (2)	Assumed Bond Spread Duration (3)	Asset Shock Increase due to Bond Sprd change (4) = (2) x (3)	**Asset Shock Increase due to Credit Sprd (1) + (4)**	Original Asset Shock LPS 3.04 (5)	**% Increase vs LPS 3.04 (6)**
1 (govt)	AAA	0.0	0.0	2.5	0.0	**0.0**	0.0	**0%**
1 (other)	AAA	0.2	0.3	2.5	0.8	**1.0**	0.8	**127%**
2	AA	0.6	0.4	2.5	1.0	**1.6**	1.0	**160%**
3	A	1.0	0.6	2.5	1.5	**2.5**	1.8	**140%**
4	BBB	1.3	0.7	2.5	1.8	**3.0**	4.0	**75%**

For a fund invested in AA securities with 2.5 years duration, the table indicates that the asset shock would increase by 1.6% of assets (from 1.0% to 2.6%), a very large increase of 159%. This is not an uncommon scenario for friendly societies.

This would translate into a capital requirement increase of similar magnitude for many funds particularly if the friendly society also adopts the common practice of distributing guaranteed credits based on a substantial portion of the earned interest.

Why a longer transition is needed

Many friendly societies fund capital needs through fund surplus. Therefore, increased capital requirements create a tension between reducing benefits in the short term to provide additional security in the longer term.

A longer transition reduces this impact and improves friendly societies' ability to manage member equity with the large increases in capital illustrated above.

The following expands on this and sets out key reasons that friendly societies need a transition period longer than two years.

- Friendly societies need time to develop management strategies – Complex issues are involved in evaluating company capabilities and member communications and expectations, then designing a range of potential solutions and considering their impacts on capital and member equity. This involves educating and engaging board and senior management so that the most appropriate solution is selected from the range of options.

  Many of the points below, which boards need to address, are exacerbated if implementation is forced over a shorter implementation time frame. This potentially makes any transition more expensive, less equitable and may impact the viability of certain options which require more time to implement. Therefore more time is needed because it increases the options available for the institution to deal with the issue in a more equitable way.

  In this context we note concerns we have heard raised publicly in relation to minimum reserve requirements that APRA has proposed for (not-for-profit) superannuation funds. These concerns involve addressing member equity issues which arise if superannuation funds are forced to raise from members (i.e. by reducing crediting or other similar means) an amount to fund reserves (of say 0.25% of assets).

  While we note considerations are not identical between superannuation funds and friendly societies, there are significant parallels, including limited sources of funds, concerns relating to reductions to immediate member benefits and the non profit nature of the entities. We also note that the minimum reserve amount being discussed for superannuation funds appears relatively modest (e.g. the 0.25% of assets mentioned above), highlighting that such small amounts are being discussed with concern in public.

- Limited access to capital – a common ownership structure for friendly societies is the mutual model, which limits access to additional capital. One potential source of capital is reduced crediting to members, however, this has equity implications which may be further complicated by member benefit expectations and past communications.

A significant and sudden increase in capital can affect credits or bonuses paid to fund members, exacerbating potential tontine effects (where the level of capital held is disproportionate to the number of members in a fund) and makes the management of intergenerational equity more difficult.

By contrast, life companies are generally less affected by this issue because they have greater flexibility of sources of capital including shareholder funds (e.g. via additional excess shareholder capital and/or the ability to retain shareholder earnings).

- Costs and impacts of implementing change – strategies to mitigate capital increases may involve changes to investment strategy and the sale of highly illiquid assets. This could be a long process for some societies, depending on the structure of their business, the maturity of their assets, the availability of suitable alternatives and the time it takes to liquidate existing holdings. It should be noted that it is common for several friendly societies to own the same class of illiquid assets, so a longer transition period would reduce the impact of multiple friendly societies trying to sell the same type of asset in the same market during a short timeframe.

- Equity and member communication – member expectations may have developed through past crediting practice/outcomes and communications such as annual statements/reports. For example these may show indicative asset mixes and/or return targets.

  Time is needed to address member expectations, by informing them and providing appropriate notice of changes – and by implementing changes over a suitable timeframe (be they investment strategy, crediting philosophy/mechanisms or both).

- Impact on returns compared with other investment and savings products – societies may need to offset significant increases in capital from the new standards with reductions in bonuses and credits (which members view in a similar way as they would interest income or a dividend) to the fund. This will have competitive implications with savings or investment products offered by other institutions and could lead to fund surrenders and higher expense recovery costs.

Proposal

As in our initial submission, Abacus proposes a transition period of three years. This will provide the flexibility needed to address the issues noted above.

APRA should also retain its discretion to extend this relief should it be clear that some illiquid and long-term assets will take a longer period to manage. Funeral plan funds with longer term liabilities often hold such assets.

Also at a high-level, it may be more suitable to introduce some changes in even stages over three years, particularly the proposed changes to credit spreads.

Issue 2 – Engagement Model

APRA has indicated that institutions should make applications for transitional arrangements before 30 September 2012 on a case by case basis.

Abacus believes that initially, it may be more constructive if APRA and industry work collectively on identifying and aggregating individual societies' implementation issues and deal with common problems at an industry-wide level. At the same time, APRA can continue its normal practice of working through company-specific matters.

For example a parallel timetable could be developed with Abacus for industry-wide consultation which can begin with further analysis and discussion in the 1st half 2012 on key industry issues. By the 3rd quarter, after completion of the workbook and further industry analysis, many issues would be well known and progress would have been made towards detailed workable solutions.

A possible engagement model is submitted for APRA's consideration on the following page.

Engagement Model and Programme for Company Specific and Industry-Wide Consultation on Transition

	24 February 2012	Q1 2012	Q2 2012	Q3 2012	Q4 2012	1 January 2013 Effective Date Final Standards
APRA		Consider submissions	1. Issue workbook 2. Issue final standards			
Individual Friendly Societies	Individual Submission on Draft Standards			1. Complete workbook 2. Begin APRA liaison	Continue liaise APRA company specific transition arrangements.	
Abacus	Abacus Submission on Draft Standards	Abacus work with members, identify issues and impacts	1. Meetings with APRA issues identified Q1	1. Consolidate workbook industry results 2. Confirm previous id issues/new issues cf analysis Q1 3. Consider implications solutions/proposed transition arrangements 4. Liaise APRA industry-wide issues and workable transition solutions.	Continue liaise APRA industry-wide issues and transition solutions.	

The key reason for suggesting this engagement model is that there are many issues that are common across all friendly societies and it may be more efficient and beneficial for APRA to address these issues with regulated institutions at the same time. Under this model, institutions will still have the option of individual consultation with APRA to discuss their specific concerns and assess their transition needs.

Given the tight timeframe to the proposed effective date of 2013, we also believe that resolving some issues at industry level would assist the industry with implementation.

Leaving final submissions to the 3rd quarter, with consideration not occurring until the 4th quarter, increases the risk that it will be too late to address major problems that may arise.

For example, capital options for most friendly societies are limited and if APRA were to refuse a friendly society's request in the fourth quarter of 2012 then the society may be left with insufficient time to find an alternate solution prior to the implementation of the capital standards as at 1 January 2013.

This problem is particularly relevant given a number of friendly societies did not participate in QIS1 or QIS2 and/or completed them with limited checking.

The proposed engagement model should also assist with early warning (to both APRA and individual institutions) for affected institutions to have the opportunity to obtain feedback from APRA earlier than the fourth quarter regarding applications for transitional relief and amendment of the $10 million capital requirement.

The Abacus submissions or discussions should not be interpreted as diminishing or prejudicing the requests of any individual institution.

2. APRA DETERMINED MINIMUM PRESCRIBED CAPITAL AMOUNT

APRA has indicated it is willing to consider applying a minimum Prescribed Capital Amount of less than $10 million for Friendly Societies that do not currently meet the $10 million minimum requirement. APRA has also indicated that friendly societies will not have to raise additional capital or reduce distributions to members to meet the minimum Prescribed Capital Amount.

Abacus reiterates that it does not support the application of a $10 million minimum capital requirement to friendly societies unless there is a very strong prudential case for doing so. Abacus believes that at this stage, there is no such justification, for the following reasons:

- it is unsuitable when compared to the systemic scale, business lines and benefit fund structures of friendly societies; and
- the approach taken is unclear and may cause confusion on how it will be applied over time.

We also note that friendly societies have never been subject to a fixed initial and continuing capital requirement. At the time friendly societies regulatory legislation transferred from the Friendly Societies Code to the Life Insurance Act, the Explanatory Memorandum was clear that no fixed initial and continuing capital requirement would apply to them.

The EM to Section 7.11 of the *Financial Sector Reform (Amendments and Transitional Provisions) Act (No 1) 1999* (Schedule 4, Section 29) clearly stated that original AFIC standard, which applied a 'Nil' minimum capital standard to friendly societies, would continue to apply:

> *7.11 It is intended that the commencing management capital standard will <u>reimpose the AFIC standard on friendly societies</u> and reimpose the section 21 and 23 shareholder capital requirements on <u>other life</u> companies.*

APRA responded in kind, using its discretionary transitional powers to impose the pre-existing requirements under Prudential Standard No.3:

PRESCRIBED MINIMUM CAPITAL AMOUNT

1. This Prudential Standard applies to a registered life company at all times from 30 June 2002.

1.1 The standard is being introduced to re-establish the minimum capital requirement previously prescribed under the Act (prior to 1 July 1999) and by actuarial standard AS6.01 (for the period 1 July 1999 to 29 June 2002).

2. At any time a registered life company is required to hold capital in the General Fund of the company sufficient to meet the prescribed amount. This is referred to as the Minimum Capital Amount.

3. The prescribed amount for the purposes of item 2 is:
a. in the case of a friendly society, nil; and
b. in the case of a registered life company other than a friendly society, $10 million.

Abacus argues that the $10 million minimum is solely a transitional amount intended to be replaced with a requirement of a different form.

APRA's proposal to impose a fixed capital amount upon friendly societies may not reflect the express intent of Parliament at the time that the Act was passed.

On this basis we request that APRA consider whether it was ever the intention of Parliament to apply a fixed dollar minimum and if not whether it is appropriate to apply one now.

At a technical level, it's important that APRA clarify further this proposal. Does APRA intend on setting a broad level for all friendly societies? What is the basis on which the minimum amount should be set initially and managed over time?

For example minor adverse experience may result in a breach of capital requirements if the minimum amount is set higher than the Prescribed Capital Amount (pre application of the minimum amount) or close to the current capital base.

Abacus believes that only the largest friendly societies meet this minimum capital amount right now. We note APRA's statement on page 56 of the Discussion Paper that it will apply a minimum prescribed capital amount of less than $10 million to 'smaller' friendly societies that do not currently comply and that the lower minimum may be varied from time to time depending on changes to each society's individual circumstances.

However the fact that the $10 million minimum will only apply to a select few in the industry and that an adjusted minimum will need to be set and regularly managed for most other societies raises questions about whether it is actually required.

Abacus seeks clarification on exactly how APRA intends on applying the minimum to friendly societies. We believe the proposal as is stands will significantly increase uncertainty and inhibit the flexibility of management in executing their long-term business plans.

At a transitional level, this is an industry wide issue. Significant issues may arise if the level is the amount is set too high or does not take into account timing of bonus/crediting rate vesting and the phasing of the transition, potentially impacting on the management of investment account business, equity issues and hindering development of solutions.

3. AGGREGATION BENEFIT

Issue – no access to aggregation benefit for friendly societies

APRA's response paper to the industry submissions makes no mention of Abacus' proposal to extend the diversification value of the aggregation benefit to friendly societies.

Abacus reiterates the importance of this benefit for friendly societies. Denying friendly access to a diversification benefit was not intended as a specific policy measure, rather, it is a technical consequence driven by the different fund structures used by friendly societies compared to life insurers.

In APRA's words, the aggregation benefit is "an explicit allowance for diversification between asset and insurance risks[1]". Yet APRA has not extended this benefit to friendly societies.

Extending the aggregation benefit to friendly societies will essentially allow a strongly performing benefit fund to support another that is not performing as well.
Abacus' previous submission provided the following comments to illustrate the issue.

> The Life Insurance Act requires benefit funds to be held as "distinct and separate" funds. They are constituted and operate under APRA approved benefit fund rules which form the basis of the contract between the friendly society and the policyholder (who are commonly referred to as "members" of the benefit fund).
>
> APRA's proposals involve calculating asset and insurance risk charges for each benefit fund (and the management fund) separately with no reduction for diversification between risks across benefit funds.
>
> By contrast, life insurers typically include a range of non-participating products within a single statutory fund. It is not unusual for a life company with a comprehensive range of risk and investment products to maintain all of its non-investment-linked life insurance business within a single statutory fund.
>
> We believe that APRA's proposal in respect of aggregation benefit need to be amended for a number of reasons including:
> - to make the aggregation benefit available to friendly societies;
> - to improve its sensitivity to risk, by allowing recognition of the potential support available from other benefit funds; and
> - to ensure a level playing field against life insurers, most of whom would be entitled to significant aggregation benefit.
>
> Disallowing aggregation benefit altogether is unduly harsh, given the other changes in the proposed standards. In particular and as noted above, this includes that changes in the draft standards compared with QIS 2 have generally resulted in greater reductions to non-friendly society life insurance capital requirements than for friendly societies.

The aggregation benefit can be extended to friendly societies via a simple, notional calculation across all benefit funds as though they were a single statutory fund.

[1] *APRA Response to Submissions, 9/12/12, Page 34*

Proposal

We propose that

- friendly societies have the option of calculating an aggregation benefit across all non-investment linked business as if they were in the same fund; and
- this benefit is allocated across benefit funds pro-rata with the pre-aggregation pre-operational risk benefit capital requirement.

4. CREDIT SPREAD FACTORS

APRA's response paper to the industry's submissions revised the credit spread factors for high risk securities (grades 6 and 7), but did not address Abacus' concerns regarding the factors for low risk securities. We are resubmitting our previous comments and proposals regarding the credit spread factors for low risk securities.

Issue – credit spread factor for default risk

As noted in the introduction to this submission, friendly societies are conservatively invested. The supporting assets of both management funds and for the major products including savings bonds and funeral plans are primarily fixed interest such as:

- at call term deposits of major trading banks (AA rated);
- at call bank accounts of major trading banks (AA rated);
- Australian Commonwealth Government Securities (AAA rated);
- semi-government debt; and
- high-rated corporate debt.

These are typically at call and/or closely duration matched to the liabilities and are highly liquid.

Friendly societies are chiefly concerned with increases to capital for highly-rated securities. The magnitude of the increases are high enough to cause extremely sharp jumps in capital requirements for some benefits funds, particularly those that are capital guaranteed. As the QIS2 results showed, some of these are as high as 160%.

This is significantly out of step with APRA's stated intention. In its May 2010 Discussion Paper, APRA pointed out that:

> *Insurers may be concerned that these capital proposals will result in higher capital requirements. This is not APRA's aim. It is to be expected, however, that a more risk-sensitive capital framework will result in some insurers having a higher capital requirement and others having a lower requirement.*

This position was reaffirmed in a direct letter to industry CEOs on 16 December 2010:

> *Most of the submissions received in response to the discussion paper and technical papers supported APRA's policy intent for LAGIC, but expressed concerns regarding the apparent increase in the overall level of required capital.*
>
> *APRA indicated in its letter of 6 August 2010 that the QIS was intended to give industry an opportunity to provide quantitative input to the capital review project. This input would be critical for APRA in assessing and refining its proposals.*
>
> *APRA's aim is to ensure that the proposed capital standards achieve an appropriate balance between APRA's objective of increasing the risk sensitivity of the capital standards and the impact on capital requirements for industry.*

Abacus contends that capital increases of the magnitude seen in the discussion paper are not balanced and are out of step with APRA's stated position that it does not intend overall capital requirements to increase.

In response to evidence of these increases seen in QIS2 APRA, in its December 2011 discussion paper (page 8) argued that:

> *"..the increase in capital requirements will be less in practice than indicated by QIS2 as insurers revise their business and capital management strategies in response to the revised capital standards".*

While Abacus accepts that many regulated institutions will need to undergo some restructuring to mitigate the impact of the new capital standards, a lessening of the capital outcome for societies as a consequence of a restructure should not be seen as confirmation that the impact of the standards was balanced and in line with its original objective.

If the increases indicated by QIS2 are very high, the extent of the changes a society will need to make will also be significant. This involves shifting asset mixes to an even more conservative and narrow universe of investments, which, in Abacus' view, is both costly and unnecessary in the context of an already conservative investment portfolio. There is no evidence to show that this would increase the security of members yet will significantly reduce the returns on their investments.

The level of the proposed increases to the credit spreads do not fit the nature of the investments held. These securities are extremely low risk and many are recognised under new Basel III liquidity framework for banks as the highest quality of available liquid assets in the market today.

As stated earlier in this submission, friendly societies adopt extremely prudent investment strategies however will see significant capital increases under the new standards. Abacus strongly urges APRA to reconsider their proposed new spreads.

A comparison of the proposed factors with the current LPS3.04 factors is set out below.

Table 2:

Credit Spread Factors - Default

Counterparty Grade	S&P Rating	LAGIC Default % (1)	LPS3.04 Default % (2)	Excess (LAGIC-LPS3.04) (1-2)
1 (govt)	AAA	0.0	0.0	0.0
1 (other)	AAA	0.2	0.0	0.2
2	AA	0.6	0.0	0.6
3	A	1.2	0.3	1.0
4	BBB	3.0	1.8	1.3
5	BB	6.0	4.0	2.0
6	B	10.0	11.0	-1.0
7	CCC	16.0	17.0	-1.0

The analysis highlights that:

- friendly societies would have to hold capital for AAA and AA where there was previously no capital requirement in respect of default risk.
- securities rated A or below will have significantly higher capital requirements than those under the existing standard (up to 200 basis points).

We have undertaken an analysis comparing the proposed default factors with those underlying Basel II. Based on our review the APRA factors are higher than the Basel II factors (after adjusting to target similar probabilities of adequacy).

We understand from our discussions with APRA that the basis underlying the selection of the Basel factors and those for APRA do not necessarily result in consistent comparison of probabilities of 1 year loss.

Nonetheless, given our analysis indicates the default factors appear high we would appreciate further detail of the analysis and data sources considered by APRA to gain a greater understanding and relationship to our analysis.

Issue – bond spread

While we do not consider the "Bonds Spread" unreasonable in isolation, as for the default factors, they are substantially higher than the current LPS3.04 factors.

A comparison of the current and proposed "Bonds Spread" factors is set out in the following table.

Table 3:

Credit Spread Factors - Bonds Spread

Counterparty Grade	S&P Rating	LAGIC Credit Spread % (1)	LPS3.04 Default % (2)	Excess (LAGIC-LPS3.04) (1-2)
1 (govt)	AAA	0.0	0.0	0.0
1 (other)	AAA	0.6	0.3	0.3
2	AA	0.8	0.4	0.4
3	A	1.2	0.6	0.6
4	BBB	1.6	0.9	0.7
5	BB	2.0	1.0	1.0
6	B	2.5	1.1	1.4
7	CCC	3.0	1.1	1.9

Proposal

Friendly societies consider it critical to understand the rationale behind the increases and would like to discuss with APRA and share analysis to gain a greater understanding of the derivation of the factors and relationship to our analysis.

Consistent with our comments on transition, we propose that, for friendly societies, any increase of the default and bond spread factors be phased in over a period of 3 years such that the full factors would apply from, say, 1 January 2016.

5. ASSET VALUE FOR TERM DEPOSITS

Many friendly societies invest in term deposits as a secure source of investment income. The current draft standards indicate that these be fair valued by discounting the maturity value for the purpose of the capital base.

Abacus appreciates APRA's clarification on page 33 of its responses to submissions that the stressed value of a term deposit will be the minimum of the guaranteed redemption value. Abacus asks APRA to confirm that the same approach applies to the value of term deposits when calculating the capital base, i.e. that the asset value of the term deposit be at least its guaranteed redemption value.

This is because in some circumstances the guaranteed value for the term deposit may be larger than the discounted fair value calculation.

Some friendly societies value their term deposits at the value of the initial investment plus accrued interest where the term is short (e.g. 3 months) as the value is not materially different from the discounted value. Where friendly societies use this valuation method because it has been considered materially accurate for the purposes of compiling their accounts, we propose that APRA indicate that it is an acceptable value to be adopted for the capital base calculation under the materiality provisions proposed by APRA.