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Dear Neil

Submission on Proposals – "Response to Submissions – Review of capital standards for general insurers and life insurers" dated 31 May 2012

Thank you for the opportunity to comment on APRA's updated proposals as part of the Life and General Insurance Capital project (LAGIC), including the draft and final standards released on 31 May 2012.

This submission, which is made on behalf of Challenger Life Company Limited, is set out in Attachment 1 and includes submissions on APRA's "Response to Submissions – Review of capital standards for general insurers and life insurers" (Response Paper) and submissions in respect of the draft and final standards.

Challenger has made several prior submissions relating to LAGIC, including submissions dated 4 August 2011, 3 November 2011 and 24 February 2012. These submissions included important comments which we believe need to be addressed by APRA. While some matters have been addressed in APRA's response and draft standards, there are many areas which we believe still need to be addressed to achieve the required outcomes. Please refer to these prior submissions for further details on these issues.

If you have any questions, please do not hesitate to contact me.

Yours sincerely

Tony Bofinger
CFO and Appointed Actuary
Challenger Life Company Limited
Attachments:

1. Challenger submissions

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Attachment 1: Challenger submissions

1. Summary

We support APRA's efforts to improve the alignment of its capital standards across the industries it regulates and to introduce a simpler, more risk-sensitive approach to capital requirements. We acknowledge that APRA has made a number of improvements over the course of the LAGIC project, most recently in the Response Paper and 31 May 2012 draft and final standards. This submission sets out further issues that need to be addressed to achieve the required outcomes.

Our submissions, which are detailed in the remainder of this attachment, are as follows:

i. Secured Lending: The LVR table should be reinstated for secured assets other than residential property in Attachment A of LPS001. Further, the LVR table should be extended to contemplate the additional higher credit-worthiness of secured lending on diversified pools of assets, consistent with the approach that applies to ADIs.

ii. Assets under a fixed or floating charge: The words "to the extent of the indebtedness secured on those assets" should be inserted after the word "security" in Section 22 of Attachment B of LPS112.

iii. Governing law for instruments qualifying as Tier 2 Capital or Additional Tier 1 Capital: Section 11 of Attachment C of LPS112, and section 9 of Attachment E of LPS 112, which set out that such instruments must be subject to Australian law, should both be removed.

iv. Assets affected by the default stress: Assets affected by the default stress (which includes all credit exposures that have not been affected by the credit spreads stress) do not qualify for any diversification benefits within the asset risk charge. They should receive the same diversification benefit as assets affected by the credit spreads stress.

v. Minimum surrender values: Part C of LPS360 should be removed.

vi. Further treatment of secured assets: The words "that are not secured or mortgaged" should be removed from section 1(c) of Attachment A to LPS001.

vii. 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

viii. Exposure to groups of related counterparties: The requirement to consider groups of related counterparties is inappropriate and should be removed. The requirements should be based on the effective exposure to counterparties and whether there is any aggregation of risk between the exposures.

ix. Reduction in Capital Base: Payment of dividends or interest payments on Additional Tier 1 or Tier 2 capital in excess of one year's after-tax earnings should not require APRA's written consent.

x. Use of Rating Agencies: For the avoidance of doubt, Section 5 of Attachment A should be clarified to read "For the purposes of paragraph 4, *where a company is departing from the general rule of using the same rating agency*, the following rule applies .. . " (inserted words in *italics*).

Detailed Submissions

2. LPS001 – Treatment of Secured Lending

In Attachment A of the revised draft LPS001, APRA has altered the requirements relating to the treatment of secured assets so that the only mortgages over residential property are eligible to be rated on an LVR basis. The Response Paper states that this change has been made in order to be consistent with the ADI approach.

This change is inappropriate, and the LVR table should be reinstated for secured assets other than residential property. Further, as set out below, the LVR table should be extended to contemplate the additional higher credit-worthiness of secured lending on diversified pools of assets, consistent with the ADI approach. If the LVR table is not reinstated, then a more appropriate default counterparty grade for secured lending is grade 4, although we note that this is a materially less optimal outcome.

APRA's proposed change to draft LPS001 is inappropriate because:

- it reduces the risk sensitivity of the capital standards;
- despite the statements in the Response Paper, the proposed approach is not consistent with the ADI approach; and
- the capital impost for commercial property is significantly worse than for residential property, even though historic experience has not been significantly worse.

Risk Sensitivity

Under the current capital standards (specifically LPS7.02) and the previous draft LPS001, a counterparty grade for secured or mortgaged assets was determined based on:

- whether the secured asset was a standard residential mortgage or other asset;
- the loan to valuation ratio; and
- the level of LMI.

Under the updated LPS001, this approach only applies for residential mortgages.

As a result, according to the Response Paper, unless APRA approval is granted, such assets are treated as "Grade 6" for counterparty exposures. (Note that, while this is APRA's intent as set out in the Response Paper, it is not reflected in the wording of the draft LPS001. This is the subject of a separate submission below.)

The removal of risk factors in the determination of appropriate capital requirements for other secured assets reduces the risk sensitivity of the capital standards, which is contrary to the intent of LAGIC. 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 greater 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.

Consistency with ADI Approach

Despite APRA's statement in the Response Paper, the proposed approach is not consistent with the approach for ADIs, as it results in significantly higher capital imposts for life companies for equivalent assets to those of ADIs. More detail is provided below; however as a simple example the statutory capital requirement for a five year asset backed loan (senior secured) would be c.18% for a life company compared to 10.5% capital held by an ADI for an equivalent asset under the standardised approach (under Basel III, including capital conservation buffer).

A knock-on effect in the wider economy will be to reduce the availability of secured lending to small and medium sized companies in the Australian market.

ADI Approach for Specialised Lending

The capital regime for asset-backed lending ("Specialised Lending") for ADIs is set out in APS 113.

For ADIs using the **standardised** approach, the risk-weight for all specialised lending is 100%.

For ADIs using the Internal Ratings Based approach, APS 113 sets out a matrix of risk weights, and the ADI maps each specific security into the matrix based on the qualitative guidelines set out in APS 113. This ensures that good quality debt assets attract a lower level of capital, with higher capital being held where the asset quality is lower. This "slotting approach" is set out below.

Supervisory category	Strong	Good	Satisfactory	Weak	Default
Risk-weight	70%	90%	115%	250%	0%
External rating equivalent	BBB- or better	BB+ or BB	BB- or B+	B to C	N/A

In addition, APRA provides relief for diversified pools of asset backed loans resulting in certain income producing real estate exposures (IPRE) being treated as general corporate exposure for credit risk rather than IPRE under Specialised Lending.

Comparison of Capital Outcomes

The table below sets out a comparison of the capital required for a secured asset under the LAGIC proposals compared to an ADI under the standardised approach, based on loan term.

Term (years)	Capital Requirement	
	LAGIC	ADI Standardised
1	12.0%	10.5%
2	13.9%	10.5%
3	15.5%	10.5%
4	17.1%	10.5%
5	18.4%	10.5%
6	19.7%	10.5%
7	20.8%	10.5%

In all cases, the capital required for a life company is higher than for an ADI. For longer terms, it is significantly higher.

Alternatively, the relative capital impost can be measured as the implied risk weight that an ADI would endure were the capital charge equal to that required of life companies. These implied risk weights are set out below.

Term (Years)	LAGIC Requirement	Implied ADI Risk Weight
1	12.0%	115%
2	13.9%	132%
3	15.5%	148%
4	17.1%	162%
5	18.4%	175%
6	19.7%	187%
7	20.8%	198%

In all cases, the implied Supervisory Category varies between "satisfactory" and "weak", demonstrating the lack of risk sensitivity and also the inconsistency of the approach with ADI requirements.

Comparison of Commercial Property Lending versus Residential Property Lending

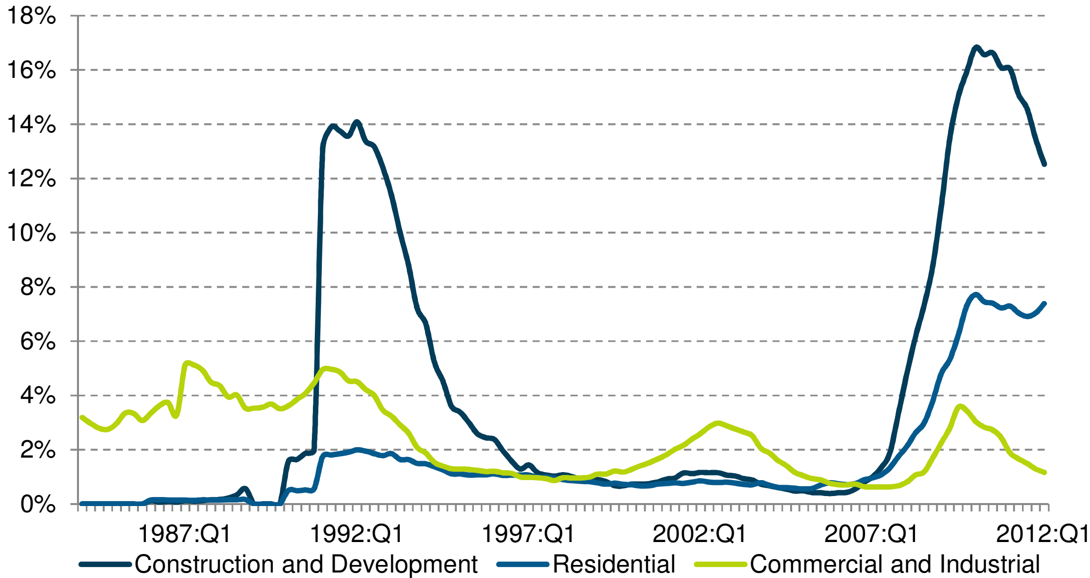
Under APRA's proposals, the amount of capital required to be held on lending backed by commercial property is significantly greater than equivalent lending backed by residential property. The table below sets out a comparison of the required capital for a 5 year loan backed by standard residential and commercial property, with LMI, based on different LVRs.

LVR	Capital Requirement	
	Residential	Commercial
50%	3.7%	18.4%
60%	3.7%	18.4%
70%	3.7%	18.4%
80%	3.7%	18.4%
90%	5.8%	18.4%
100%	8.9%	18.4%
110%	13.1%	18.4%

This significant difference in capital outcome is not reflected in differences in the experience of standard residential versus commercial property. The charts below show a

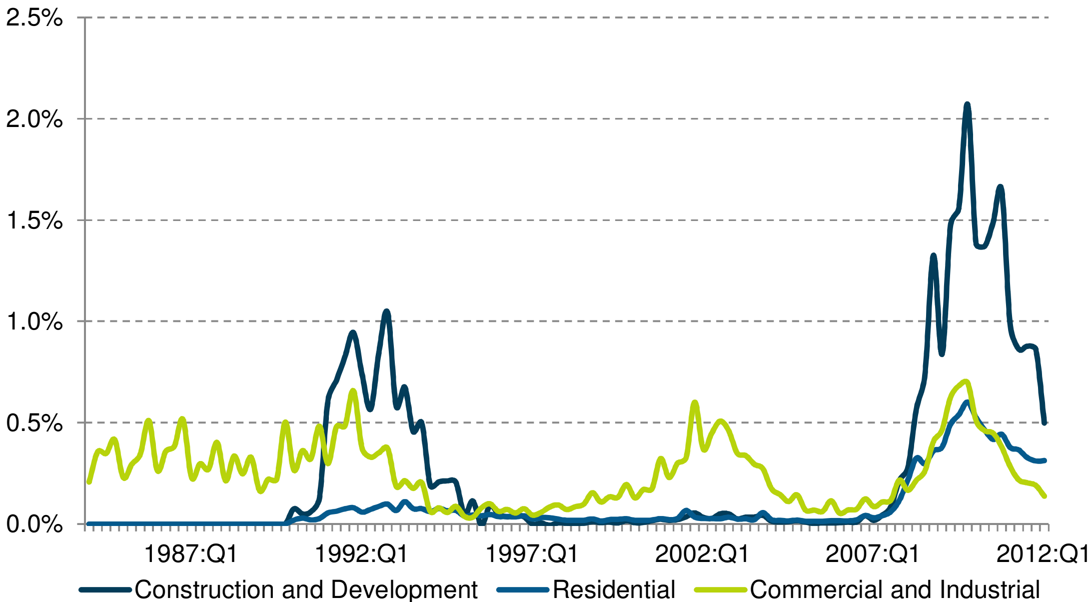
comparison of the percentage of non-performing loans and net charge offs for lending to construction, residential and commercial property, based on US data from the FDIC. These charts demonstrate that, once construction lending is excluded, commercial property outcomes are not reflective of the capital imposts proposed by APRA.

Non Performing Loans (% of Loan Type)



Source: Federal Deposit Insurance Corporation

Net Charge-offs (% of Loan Type, Total Loans Outstanding)



Source: Federal Deposit Insurance Corporation

While the data is more difficult to come by, there is no reason to expect that the Australian experience would support different conclusions. Challenger's own experience in lending against commercial property supports the conclusion that there is considerable scope for risk sensitivity in the application of capital charges for commercial property lending.

Proposed Approach for Life Insurers

We submit that the LVR table should be reinstated for secured assets other than residential property. Further, the LVR table should be extended to contemplate the additional higher credit-worthiness of secured lending on diversified pools of assets, consistent with the approach that applies to ADIs. We submit that a table such as the following is appropriate.

Loan to Value Ratio	Diversified		Non-Diversified	
	No LMI	>40% LMI	No LMI	>40% LMI
<=60%	2	2	3	2
>60% but <=80%	3	2	4	3
>80% but <=90%	4	3	5	4
>90% but <=100%	5	4	5	4
> 100%	5	5	5	5

Note that even with the same matrix as the existing standard, capital requirements will still increase as the stresses under the draft standards are higher.

Alternatively, if APRA prefers to adopt an approach which is not risk sensitive, the default for all secured lending other than residential mortgages should be a counterparty grade of 4 (BBB). For a 5 year loan, this gives a capital requirement of 9%, compared to an ADI requirement of 10.5% for the same asset type. The proposal in LPS001 of an equivalent rating of B, gives a capital requirement of 18% for life insurers. We note that this is a materially less optimal outcome.

3. LPS112 – Assets under a fixed or floating charge

Section 22 of Attachment B sets out 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."

Effectively this results in no value being ascribed to any asset against which security is held. Such an outcome is inappropriate as such assets can still have material value which contributes to policy owner security.

We submit that the words "to the extent of any the indebtedness secured on those assets" should be inserted after the word "security". This means that the unencumbered component of any asset can be recognised in capital base. Any additional risk associated with the gearing of an asset can be dealt with under the principles set out in section 23 of LPS 114 – that is, the gross asset value will be shocked with the appropriate stress and the debt value is unchanged.

4. Instruments qualifying as Tier 2 Capital or Additional Tier 1 Capital must be issued under Australian Law

This proposed restriction will impact both access to, and cost of, regulatory capital across international markets. Foreign investors will be reluctant to accept instruments documented under Australian law due to their perceived risks (for example, submission to jurisdiction of Australian courts) or lack of familiarity. Historically Tier 1 and Tier 2 instruments issued offshore are documented under foreign laws such as English, Delaware or New York. The proposed restriction will reduce the amount of such instruments that can be issued, or increase the rate of interest payable. This will result in a reduction of policyholder security.

We submit that section 11 of Attachment C of LPS112 and section 9 of Attachment E of LPS 112 should both be removed.

5. LPS114 – Assets affected by the default stress

Section 69 of LPS 114 sets out that the default stress applies to "reinsurance assets, over the counter derivatives, unpaid premiums, and all other credit or counterparty exposures that have not been affected by the credit spreads stress".

Section 77, which sets out the Aggregation formula, specifically excludes assets that are affected by the default stress from any correlation benefit. These shocks should be included with the assets affected by the credit spreads stress as they are similar in nature. In many cases a company could have debt exposures to a counterparty that are covered under the credit spread stress, and exposures to the same counterparty that fall under the default stress module. It is inconsistent that the first type of exposure receives a diversification benefit and the other does not.

6. LPS360 – Minimum Surrender Values

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 is inappropriate, and Part C of draft LPS360 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 submit that Part C of draft LPS360 should be removed.

7. LPS001 – Further Treatment of Secured Assets

In the Response Paper, APRA sets out its intent with respect to non-residential secured lending as follows:

> "Mortgages over commercial property, speculative construction and property developments cannot apply the LVR basis and instead, unless APRA approval is granted, are treated as 'Grade 6' counterparty exposures."

We submit that this intent is not reflected in the wording of LPS001 and the words "that are not secured or mortgaged" should be removed from section 1(c) of Attachment A to LPS001. This change is required because the current wording specifies that APRA can only approve private ratings of a life company's own ratings where the assets are non-publicly rated and are not secured or mortgaged. Any secured or mortgaged asset other than residential property will therefore fall under 1(d) of Attachment A.

8. LPS001 – Definition of Wholesale Business

We have previously submitted that ordinary business where the effective purchasing decision is made by a trustee or company should be considered wholesale business. APRA did not address this issue in its Response Paper nor in the updated drafts.

We submit that the limitation of the definition 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.

9. LPS110 and LPS117 – Exposure to Groups of Related Counterparties

LPS110 and LPS117 set out that, for asset concentration risk purposes, consideration must be given to exposures to single counterparties or groups of related counterparties, where related entities are determined based on the meaning in relevant Australian Accounting Standards. The requirement to consider groups of related counterparties is inappropriate and should be removed.

The requirements should be based on the effective exposure to counterparties, as set out in section 18 of LPS117, and whether there is any aggregation of risk between the exposures. This is a different test from an accounting definition of related entities.

Aggregation of exposures to related parties would not be appropriate where each exposure is individually ring-fenced with no cross-collateralisation, such as:

- lending to private equity investments which have a common sponsor but which are distinct and separate businesses; and
- lending to properties with common sponsors.

10. LPS110 – Reductions in Capital Base

LPS110 sets out that if a company wishes to pay dividends on common shares, or dividends or interest payments on Additional Tier 1 or Tier 2 capital, that exceed a life company's after-tax earnings in the financial year (as defined) to which they relate, it must seek APRA's written consent.

Such an approach:

- is inconsistent with a principles-based framework and APRA's previous statements with respect to its intervention framework;
- leads to unnecessary delays arising from the requirement for the life company to provide an updated ICAAP report, along with any timeframes required for APRA to assess the application; and
- creates greater uncertainty for the providers of capital to life companies, as they may not be able to receive dividends and or capital returns even where the life company holds significant excess capital.

This may then have the unintended consequence of encouraging capital providers to hold minimum levels of capital in the life company, and lead to an increased cost of shareholder capital and lower returns to future customers.

We submit that the existing requirements are sufficient, being that a company must obtain written advice from the Actuary prior to any distributions from a statutory fund, and the restrictions on interest and capital returns on subordinated debt.

If APRA were to introduce such a requirement, then it should:

- not require an updated ICAAP report;
- specify the criteria that it will consider in determining whether to consent to a reduction in capital base; and
- commit to providing its consent in a timely manner, with defined service standards.

11. LPS001 – Use of Rating Agencies

Section 5 of Attachment A could be misinterpreted to suggest that a life company must, in all cases, examine the credit ratings issued by multiple rating agencies and follow the rules set out.

For the avoidance of doubt, Section 5 of Attachment A should be clarified to read "For the purposes of paragraph 4, *where a company is departing from the general rule of using the same rating agency*, the following rule applies .. . " (inserted words in *italics*).

The result is that where a company has a general rule of using the same rating agency for determining all counterparty grades, this is permissible under both the current and the proposed standards, and the guidelines in paragraph 5 only apply in situations where a company is not using its “usual” rating agency.