9 August 2012

Mr Neil Grummitt
General Manager
Policy Development
Australian Prudential Regulation Authority
400 George Street
SYDNEY NSW 2000

By Email: InsuranceCapital@apra.gov.au

Dear Neil

Submission on APRA draft prudential standards released for consultation in May 2012

The attached paper sets out the Actuaries Institute's submission in response to APRA's draft prudential standards and response to submissions released for consultation on 31 May 2012.

The Actuaries Institute is the sole professional body for actuaries in Australia, providing expert and ethical comment on public policy issues wherever there is uncertainty of future financial outcomes. It represents the interests of over 3,800 members, including more than 2,000 actuaries.

Please do not hesitate to contact Melinda Howes, Chief Executive Officer by email [redacted] or phone [redacted] to discuss any aspect of this paper.

Yours sincerely

David Goodsall
President

Institute of Actuaries of Australia
ABN 69 000 423 656
Level 7, 4 Martin Place, Sydney NSW Australia 2000
t +61 (0) 2 9233 3466 **f** +61 (0) 2 9233 3446
e actuaries@actuaries.asn.au **w** www.actuaries.asn.au

1.0 Summary

In May 2012, APRA released additional draft standards as part of its Life and General Insurance Capital (LAGIC) project. This included Draft Prudential Standards LPS112 (Capital Adequacy: Measurement of Capital) and proposed amendments to the other relevant prudential standards for general insurers and life insurers as a consequence to the revised capital framework for insurers.

The Actuaries Institute recommends some changes to these prudential standards as outlined below. In addition, there are recommendations made by the Actuaries Institute through previous submissions to APRA which have not been addressed by this latest APRA response. We encourage APRA to again consider the key points laid out below.

2.0 Definitions contained in Draft Prudential Standard LPS 001 (Definitions)

Variable Annuities

In the draft LPS 001 (Definitions), APRA defines Variable annuities as policies with benefits calculated by reference to the value of the units allocated to the policy, but the benefits may exceed the value of those units in specified circumstances. This description could be interpreted to include all investment linked products containing an investment performance guarantee. This would represent a change in accounting treatment for a number of life insurers and we do not think that this is APRA's intention. Therefore we recommend that APRA adjust the definition to specifically focus on investment linked products that contain both asset and insurance risks.

Definition of Risk business

In the draft LPS 001 (Definitions) APRA has substantially revised the definition of Risk business and proposes to exclude policies that continue for the entire lifetimes of the lives insured. This definition could lead to a reclassification of insurance risk products where the sum insured is offered at the same level for all years provided premiums continue to be paid. These premiums would change over time but if the "terms" referred to in the definition includes the policy proceeds then it could be argued that these policies are no longer classified as risk business. We recommend that APRA adjust the wording to specify what terms need to continue for the entire lifetime in order for policies not to be classified as risk business.

Institute of Actuaries of Australia
ABN 69 000 423 656
Level 7, 4 Martin Place, Sydney NSW Australia 2000
t +61 (0) 2 9233 3466 **f** +61 (0) 2 9233 3446
e actuaries@actuaries.asn.au **w** www.actuaries.asn.au

Definition of "risk-free"

There are several references to using a "risk-free" discount rate in the proposed prudential standards. Draft LPS 001 (Definitions) defines risk-free discount rates as yields of Commonwealth Government Securities. Draft LPS 340 (Valuation of Policy Liabilities) states that the gross rate used to discount expected future cash flows for some contracts must be a discount rate that the life company considers to be risk free. Finally, draft LPS 360 (Termination Values, Minimum Surrender Values and Paid-up Values) requires the use of a risk free rate. In order to avoid confusion, we feel it is important that APRA clearly differentiate between the discount rates used in LPS 112 and in LPS 340.

Application of loan to value ratio

Draft LPS 001, Attachment A has changed the application of the "loan to value ratio" approach to secured assets so that it only applies to residential properties. This is designed to be consistent with ADIs but we have identified some inconsistencies between APRA's intention and the wording in the draft standard:

- By removing a loan to value ratio based approach for rating secured assets, including assets secured against commercial property, APRA has reduced the risk sensitivity of the standards. For example, the same capital requirement will apply to a loan secured over a commercial property irrespective of whether the LVR is 30% or 80%. As the latter loan would pay a higher interest rate, the return on capital on the higher LVR loan would be significantly higher and therefore the proposed change could have the unintended consequence of incentivising life companies to make higher LVR loans. This outcome could arise irrespective of any intent by the life company simply because the life company would be priced out of the market for higher quality lending;
- The consistency with the ADI approach has not been achieved as under the ADI standardised approach, commercial property lending is 100% risk-weighted so gets a capital requirement of around 8%. A similar asset of say 3 years for a life insurer following this standard would have a higher capital requirement of up to 17% of value;
- Under existing wording, lending secured on other than residential property can not fall under the APRA-approved internal approach because it is not externally rated, is not residential property, and is not an unsecured assets, therefore defaults to 1(d) classification (on page 13 of draft LPS 001).

We recommend that the LVR table for secured assets other than residential property be reinstated.

Definition of “wholesale business”

The limitation of the definition of wholesale business to superannuation business is unnecessary, and ordinary business where the effective purchasing decision is made by a trustee or company should be considered wholesale business.

3.0 Draft Prudential Standard LPS 112 (Capital Adequacy: Measurement of Capital)

Assets under a fixed or floating charge

Draft LPS 112 Attachment B section 22 states that “A life company must deduct all assets of the life company that are under a fixed or floating charge, mortgage or other security. This deduction may be reduced by the amount of any liability for the charge that is recognised on the life company’s balance sheet”. This can be interpreted as if the total value of any assets under a charge must be deducted which is different to the previous approach of only being deducted up to the value of the security. We recommend that the wording of this section is revised to be consistent with the messages conveyed in section 3.1.4 of APRA’s response paper in this regard, by inserting the words “to the extent of the indebtedness secured on those assets” after the word “security”.

4.0 Draft Prudential Standard LPS 360 (Termination Values, Minimum Surrender Values and Paid-up Values)

Scope of Draft LPS 360 (Termination Values, Minimum Surrender Values and Paid-up Values)

The Actuaries Institute welcomes comments from APRA as to the need for a prudential standard to specify minimum payment amounts to policyholders. We understand that this standard currently exists but consider it an opportune time to review the validity of this standard.

Part C of draft LPS360 sets out:

- in Section 38, that the “minimum surrender value is the lowest value that must be paid to a policy owner if the policy owner requests the company to surrender the policy”; and
- in the remainder of that part, specifies the minimum amount that must be paid.

The function of this Part C, therefore, is to mandate certain product features for life insurance business.

The mandating of product features should be removed, because:

- The setting of mandated product features is not APRA's role.

  APRA defines its mission to be "to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system".

  APRA's role, therefore, is to ensure that life companies' financial promises are met, rather than mandating what promises a life company should make.

- ASIC, in its consumer protection role, is focused on disclosure to deal with product features, rather than mandating product features.

  ASIC's sets out its vision to be to "ensure we have confident and informed investors and financial consumers who participate in fair and efficient markets while being supported by efficient market registration and licencing".

  It states that it protects consumers by:

  - providing education, through the National Financial Literacy Strategy;
  - providing trusted and independent information, tools and ongoing support; and
  - working in partnership with the financial services industry and promoting best practice.

  It does not mandate product features as part of its consumer protection role.

  Life companies, as part of their AFSL requirements, are bound by the requirements of Chapter 7 of the Corporations Act which deal with how a product is issued, the disclosures made to consumers, enforcement against unscrupulous providers, and complaints and dispute mechanisms.

- The mandating of certain product features is anti-competitive and an impediment to innovation.

  The mandating of certain product features places life companies at a disadvantage when compared to other providers offering economically equivalent products but which are free to offer product features which meet the needs of their customers. This is in conflict with APRA's role as set out in the Australian Prudential Regulation Authority Act which requires it to consider competitive neutrality and competition in performing and exercising its powers.

  Further, the mandating of certain product features is an impediment to the development of innovative products which meet the needs of consumers. In setting mandated product features based on an existing product set, it cannot be expected that APRA can foresee the range of possible products that could be developed. As a result, it is highly likely that the "black letter law" requirements of

mandated product features will act to impede innovation through unintended consequences of restrictive definitions.

This is in conflict with the principal object of the Life Insurance Act as set out in section 3(1) which states that:

> "The principal object of this Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, **competitive and innovative life insurance industry**." [emphasis added]

We recommend that Part C of LPS360 should be removed.

5.0 Other recommendations

There are some recommendations contains in previous submissions which we would like to re-emphasise to APRA which we feel are critical to the on-going suitability of these proposed regulations:

Ongoing Review of Parameters

The Actuaries Institute previously highlighted that there are a number of assumptions and parameters which APRA has specified in the draft prudential standards and there is a risk that these can become outdated or evidenced to be unsuitable over time. These include the prescribed asset stresses, the asset correlation matrix, the prescribed insurance stresses, the insurance correlation matrix, the operational risk charge factors and the asset/insurance correlation factor. In particular, economic conditions may change resulting in revisions to future economic assumptions. We suggested that due process would be for APRA to review all parameters in the new standards by the end of 2015 and every 3 years on-going, and that the Actuaries Institute would welcome any opportunity to be involved in this process of review.

APRA's latest response to submissions did not seem to address these concerns or set expectation on any review of the key parameters. We welcome further consideration by APRA of this issue.

Definition of Risk-Free Discount Curve

The Actuaries Institute would like to raise continuing concerns about only being able to use CGS yields for measuring risk free for capital purposes.

These concerns include:

- pro-cyclicality arising from movements in CGS yields during stressed conditions (particularly taking into account Basel III developments);
- inconsistencies with asset valuations; and
- limited volumes and durations of CGS to match long-term insurance liabilities.

We note that CGS rates have dropped significantly over recent times, more than swap rates, with the spread between 5 year CGS and swap rates expanding from c.60bps at June 2010 to c.100bps in June 2012[1]. This may, in part, be driven by demand for highly rated government securities by foreign investors. As at 31 March 2012, around 85%[2] of CGS were foreign owned.

Further, the potential pro-cyclicality is highlighted when it is considered that total CGS on issue amount to $236bn at 31 March 2012, versus total non-investment linked life insurance assets of $77bn[3], with further significant demand from the banking sector. This could be further exacerbated if there are not future issuances of CGS. At 31 December 2008, the total issuance of CGS was $58bn[4], versus total non-investment linked life insurance assets of $69bn[5]. In times of financial stress, life companies are highly incentivised to purchase from the limited volume of available CGS in preference to other instruments and this is likely to result in significant pro-cyclicality.

[1] Bloomberg
[2] RBA
[3] APRA
[4] RBA
[5] APRA